Regional Outlook

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In Focus This Quarter

◆ ***Recent Trends Raise Concerns about the Future of Business Credit Quality***—**Commercial and industrial (C&I) lending is one of the largest and fastest-growing lending lines at insured institutions. Recent growth in C&I lending can be attributed to a strong U.S. economy, increased industrial merger activity, and a willingness of lenders to extend credit. While C&I credit quality remains relatively strong, signs of deterioration have recently begun appearing in C&I portfolios and in corporate bond defaults. These signs of weakness in commercial credit quality raise concerns because they are appearing during a period of economic strength. Business credit quality could deteriorate further in the event of an economic slowdown, higher interest rates, or a loosening of underwriting practices.** ***See page 3.***

By Arlinda Sothoron, Alan Deaton

◆ ***Local Industries in the Global Economy***—**The contribution of international trade to overall U.S. economic activity has been increasing for a number of years. Although the United States trades with many nations, most activity is concentrated in a few markets—Canada, Japan, and Mexico. Across a collection of industries, there is, however, considerable variation in both the level of exposure to export markets and the intensity of import competition. A number of industries are highly exposed to international markets, suggesting that economic conditions abroad are particularly important in any assessment of future revenue growth or profitability.** ***See page 11.***

By Paul C. Bishop

Regional Perspectives

◆ ***Economic and Banking Conditions***—**Although the regional economy is healthy, employment growth is slowing because of tight labor markets, slowing export levels, and weaknesses in the manufacturing and agricultural sectors. Overall banking conditions remain favorable, although net interest margins have compressed.** ***See page 19.***

◆ ***Changing Loan Portfolio Composition Increases Inherent Credit Risk***—**Recent loan growth has occurred in traditionally higher-risk commercial and commercial real estate loans. While traditional asset quality measures remain favorable, weaknesses in some borrowers and examination findings indicate that levels of credit risk could rise.** ***See page 21.***

◆ ***Longer Asset Maturities May Be Increasing Market Sensitivity***—**The complexity of managing interest rate risk is increasing as asset maturities and repricing frequencies extend. Banks may be more vulnerable to economic losses resulting from higher interest rates if funding strategies or interest rate risk management practices do not adequately compensate for these changes.** ***See page 24.***

By the Memphis Region Staff

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Recent Trends Raise Concerns about the Future of Business Credit Quality

- **C&I loan portfolios have been growing rapidly during this economic expansion.**
- **Indicators of weakening corporate credit quality have begun to appear, including higher C&I loan losses and rising corporate bond defaults.**
- **The future of business credit quality will depend on the economy and on underwriting practices.**

Commercial and industrial (C&I) lending is one of the largest and fastest-growing segments of lending at insured institutions. As of the third quarter of 1999, C&I loans comprised 24 percent of total loans and leases held by FDIC-insured institutions, up from 21 percent at the end of 1995. C&I loan portfolios have grown primarily because of strong loan demand driven by a long economic expansion during which the indebtedness on corporate balance sheets has expanded rapidly. Even as the economic expansion continues, C&I loan charge-offs have begun to trend upward, albeit from historically low levels. By some measures, banks and the financial markets appear to be assuming increased levels of risk that could lead to greater C&I loan losses when the economy eventually weakens.

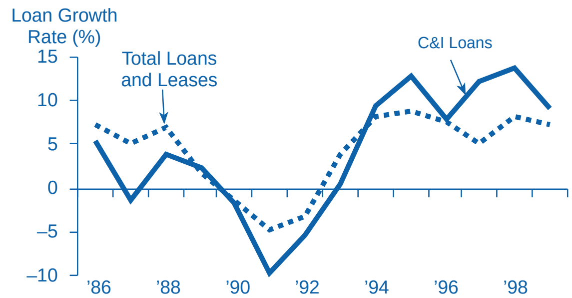
High rates of growth in commercial lending and weakening indicators of C&I credit quality raise concerns about the future of credit quality at insured institutions. This article examines the factors that have contributed to high C&I loan growth rates and discusses the drivers that will determine the direction of C&I credit quality in the future. While loan performance at insured institutions is relatively good at the present time, signs of deterioration and stress have begun to appear despite the continued strength of the domestic economy. The future of C&I credit quality will ultimately be determined by trends in underwriting and corporate debt levels, along with the performance of the U.S. economy.

C&I Loan Growth Has Accelerated

C&I loans held by FDIC-insured banks and thrifts grew by almost 9 percent during the 12 months ending in September 1999, down somewhat from a 13.4 percent rate of growth in 1998 (see Chart 1). By contrast, total loans and leases at insured institutions grew by only 7 percent in the 12 months ending in September 1999. C&I loans accounted for approximately 29 percent of all net new loans booked during the 12 months ending in September 1999, while unfunded C&I loan commitments grew by approximately 17 percent to $1.6 trillion. Syndicated lending played a major role in C&I loan growth during the 1990s. As intense competition and a narrowing of financial institutions' net interest margins have encouraged lenders to seek additional sources of revenue, larger institutions have become increasingly active as loan syndicators and as purchasers of syndicated credits. Syndicated loan volume reached its peak in 1997, when originations totaled some $1.1 trillion (see Chart 2, next page).[1] After falling off in 1998, originations of syndicated loans rose by 17 percent in 1999 to just over $1.0 trillion. Leveraged loans, in which the borrower's debt-to-equity ratio is significantly higher than the industry average, served as a catalyst for syndicated lending growth in 1999, accounting for 32 percent of total syndicated loan originations. Leveraged lending is very attractive to lending institutions because of the generous fee income associated with leveraged originations. Leveraged loan originations grew to $320 billion in 1999, partly because of the continued rapid pace of corporate mergers in 1999.[2]

CHART 1

Commercial and Industrial (C&I) Loans Are Growing at a Faster Rate than Total Loans and Leases



Note: 1999 data are annualized based on 3Q99 data.
Source: FDIC Research Information System

[1] *LPC Gold Sheets,* Vol. XIV, No. 1. Loan Pricing Corporation. January 10, 2000.

[2] According to Houlihan Lokey's *Mergerstat,* total M&A activity set a new record of $1.4 trillion in merger deal value in 1999.

Most of the C&I loan growth among insured institutions since 1997 has been concentrated in loans to domestic borrowers. C&I loans held in foreign offices declined following the Asian economic crisis and the Russian government bond default in 1997 and 1998, respectively, while domestic C&I lending was growing at double-digit rates. During the 12 months ending in September 1999, C&I loans held in domestic offices grew 12.2 percent while C&I loans held in foreign offices declined by almost 6 percent.

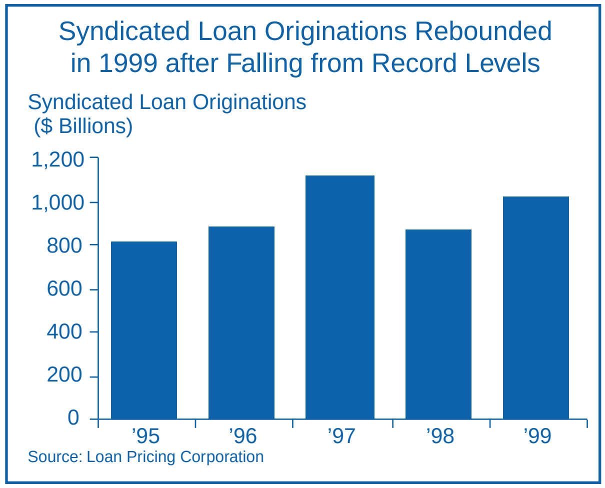
Is This Rapid Loan Growth a Cause for Concern?

The effect of rapid loan growth on subsequent credit quality has been the subject of a number of articles. A recent study by the ***Federal Reserve Bank of Kansas City*** found that high rates of loan growth in the early 1980s and early 1990s appeared to be positively correlated with future higher loss rates.[3] The study also noted, however, that relatively high loan growth rates in the late 1980s did not result in sharply higher loss rates. Another study by the ***Federal Deposit Insurance Corporation*** found that banks that failed during the banking crisis of the 1980s were generally more likely to have grown their loan portfolios aggressively than banks that did not fail.[4] But it remains to be seen whether the high C&I loan growth rates of today will necessarily contribute to higher losses for insured institutions in the future. The future course of industry loan losses depends on many factors, including the condition of the economy, the interest rate environment, and underwriting standards used in originating C&I credits.

The Condition of the Economy Is an Important Driver of C&I Loan Growth

Recent economic conditions have been particularly conducive to rapid growth in domestic C&I lending. Business investment has expanded at double-digit annual rates as firms have invested in new technologies to raise productivity and keep costs down. These productivity gains have been instrumental in allowing the economy to grow at a relatively rapid pace with low inflation. Strong growth in real wages has helped boost the consumer confidence index to an all-time high of 144 in January 2000. Robust consumer demand for goods and services has kept business profits growing, further spurring business borrowing to finance inventories, new construction, and fixed assets such as computer networks. Amid all of these favorable trends, C&I loan charge-off rates have remained at record lows of less than 0.5 percent since 1994. Recently, however, despite a continuation of generally favorable conditions in the economy and the financial markets, signs of credit quality deterioration have begun to appear in C&I loan portfolios.

CHART 2



Evidence from Financial Institutions Points to a Weakening in Business Credit Quality

Despite strong business conditions and generally good asset quality, signs of deterioration in C&I credit quality have begun to appear in bank portfolios. While problem C&I loan levels remain low by historical standards, net C&I loan charge-offs during the 12 months ending in September 1999 were 63 percent higher than during the previous 12-month period. The net C&I loan charge-off rate rose in the 12 months ending in September 1999 to 0.5 percent, up from 0.3 percent one year earlier. Similarly, noncurrent C&I loans as of September 1999 rose to $11.2 billion, or 1.2 percent of total C&I loans.[5] In dollar terms, this level of noncurrent loans is 30 percent higher than one year earlier.

[3] William R. Keeton. "Does Faster Loan Growth Lead to Higher Loan Losses?" *Economic Review.* Federal Reserve Bank of Kansas City. Second quarter 1999.

[4] Federal Deposit Insurance Corporation, Division of Research and Statistics. *History of the Eighties: Lessons for the Future. Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s.* 1997. http://www.fdic.gov/bank/historical/history/contents.html.

[5] Noncurrent C&I loans include C&I loans past-due over 90 days and all C&I loans in nonaccrual status.

Despite these increases in C&I charge-offs and noncurrent C&I loans, the current industry ratios for these measures remain well below the 1.9 percent and 4.5 percent ratios reported during the recession in 1991 for net C&I charge-offs and noncurrent C&I loans, respectively.

Interagency Loan Review Reveals Increases in Problem Credits from Previously Low Levels

The results of the ***1999 Shared National Credit (SNC)*** review provide another indication of slipping credit quality at large commercial banks.[6] According to the ***Federal Reserve Board of Governors,*** adversely classified syndicated loans rose to $37.4 billion in the 1999 review, a level approximately 70 percent higher than that reported in 1998. This figure represents 2 percent of the $1.8 trillion in drawn and undrawn loan commitments reviewed in 1999. By contrast, adversely classified assets identified in the 1998 SNC review totaled only $22 billion, or 1.3 percent of loans reviewed in 1998.[7]

While the level of adversely classified syndicated loans remains low, 14 percent of the loans adversely classified during the 1999 review were loans made to new borrowers since the 1998 SNC review. In reference to this finding, ***Office of the Comptroller of the Currency (OCC)*** First Senior Deputy Comptroller and Chief Counsel Julie Williams has noted that "Banks are booking new loans that are weak at their inception."[8] The high rate of adversely classified new loans could be attributable to the continued effects of loan originations made toward the end of a period of loosened underwriting standards in 1997 and early 1998. Alternatively, it could indicate a higher-risk credit mix in current C&I loan portfolios.

Signs of corporate stress that may weaken credit quality at insured institutions are also reflected in recent ***Banc of America Securities*** analysis of publicly available bank loan amendments.[9] This study shows a significant increase in the number of loan amendments generated because of covenant relief requests, from 22 percent of all loan amendments during the last six months of 1998 to 45 percent during the first ten months of 1999.

[6] The annual interagency process reviews commercial loans over $20 million that are shared by three or more participants.

[7] Federal Reserve Board Press Release. November 10, 1999.

[8] "OCC's Williams Warns of Credit Risk in the Banking System; Calls for Bankers to Scrutinize Loan Portfolios More Closely." OCC Press Release. October 5, 1999.

[9] "Leveraged Loans: The Plot Thickens." Banc of America Securities Syndicated Finance Research. November 15, 1999. This loan amendment analysis was completed using only publicly available information from Loan Pricing Corporation and Banc of America Securities LLC.

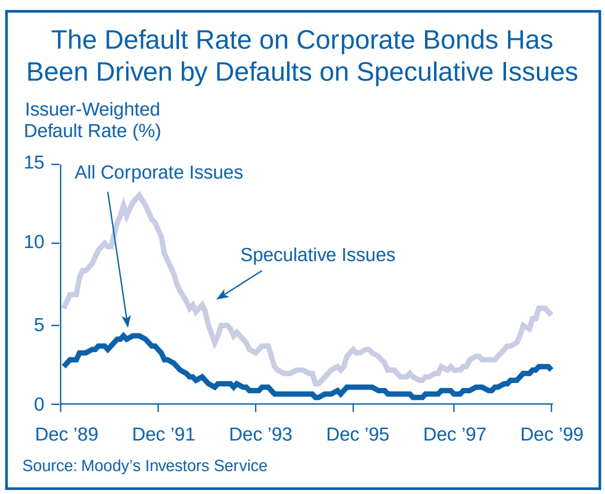
Corporate Bond Defaults Soared in 1999

Trends in corporate bond defaults also indicate increasing levels of stress in the corporate sector. During 1999, 147 issuers defaulted on $44.6 billion in long-term debt. Default rates as a percentage of volumes outstanding (or dollar default rates) have trended upward each year since 1996, reaching 2.2 percent for all corporate issues at year-end 1999. Much of the increase can be attributed to a rising dollar default rate for speculative-grade issues, which peaked in November 1999 at 8.2 percent. Measured as a percentage of all issuers, the default rate for speculative-grade issues rose to a post-1991 high of 6 percent in September 1999 (see Chart 3). According to ***Moody's,*** year-end 1999 default rates improved marginally but are expected to remain high through mid-2000.[10] In addition, domestic speculative-grade issuers reported twice as many issuer downgrades as upgrades during the fourth quarter of 1999, although the dollar volume of upgrades exceeded the dollar volume of downgrades by 55 percent.[11]

[10] "Corporate Bond Default Rates Highest Since 1991." Moody's Investors Service. October 13, 1999.

[11] "Moody's Default Rate Pendulum." Moody's October 1999 Commentary. Moody's Investors Service. October 18, 1999.

CHART 3



Why Are C&I Loan Losses Increasing Amid Strong Economic Growth?

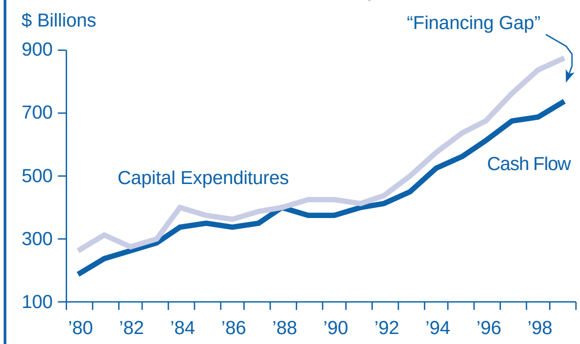
Several factors have contributed to the current signs of deterioration of C&I credit quality in an environment of favorable business conditions. These factors include global competition and deflationary pressures, an increase in corporate debt levels, loosened underwriting standards, and a greater appetite for risk.

Global competition and deflationary pressures have squeezed revenues. An era of low inflation and intense global price competition has contributed to low or negative revenue growth in a number of domestic industry sectors, particularly commodities and manufacturing.[12] The result has been an increase in loan losses and corporate bond defaults in these sectors. ***Moody's*** noted that the industrial sector, weakened by low commodity prices, accounted for 64 percent of all defaults in 1999, with the oil and gas, steel, and shipping industries being especially hard-hit.[13] For example, ***Standard & Poor's (S&P)*** reports that third-quarter 1999 earnings for the iron and steel sector declined 80 percent from one year earlier after five consecutive quarters of negative year-over-year earnings growth. Initially, commodity price declines and the international economic turmoil in 1997 and 1998 resulted in slowed foreign C&I lending and increased net losses of C&I loans held in foreign offices. These losses accounted for the majority of net C&I loan losses in 1997 and 1998. However, this adverse trend reversed itself in 1999, when C&I loans held in domestic offices accounted for the majority of losses.

Corporations are increasingly reliant on debt markets. Increasing levels of debt on corporate balance sheets have helped to foster C&I loan growth. The growth in corporate debt is partially a result of actions taken by firms to improve operating efficiency, including increasing merger and acquisition (M&A) activity and rising spending on fixed investments. Capital expenditures on fixed investments by businesses have increased at a steady rate since the 1990–91 recession, as evidenced by Chart 4. Cash flow has also been increasing, but at a slower rate, resulting in a growing "financing gap" that reached an annualized level of $142 billion in the third quarter of 1999. Where cash flow has not been available to finance investment, firms have turned primarily to debt financing as opposed to equity financing. Net new corporate equity issues by nonfarm nonfinancial corporations have been negative in each year since 1993, while net new corporate bond issuance has increased from $75 billion in 1993 to $219 billion in 1998.

CHART 4

The Financing Gap Has Widened for Nonfinancial Corporations



Note: 1999 data are annualized based on 3Q99 data.
Source: Federal Reserve Board (Haver Analytics)

Loosened underwriting standards in 1997 and early 1998 are contributing to current losses. Signs of stress in C&I loan portfolios can be partially attributed to loosened underwriting standards in 1997 and early 1998. During 1997 and early 1998, loan underwriting standards loosened, accompanied by reduced spreads and pricing. In May 1998, the ***Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices*** reported that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." ***Moody's*** describes the second half of the 1990s as a "mini credit cycle." The cycle began in 1995, when the strong economy, accompanied by falling interest rates and low loan losses and default rates, encouraged investor demand for high-yield bonds and loans.[14]

A record number of first-time speculative-grade deals were also brought to market during 1997 and early 1998. The increase in the volume of issuance was itself enough to push the default rate lower, which in turn may have fueled investor demand for additional high-risk bonds. However, the Asian crisis during 1997 and the Russian debt default during the second half of 1998

[12] See also Richard A. Brown and Alan Deaton. "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality." *Regional Outlook,* third quarter 1999. http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf.

[13] "Historical Default Rates of Corporate Bond Issuers, 1920–1999." Moody's Investors Service, January 2000.

[14] "Default Rate Pendulum." October 18, 1999.

caused new issuance of speculative-grade bonds to slow significantly while defaults rose sharply, to a rate of 6 percent by issuer in September 1999. While speculative-grade bond issuance declined, banks stepped in to fill the void by raising originations of highly leveraged loans between second-quarter 1998 and fourth-quarter 1999.[15]

Financial markets have evidenced greater risk appetite. While the ratio of speculative-grade bond issues to total corporate bond issues has remained fairly stable at approximately 40 percent during the past decade, the composition of borrowings has shifted substantially. ***Moody's*** reports a shift in the distribution of bond issue ratings within the speculative-grade category toward the lower end of the ratings scale (see Chart 5).[16] Evidence of this shift is demonstrated by the fact that bonds rated B3 or lower currently comprise approximately 35 percent of all speculative-grade issues, a record high and up from 24 percent in 1995.[17] Furthermore, almost 50 percent of the issuers that defaulted during the year ending September 1999 were rated for three years or less.[18] This change in the composition of ratings has contributed to the current increase in speculative-grade defaults and could affect the future volatility and liquidity of the market. The current high volume of corporate bond defaults reflects the looser standards in 1997 and 1998 for corporate debt issued by low-rated first-time issuers, who accounted for 40 percent of rated bond defaults in 1999.[19] This relationship is analogous to the current increase in net C&I charge-offs partially attributable to weakened underwriting standards in 1997 and early 1998.

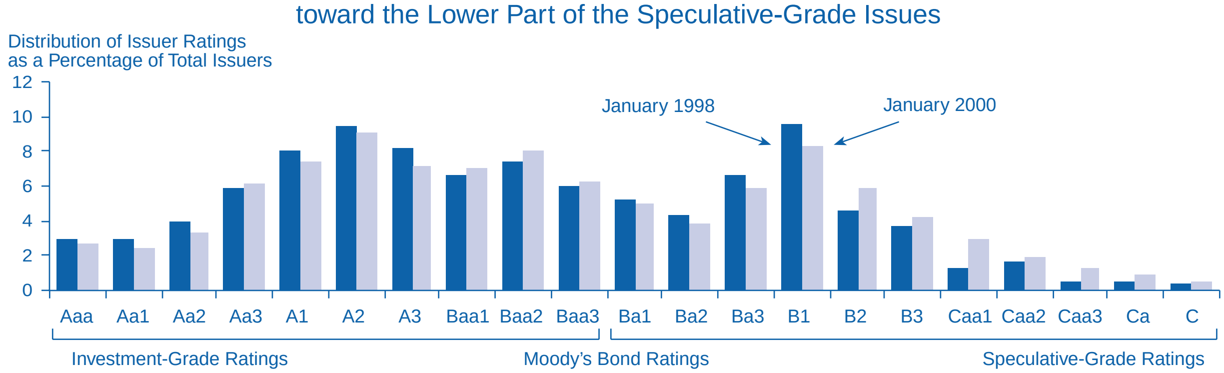
The Increase in Leveraged Lending Could Result in a Riskier Mix in C&I Loan Portfolios

Leveraged lending comprises an important part of the syndicated lending market and generates considerable fee income for financial institutions. Leveraged loans have grown from 12 percent of total syndicated loan originations in 1995 to 32 percent in 1999 (see Chart 6, next page). Leveraged syndicated loan originations grew 19 percent to $320 billion in 1999, as investors were seeking higher risk-adjusted returns and lenders were seeking higher fees. ***Paine Webber*** analysts estimate that leveraged lending accounts for over 80 percent of syndicated loan fees and profits earned by loan underwriters.[20] Highly leveraged lending increased to a new record of $190 billion in 1999.[21] This growth in loan originations reflects the current high corporate demand for loans, and by definition these loans are being made to borrowers with higher-than-normal levels of financial leverage and risk. In return for their higher risk profile, leveraged borrowers must compensate financial institutions through higher pricing and higher fees.

[15] *LPC Gold Sheets.* January 10, 2000.
[16] Moody's January 2000 Commentary. January 18, 2000.
[17] "Refunding Risk for Speculative Grade Borrowers." Moody's Special Comment. Moody's Investors Service. December 15, 1999.
[18] "Default Rate Pendulum." October 18, 1999.
[19] Moody's January 2000 Commentary. January 18, 2000.
[20] "The Biggest Secret of Wall Street." Paine Webber Equity Research. May 14, 1999.
[21] Loan Pricing Corporation defines highly leveraged loans as those for which pricing exceeds 250 basis points over LIBOR and generally involves sub-investment-grade credits.

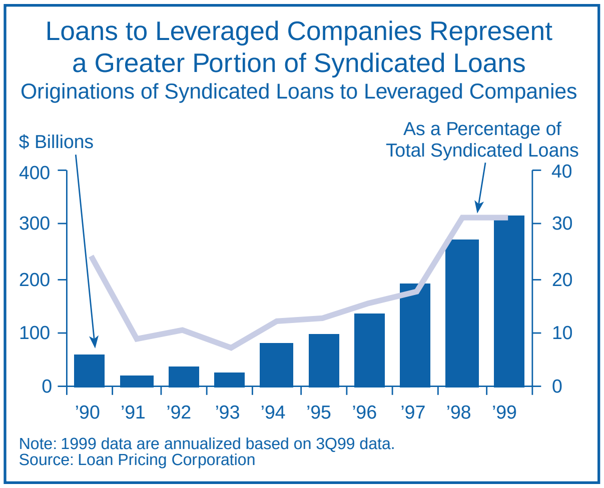
Chart 5

The Composition of the Rated Bond Market Has Shifted toward the Lower Part of the Speculative-Grade Issues



Note: Unrated issues of corporate debt fall below the speculative-grade "C" rating.
Source: Moody's Investors Service

CHART 6



Leveraged lending volumes have recently been partially driven by M&A lending, which comprised over 30 percent of the total syndicated loan market in 1999. M&A activity approached $1.4 trillion in total volume during 1999, increasing the demand for capital and driving corporations to the loan market.[22] Approximately 22 percent of leveraged loans originated in 1998 were to the media and telecommunications industries, which have experienced significant levels of M&A activity.[23] Leveraged buyout activity contributed an additional 15 percent to leveraged lending volumes, surpassing 1998 levels in quantity.

Where Is Business Credit Quality Heading?

The future direction of business credit quality will be influenced by several factors, including the condition of the economy, growth in the indebtedness of corporate borrowers, exposure to vulnerable industry sectors, the interest rate environment, the development of emerging markets, and underwriting standards.

Economic growth will remain an important determinant of credit quality. Should economic growth slow and corporate profits decline, the demand for C&I loans is likely to fall, and problem asset levels are likely to rise. A recent S&P survey of global credit conditions noted that excessive credit, attributable to unsustainable corporate indebtedness and falling asset values, has weakened the financial systems of 20 nations. As for credit expansion in the United States, the survey noted that the ratio of private sector loans outstanding to gross domestic product rose from 101 percent in 1995 to 142 percent in 1999. S&P also noted evidence that banks' C&I loan portfolios may be relying too heavily on loan repayments based on projections that are realizable only if the current economic expansion continues. S&P estimates that 5 to 15 percent of bank loans could default should the United States experience a significant downturn in the stock market leading to a hard landing for the domestic economy.[24]

Continued growth in corporate indebtedness could contribute to increased losses and defaults. The growth rate of corporate debt has surpassed the growth rate of the economy in each year since 1994. A widening financing gap and increasing debt levels could pose problems if there are adverse changes in the interest rate environment or if corporate revenue growth slows. Rising rates will increase the costs of servicing debt, while a slowdown in revenue growth would reduce the cash flow available to service outstanding debt. Under such a scenario, business bankruptcies and failures are likely to rise, causing increased loan losses and bond defaults.

Lending to some industries involves high-risk exposures. Despite the strength of the U.S. economy, some domestic industries are continuing to experience stress. Exposures to weakened industry sectors, such as health care and oil and gas, could negatively affect C&I credit quality at insured institutions. One way to evaluate the relative riskiness of firms operating in a given industry is through ***KMV Corporation's***® Expected Default Frequency™ (EDF™) analysis. KMV Corporation® has developed a proprietary method of measuring the degree of credit risk inherent in corporate borrowers by calculating an EDF™ score to estimate the probability that a firm will default on its obligations within one year.[25] Chart 7 diagrams syndicated loan exposures along with December 1999 EDF™ scores and the direction of change since December 1998. This chart illustrates one measure of the risk associated with the 10 industry sectors having the highest expected default

[22] Houlihan Lokey's *Mergerstat.* www.mergerstat.com.

[23] "The Biggest Secret of Wall Street." May 14, 1999.

[24] "Global Financial System Stress: The Weak, the Vulnerable, and Those Limping Toward Recovery." Standard & Poor's. December 17, 1999.

[25] KMV's® proprietary calculation for EDF™ is based on (1) the current market value of the firm, (2) the structure of the firm's current obligations, and (3) the vulnerability of the firm to large changes in market value. Multiplying industry originations by median industry EDF™ scores provides an estimate of expected default volumes. This figure provides a more meaningful measure of aggregate lending risk exposure than pure origination volumes alone and can be used to rank industry exposures.

volume based on the volume of 1999 syndicated loan originations. In 1999, loans originated to mortgage lenders (including subprime lenders), communications firms, oil and gas firms, health care firms, and retail trade organizations generated the five highest expected default volumes among 50 broad industry sector classifications.

The interest rate environment and refunding risk affect the demand for and availability of credit. Declining interest yield spreads from 1996 to 1998 benefited borrowers. As spreads declined, the rate of syndicated loan growth increased and refinancing activity was high. Increases in spreads since 1998, along with higher interest rates, have caused refinancing activity to slow significantly. However, rising rates have not significantly affected origination volumes, as new debt continues to come into the market. Rising interest rates and refunding risk particularly affect speculative-grade borrowers. Higher interest rates would raise businesses' cost of borrowing, potentially decreasing the demand for business credit and impairing borrowers' ability to repay their debts. Once a corporation's debt service ability is compromised, access to new capital markets can become limited. A sharp rise in interest rates would particularly impair the ability of highly leveraged firms to repay floating-rate debt obligations.

Refunding risk continues to be a concern for speculative-grade borrowers as they face potential problems refinancing the maturing portions of long-term debt. The current tightening of terms in the C&I market and increasing default rates heighten refunding risk to borrowers. Rising interest rates or limited access to secondary markets could also increase refunding risk. This situation could continue to be problematic, since a rising volume of speculative-grade borrowings, consisting largely of unsecured bank debt, matures in 2001 and 2002. Specifically, $64 billion in speculative-grade debt matures in 2001 and 2002, and approximately 63 percent of the debt is unsecured.[26]

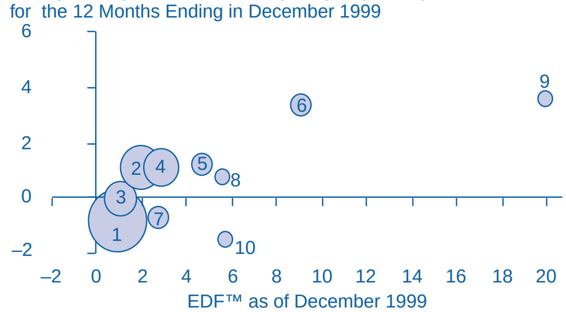
Potential growth in new markets presents both opportunities and challenges. The Internet and European syndicated loan markets represent both future potential growth areas and possible sources of credit risk for C&I lenders. The Internet has introduced large new markets to the loan and bond markets and has

[26] "Refunding Risk for Speculative Grade Borrowers." December 15, 1999.

Chart 7

Lending to Some Industries May Involve Higher Risk Exposures

Change in Expected Default Frequency™ (EDF™) for the 12 Months Ending in December 1999



Industry Name and Origination Dollars in Billions:
1. Communication Services - $234.6
2. Motor Vehicles and Parts - $133.1
3. Chemicals and Drugs - $96.1
4. Retail Trade - $92.1
5. Wholesale Trade - $46.5
6. Health Care Services - $42.3
7. Oil & Gas Extraction - $41.8
8. Entertainment - $33.5
9. Mortgage Lenders and Mortage-Backed Securities - $20.2
10. Hotels & Lodging Services - $20.2

Note: Data and bubble size represent total syndicated loan originations for the year ending 1999.
Sources: Securities Data Corporation; KMV Credit Monitor®

increased market efficiency. The "Internet economy" grew 68 percent from the first quarter of 1998 to the first quarter of 1999, with annual revenue expected to exceed $500 billion in 1999.[27] Internet technology has improved the efficiency of the syndicated loan markets, with recent changes including the development of public price reporting, credit ratings, and Internet sites for online trading.[28] Increased levels of credit risk could result from the volatility of Internet stock prices and the competitive disadvantage faced by firms that do not have an Internet presence but must compete against firms that do.

While the majority of syndicated loan financing currently occurs in the United States, analysts predict that syndicated lending activity in Europe will accelerate significantly because of increased cross-border competition generated by the introduction of the euro and new financing needs. In addition, the European high-yield bond market is still developing but produced $6.8 billion of volume in the third quarter of 1999, or 61 per-

[27] "Internet Indicators." The Center for Research in Electronic Commerce at the University of Texas Graduate School of Business. October 27, 1999.

[28] "Syndicated Loan Market Soars as Efficiency Increases." *The Wall Street Journal.* December 6, 1999.

cent of the total market.[29] Domestic lenders have begun to compete for this market but face credit risks because the European markets also pose sovereign and foreign exchange risk.

Underwriting Remains the Key to Assessing C&I Credit Quality

The August 1999 ***OCC Survey of Credit Underwriting Practices*** reported some tightening of commercial loan underwriting standards. However, loan officers also reported increased embedded risks in commercial loan portfolios for the fifth consecutive year. Survey respondents attributed the increased risks to weakened underwriting standards in previous years. The November 1999 ***Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices*** found that 30 percent of domestic banks reported increasing risk premiums, credit line costs, and loan spreads during the preceding three months. Loan officers cited an uncertain or unfavorable economic outlook, an expected worsening of industry-specific problems, and a reduced tolerance for risk as reasons for tightening C&I lending standards.

Despite signs of tightening underwriting standards, the mix of credits appears to be riskier than in recent times. The OCC issued an advisory to banks in May 1999 warning of potential problems with leveraged lending. The OCC stated that highly leveraged corporations could be particularly vulnerable to economic weakness and may not be able to compete effectively in a rising interest rate environment. The OCC also addressed reliance on enterprise value loans, which are often used to support leveraged lending. Enterprise values are calculations based on projections of the future income of a firm. If such estimates are overly optimistic, or if the company fails to meet the assumptions underlying these estimates, the lender may be subject to considerable credit risk. The last interagency SNC review also noted instances of inadequate documentation and support for enterprise loans.[30]

Summary

C&I lending is one of the largest and fastest growing lending lines at insured institutions. Recent growth in C&I lending can be attributed to a number of factors, including a favorable economy, merger and acquisition activity, and other sources of high loan demand, strong asset quality, aggressive pricing, and attractive fee income. While indicators of C&I loan performance remain generally strong, signs of deterioration in commercial credit quality have begun to surface. These signs are cause for some concern because they are surfacing during a period of remarkable economic strength. Increasing corporate indebtedness, signs of corporate stress, and adverse trends in corporate bond defaults suggest that an economic downturn could result in a much more challenging environment for business credit quality.

By Arlinda Sothoron, Senior Financial Analyst
Alan Deaton, Economic Analyst

[29] *LPC Gold Sheets,* Vol. XII, No. 44. Loan Pricing Corporation. November 15, 1999.

[30] Remarks by OCC First Senior Deputy Comptroller and Chief Counsel Julie L. Williams before the Robert Morris Associates Conference on Lending and Credit Risk Management, October 5, 1999.

Local Industries in the Global Economy

- **The contribution of international trade to U.S. economic activity has risen rapidly during the past decade. The U.S. economy has been increasingly influenced by conditions abroad, such as the recent financial market turmoil in several emerging markets.**

- **Canada, Japan, and Mexico are the largest U.S. trading partners, accounting for approximately 40 percent of U.S. trade. Western Europe and Asia (excluding Japan) also account for a large share of U.S. trade.**

- **The importance of trade at the industry level varies widely. The industries most dependent on trade, including machinery and transportation equipment, also account for a large share of U.S. trade.**

The value of goods and services traded on international markets has more than doubled during the past decade. More goods and services than ever are being shipped abroad and imported from all parts of the globe. Consequently, U.S. economic activity is increasingly influenced by the flow of goods, services, and capital across national borders.

The increasing importance of international trade is reflected in different types and levels of exposure to international markets. First, total exports and imports compared with overall economic activity confirm the increasing contribution of trade to the economy as a whole. Second, the amount of U.S. trade with foreign markets, although widely varied, is concentrated in a small number of countries, namely Canada, Japan, and Mexico. Consequently, economic conditions in these countries are particularly important in assessing the influence of global economic conditions on U.S. trade. Third, the level of exposure to international trade across industry sectors varies considerably. Some industries are not influenced greatly by activity in international markets, while for other, more trade-dependent industries, conditions in the world economy are an important factor in determining the level of sales and profit. The exposure to international markets, either through reliance on trade with particular countries or via industries with a significant exposure to international markets, is an important consideration for lenders seeking to determine a firm's future profitability and financial condition.

International Trade Is of Growing Importance

Over the past 30 years, international trade has grown more quickly than the economy as a whole. Exports, which include both merchandise and services, have risen from less than 5 percent of U.S. gross domestic product (GDP) in 1970 to approximately 12 percent today. The merchandise component accounts for about 73 percent of exports and includes manufactured goods, agricultural products, and raw materials such as metals and oil. The services component of exports, accounting for about 28 percent of total exports, includes travel services, passenger fares, royalties, freight and port services, and a number of smaller sectors such as financial and educational services.

Imports also account for a growing share of U.S. consumption of goods and services, exceeding 15 percent of U.S. GDP in 1999, up from 6 percent in 1970. Merchandise is the largest component of imports, accounting for 83 percent, while services account for 17 percent (see Table 1, next page).

Although trade in services has grown quickly for many years, merchandise still accounts for the majority of all trade. The dominance of merchandise is attributable, in part, to the difficulty of trading many types of services. With few exceptions, services are generally produced and consumed within a local market because they cannot be transported easily and are subject to language and cultural barriers. Hospitals, dry cleaners, and movie theaters, for example, serve well-defined local markets and produce products that cannot be traded competitively on international markets. Although trade in services such as travel continues to grow, the remainder of this article focuses primarily on the dominant merchandise component.

U.S. Trade Activity Has Reflected Recent Global Economic Turmoil

Over time, conditions in the international economy have become an increasingly important influence on U.S. growth, since a rising share of all domestically produced goods and services is sold abroad. Similarly, an increasing volume of imported goods and services implies a higher level of competition for domestic producers that compete directly with imports.

Table 1

Merchandise Is the Largest Component of Trade	Dollar Value* (1998, $ millions)	Percent of Total	1999 Growth**
Exports	**$ 933,910**	**100.0%**	**1.8%**
Merchandise	682,138	73.0%	0.8%
Agriculture and Related Commodities	26,603	2.8%	-1.8%
Mineral Commodities	6,644	0.7%	-17.4%
Manufactured Goods	593,297	63.5%	-0.1%
Other Merchandise	55,593	6.0%	39.5%
Services	263,662	28.2%	4.3%
Travel	71,250	7.6%	3.0%
Passenger Fares	19,996	2.1%	2.7%
Royalties and License Fees	36,807	3.9%	4.1%
Freight and Port Services	25,520	2.7%	6.4%
Other Services	110,089	11.8%	5.0%
Adjustments***	(11,890)		
Imports	**$ 1,098,193**	**100.0%**	**10.3%**
Merchandise	907,647	82.6%	10.4%
Agriculture and Related Commodities	22,859	2.1%	-2.2%
Mineral Commodities	38,619	3.5%	5.6%
Manufactured Goods	803,384	73.2%	11.6%
Other Merchandise	42,786	3.9%	-0.6%
Services	181,015	16.5%	9.6%
Travel	56,105	5.1%	7.2%
Passenger Fares	19,797	1.8%	8.3%
Royalties and License Fees	11,293	1.0%	11.0%
Freight and Port Services	30,460	2.8%	11.4%
Other Services	63,360	5.8%	10.9%
Adjustments***	9,531		

* Sum of components may not equal total due to rounding.
** First three quarters of 1999 versus first three quarters of 1998.
*** Because of different methods of estimating the merchandise and services components of trade, an adjustment term is necessary. Consequently, percentages may not sum to 100.
Sources: Bureau of Economic Analysis; Bureau of Census

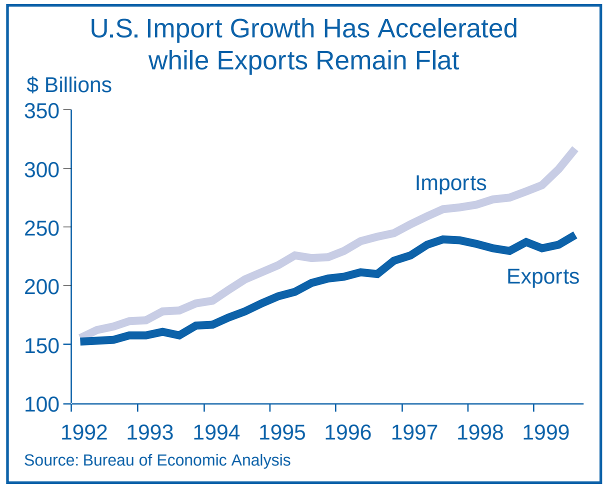
During the past two and a half years, for example, the international economy has been buffeted by a series of crises that resulted in steep exchange rate depreciations for a number of countries and a marked slowdown in economic growth in many emerging markets. Although the U.S. economy remained surprisingly strong during the worst of the emerging markets crises, the fallout was evident in the diverging performance of U.S. exports and imports over the period.

From mid-1997 through mid-1999, U.S. exports were generally flat, reflecting the sluggish pace of growth in several important U.S. export markets. Export prices fell by 4 percent over the period in response to weak demand for U.S. exports. In particular, exporters of agricultural products, basic manufactured goods, and commodities faced rapidly deteriorating conditions in several important overseas markets. For example, the value of merchandise exports to the Pacific Rim fell by 15 percent during the first six months of 1999 compared with the same period in 1997 because of the recent financial market turmoil in the region.

U.S. imports continued to grow during the period, however, reflecting both strong demand for imported goods and falling prices. In fact, average import prices fell by 5 percent between 1997 and 1999. At the same time, competition from imports limited the pricing power of domestic producers that compete with goods produced abroad. Although producers that compete with cheaper imports experienced adverse effects on profitability, consumers and firms that purchased goods from abroad generally benefited from falling import prices.[1]

The slowdown in U.S. export activity and the acceleration of import growth have resulted in an increasing trade imbalance (see Chart 1). The U.S. trade deficit, which reached a record $26.5 billion in November, has raised concerns among analysts about the vulnerability of the dollar. Faster growth abroad or a slowdown in U.S. growth could convince foreign investors to increase purchases of assets outside the United States, resulting in a sell-off of the dollar. Depending on the severity and speed of a sell-off, heightened financial market volatility and rising U.S. import prices could result. Although potentially many forces are at work in such a scenario, rising inflation or a falling dollar may ultimately result in higher interest rates and slower U.S. growth. The extent to which U.S. trade would be affected by such a scenario is difficult to assess, since changes in the prices of either imports or exports would result in both positive and negative effects on firms' costs, revenue, and profitability.[2]

CHART 1



Most U.S. Trade Is Concentrated in a Few Foreign Markets

Because the United States trades with most nations, economic conditions abroad are one of the critical factors that determine the growth of U.S. trade. Foreign demand for U.S. goods and services depends on the strength of the markets to which exporters ship their goods. Consequently, economic weakness abroad often results in slower U.S. export growth. Economic conditions abroad also influence the level of import competition that U.S. firms experience. Foreign firms facing slack demand in their own domestic markets, much like manufacturers in Southeast Asia during the recent market turmoil, may

[1] Weak import prices are a factor cited by analysts to explain the benign performance of U.S. inflation during the past few years.

[2] During the early 1980s, the dollar rose by roughly 50 percent, as measured against a trade-weighted basket of currencies. The increase in the value of the dollar made U.S. exports much more costly on world markets and contributed to financial stress among export-dependent manufacturers and agriculture producers. Beginning in mid-1985 the dollar fell sharply, back to its pre-appreciation level. The resulting improvement in U.S. competitiveness contributed to robust growth in U.S. exports that lasted during the rest of the 1980s.

reduce prices of their U.S.-bound goods to compete more effectively with U.S. producers.[3]

Although the U.S. trades with many nations, a large share of U.S. trade is concentrated among a small number of countries. Canada, Mexico, and Japan account for more than 40 percent of merchandise exports and imports. Asia (excluding Japan) and Western Europe each account for just over 20 percent of U.S. exports and a broadly similar share of imports. Central and South America, despite proximity to the United States, account for less than 10 percent of exports and only 5 percent of imports (see Chart 2).

The United States has routinely run a trade deficit with its largest trading partners. The trade deficit with Canada was $22.8 billion through the first three quarters of 1999. The trade deficit with Mexico topped $18.8 billion during the same period. The trade deficits with Japan and China, by far the two largest at $53.4 billion and $49.4 billion, respectively, accounted for approximately 40 percent of the total U.S. merchandise trade deficit through the first three quarters of 1999.

The Importance of Trade Varies among Industries

The level of export activity or the intensity of import competition also varies across industries. Besides the overall dollar volume of exports, industries differ in the proportion of total production that is exported. Although some industries, such as leather products, account for a relatively small share of total U.S. exports, exports from this industry make up a large share of all U.S. leather goods production. In cases such as this, conditions in export markets are important for producers even if total export sales from a particular industry are small.

Industries also differ in the share of total spending devoted to imports. Imports account for a relatively small portion of all domestic spending on farm products such as grains and livestock, for example, while imports account for a relatively large share of all U.S. oil consumption. These differences expose U.S. industries to varying levels of competition from abroad. In industries characterized by high levels of import competition, import prices may largely shape the domestic pricing environment and, by extension, the revenue and profit growth of domestic firms.

CHART 2

For the purposes of this article, industries can be assigned to one of three broad categories depending on their exposure to international markets either through exports or through the intensity of import competition. Firms in *Less Exposed Industries* are not directly influenced by conditions in the global markets. Export markets are not a particularly important source of revenue, and imports are a negligible share of all domestic consumption of goods produced by these industries. In contrast, some industries are highly exposed through their reliance on export markets, through competition from imports, or in some cases, through both. For firms in these *Highly Exposed Industries,* conditions in international markets are clearly one of the important factors influencing current and prospective financial performance. Industries not part of either group, or *Moderately Exposed Industries,* face some competition from abroad and may earn a relatively small amount of revenue from export markets.

To gauge these differences more fully, a measure of exposure to international markets was calculated for a set of 26 industries (20 manufacturing industries, 4 mining industries, and 2 agriculture sectors). Table 2

[3] From the perspective of a foreign exporter, increased sales of goods abroad, even at reduced prices, may be a preferred strategy to offset lower sales within its own weaker domestic market. A foreign steel mill facing weak sales in its home market may choose to sell its output below cost on the world market if it can still cover its fixed costs of operation. There also may be an incentive to maintain or even expand market share and recoup current losses in the future when prices rebound.

TABLE 2

INDUSTRY EXPOSURE TO INTERNATIONAL TRADE

Export Share of U.S. Production	Import Share of U.S. Consumption: Low	Import Share of U.S. Consumption: Medium	Import Share of U.S. Consumption: High
Low	Printing and publishing Food products	Lumber and wood products Petroleum and coal products Agricultural services, forestry, and fishing Furniture and fixtures	Oil and gas extraction
Medium	Coal mining Tobacco products Nonmetallic minerals, except fuels Fabricated metal products	Metal mining Paper and allied products Textile mill products Stone, clay, and glass products Rubber and plastic products Primary metal industries	Miscellaneous manufacturing industries Apparel products
High	Farm products	Chemicals and allied products Instruments and related products	Transportation equipment Industrial machinery and equipment Electronic equipment Leather and leather products

Highly Exposed Industries (Low export/High import; Medium export/High import; High export in all import columns)
Moderately Exposed Industries (Low export/Medium import; Medium export/Low and Medium import)
Less Exposed Industries (Low export/Low import)

summarizes the results of the assessment.[4] Each row shows industries that have high, medium, or low reliance on export markets, defined as the share of U.S. production in a particular industry that is exported. Each industry was ranked by this measure, with the 7 highest industries placed in the High category, the 7 lowest in the Low category, and the remaining 12 in the Medium category.[5] Table 2 shows, for example, that a relatively low proportion of production in the printing and publishing, lumber and wood products, and oil and gas extraction industries is exported. In contrast, a relatively high percentage of production in the farm products sector, chemicals, and transportation equipment industries is exported.

[4] Export share of production (rows in Table 2) was calculated as the ratio of inflation-adjusted exports at the industry level divided by inflation-adjusted production in that industry (Gross Output by Industry from the Bureau of Economic Analysis was used as a measure of industry production). The import share of consumption (columns in Table 2) was calculated as the share of inflation-adjusted industry imports divided by inflation-adjusted domestic production less exports plus imports. All calculations were based on 1997 data, the latest industry-level production data available.

[5] This allocation, while completely arbitrary, roughly corresponds to a distribution where 50 percent of the industries are assigned to the Medium category, with the remaining 50 percent evenly allocated between the High and Low categories. Breakpoints for the distribution of industries by export share of production were as follows: Low: less than 7 percent; High: greater than 13 percent.

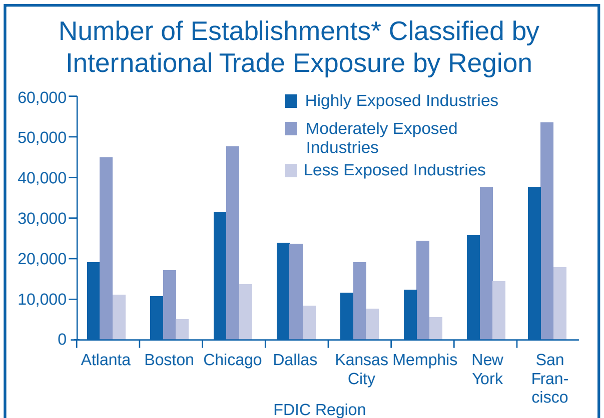
The industries in each column are categorized by the share of U.S. consumption expenditures in a particular industry that are satisfied by imports. Again, the Low and High categories each include 7 industries, and the Medium category includes the remaining 12 industries.[6] On the basis of this analysis, for example, a relatively low share of U.S. consumption of food, fabricated metals, and farm products is imported. In contrast, a large share of U.S. consumption of oil, apparel, and electronic equipment is imported.[7]

As shown in the lower right cell of the table, four industries are highly exposed to both export markets and import competition. These industries—transportation equipment, industrial machinery, electronic equipment, and leather products—account for slightly less than half of total U.S. exports and a similar percentage of total U.S. imports. Not only are these industries more closely tied to international markets than most other industries examined, but they also account for a large share of U.S. international trade.

Using the terminology introduced above, Highly Exposed Industries are defined as those assigned to either of the High categories; industries in this group either are very reliant on export markets or face high levels of import competition. Less Exposed Industries are defined as those that have little exposure to either export markets or import competition; they are shown in the upper left cell in the Low classification. The remaining industries are defined as Moderately Exposed Industries.

Chart 3 illustrates the distribution of establishments in each of the three categories by Region.[8] Among the

CHART 3



*An establishment is a single physical location at which business is conducted.
Source: Bureau of Census, 1997 County Business Patterns Database

group of industries analyzed, most are in the Moderately Exposed Industries category. Of the FDIC Regions, Atlanta, Chicago, and San Francisco have the greatest number of establishments in this category. The Chicago and San Francisco Regions lead in the number of establishments in the Highly Exposed Industries group, followed by the New York and Dallas Regions.[9] Less Exposed Industries account for a relatively small number of establishments. As suggested above, however, most service-sector, construction, and government enterprises, while not part of this analysis, could be classified as Less Exposed.[10]

Although this analysis highlights the varying level of direct exposure to international markets, industries also may be exposed through a less direct secondary channel. Several industries, although not highly exposed themselves, are suppliers to Highly Exposed Industries. For example, the rubber and plastics industry produces goods that are used in the manufacture and assembly of transportation equipment, a Highly Exposed Industry.

[6] Breakpoints for the distribution of industries by import share of consumption were as follows: Low: less than 9 percent; High: greater than 25 percent.

[7] Although not directly included in the analysis, most domestically produced services also have minimal reliance on export markets and face little import competition. Retail trade, construction, local transportation services, and government, for example, all operate in relatively sheltered markets and are dependent on the health of the local economy. Particular firms may engage in high levels of international activity in tradable services such as travel, but manufacturing, mining, and agriculture account for the majority of imports and exports.

[8] An establishment is defined as a single physical location at which business is conducted or services or industrial operations are performed. It is not necessarily identical with a company or enterprise, which may consist of one or more establishments. Data are from *County Business Patterns* (Bureau of Census, 1997).

[9] An alternative way of analyzing the establishment data is to calculate the percentage of all establishments across the 25 industries that are in Highly Exposed Industries. On the basis of this calculation, the Dallas Region ranks highest at 42 percent because of the large number of establishments engaged in oil and gas extraction. For the remaining Regions, the percentages vary between 25 percent and 35 percent. Across all industries (including services and other sectors not part of this analysis), the percentage of Highly Exposed Industries in each Region ranges from 1.7 percent (Atlanta Region) to 3.4 percent (Boston Region) of total establishments.

[10] These data do not include a count of establishments in the farm products sector (Standard Industrial Code (SIC) 01 and SIC 02). Therefore, 25 industries are represented in the establishment data, and not 26 as in Table 2.

Consequently, conditions in export markets for transportation equipment are of particular interest for manufacturers of certain types of rubber and plastic products. These supplier industries are also vulnerable to import competition through this secondary exposure to international markets. A transportation equipment manufacturer, in response to heightened competition in international markets for its products, may switch from a domestic supplier of rubber products to a cheaper foreign supplier if a favorable price differential emerges. Therefore, assessing the exposure of industries to either exports or imports requires consideration of any secondary linkages between suppliers and purchasers of industry products.

Summary

The contribution of international trade to overall U.S. economic activity has been increasing for a number of years. The growing significance of trade has been highlighted by the recent series of economic and financial crises across the globe. One result of recent global economic turmoil has been a slowdown in U.S. export growth resulting from both slumping international demand for U.S. goods and services and weak prices. Import growth has continued unabated, largely because of strong U.S. growth, leading to a rapidly widening trade deficit. The effects of import and export growth on particular industries vary because of differing levels of reliance on export markets and the extent of import competition. This analysis suggests that several industries are highly exposed to changing global economic conditions. Lenders should be aware that for firms in these industries, changes in global economic conditions, including demand for U.S. exports and prices of both imports and exports, largely determine pricing, revenue growth, and profitability.

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Senior Financial Economist

Memphis Region's Exports Decline

Although the Memphis Region is less dependent on exports than the nation, the share of the Region's gross state products represented by export activity rose during much of the 1990s. However, the value of regional exports started to fall after the third quarter of 1997, primarily because of economic and financial troubles in emerging markets coupled with a stronger U.S. dollar. The reduction in the value of exports has been more pronounced in certain sectors and states as indicated by the export growth figures in Table 1.[1]

Table 1

Memphis Regional Export Values Have Declined in Recent Years (Year-over-Year Percent Change)

	3Q97	3Q98	3Q99
Arkansas	27.3	–28.1	–3.4
Kentucky	20.0	6.5	9.7
Louisiana	–9.0	1.2	–15.7
Mississippi	13.0	2.8	1.6
Tennessee	15.7	–0.7	–2.5
Region	12.4	–0.9	–1.0

Source: Massachusetts Institute for Social and Economic Research

The Region's agricultural and manufacturing sectors have experienced the greatest volatility in export activity. Export values declined significantly for agricultural products, such as oil seeds, processed foods, poultry, lumber, and wood products. Moderate declines in exports also occurred in manufacturing sectors, including chemicals, electronics, industrial machinery, and primary metals, beginning in the third quarter of 1998 and continuing through the third quarter of 1999. The declines in manufacturing exports were most pronounced in **Louisiana;** however, declines have also occurred in **Arkansas** and **Mississippi.** The influence that a state's export performance exerts on the manufacturing and agricultural sectors varies.

Arkansas and Louisiana showed the greatest volatility in export values during recent years. Arkansas, a major crops and poultry exporter, experienced a decline in export activity in 1998 primarily because of financial difficulties in Russia and to a lesser extent Asia. Russia was a major importer of the state's poultry products during the 1990s. Worldwide low commodity prices for much of 1998 and 1999 hampered both states' agricultural exports. The decline in export value results from currency appreciation (price) and reduced shipping volumes. However, currency appreciation, which results in products becoming more expensive for foreign customers, has exerted the most pronounced effect. According to the U.S. Department of Agriculture, about 80 percent of the drop in commodity export values nationally can be attributed to price fluctuation. Reduced tonnage accounted for only 20 percent of the decline.

Louisiana's worldwide exports declined 6 percent to $12.5 billion during the first nine months of 1999, compared with the same period in 1998. (Note, export figures attributed to Louisiana include products that are produced outside the state and shipped through the ports of Louisiana, particularly agricultural products produced in the Midwest.) Exports of processed foods and chemicals experienced declines during the first nine months of 1999. The processed foods sector experienced the largest decline at 29 percent. Processed foods have traditionally been a strong export sector, especially prepackaged mixes and spices, and seasonings.

Kentucky's ability to generate significant positive export growth during the past few years distinguishes it from other states in the Region. This performance can be attributed largely to strong demand for auto and related component parts. In addition, the state's largest trade partner, Canada, has encountered less economic volatility than has been experienced by the state's other trading partners.

Increasing global competition is also resulting in job losses for the Region. Low-cost foreign labor and cheap foreign currencies, relative to the dollar, are motivating manufacturers to relocate production of some goods and related jobs out of the Region. For example, during 1998 approximately 8,000 jobs in Tennessee's apparel industry were lost, primarily as a result of production being moved to overseas locations. Job losses have been concentrated in rural areas and in low-skilled positions.

The outlook for export growth among states in the Region is encouraging, as international economies recover. The Organization for Economic Cooperation and Development projects the world economy to grow at an annual 3.5 percent in 2000. Sectors in the Region with the greatest potential to benefit from export growth are the ones hurt most recently by weakened trade conditions, including agriculture, electronics, chemicals, and industrial machinery. One indication of an improving outlook for the Region's export activity is the planned $1 billion Millennium Port in **Plaquemines** Parish, Louisiana, which will handle container trade activity between North America and Latin America. Port-related activity in the state currently generates approximately 51,000 jobs, and about $1 billion in earnings.

[1] Exporter location series allocates exports according to the physical location of exporters.

Regional Perspectives

- **Although the Region's economy is healthy, employment growth is slowing. Continued weakness in agriculture is affecting some lenders. Overall banking conditions, however, remain favorable.**

- **Many insured institutions may be accepting greater inherent asset risk in exchange for improved yields.**

- **Recent loan growth has occurred in traditionally higher-risk commercial and industrial (C&I) and commercial real estate loans. While asset quality remains favorable, weaknesses in some borrower sectors and examination findings point to the potential for increased levels of credit risk.**

- **The complexity of managing interest rate risk is increasing as asset maturities and repricing frequencies extend. Both loan and investment portfolios appear more sensitive to market conditions.**

Region's Economic and Banking Conditions

Growth in the Memphis Region Lags the Nation

The Memphis Region's economy, as measured by payroll employment growth, underperformed the nation's in third quarter 1999 (see Table 1). After peaking in the mid-1990s, payroll employment growth consistently has lagged the nation; in fact, the gap between national and regional growth widened during the first nine months of 1999 (see Chart 1). Among sectors, employment growth in services and retail trade remains encouraging for the Region, except in **Mississippi,** where previously vigorous growth in casino-related service employment is slowing. Job gains in the retail sector are attributable to continued strong consumer confidence as personal expenditures bolster economic activity. The overall slowing in the job creation rate results from tight labor markets, a second consecutive year of declining exports, and weaknesses in the manufacturing and agricultural sectors.

TABLE 1

Employment Growth Slows Year over-Year, %		
	3Q98	3Q99
Arkansas	1.66	1.48
Kentucky	2.72	1.84
Louisiana	2.71	0.65
Mississippi	2.51	0.01
Tennessee	2.41	1.12
Region	**2.45**	**1.06**
United States	**2.73**	**1.85**

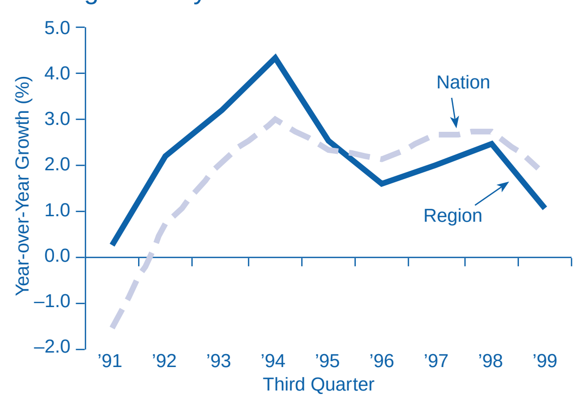
Source: Bureau of Labor Statistics

The Region's generally healthy economy is evidenced by an unemployment rate of 4.4 percent in the third quarter of 1999. While this rate is slightly higher than the 4.2 percent reported nationally, labor markets in many of the Region's metropolitan statistical areas (MSAs) are extremely tight. **Louisiana** MSAs reported the highest unemployment rates, affected by layoffs in the oil and gas sector. Most other major MSAs reported unemployment rates between 3.0 and 3.5 percent. **Nashville, Tennessee,** and **Lexington, Kentucky,** reported extremely low unemployment rates at 2.5 and 2.1 percent, respectively. Firms in these areas face considerable difficulty recruiting qualified workers.

Weak conditions persist in the manufacturing sector. Manufacturing firms have been shedding jobs in recent

CHART 1

Regional Payroll Growth Trails the Nation's



Source: Bureau of Labor Statistics

years, especially in textile and apparel. These two industries have been shrinking nationwide because of international competition and lower overseas labor costs. Tennessee, with the largest employment base in textiles and apparel in the Region, reported that 70 manufacturing firms in the sector ceased operations in the past two years.[1]

Weaknesses in exports also contributed to slowing economic growth. The dollar value of the Region's exports declined by 1.0 percent in third quarter 1999 from one year ago, the second annual decline since robust 12.4 percent growth was reported in third quarter 1997. Weakness in trade contributed to the Region's slowing overall employment growth and led to layoffs and some plant closures, especially in low-skilled manufacturing plants. For more detail on the national and regional trade situation, see the "Local Industries in the Global Economy," ***In Focus*** article in this issue.

In the agricultural sector, weaker exports and falling commodity prices led to disappointing farm earnings for much of the 1999 season. Although net farm income in 1999 is expected to increase 8.8 percent from 1998, the change is largely attributable to increased government subsidies and emergency funding. During 1999, direct government payments to farmers are expected to represent nearly 48 percent of net farm income, up from 27.7 percent in 1998 and 15.4 percent in 1997. While the additional government funding should enable most farmers to meet debt obligations, crop prices remain low with little improvement expected in 2000, barring any supply shocks. As a result, farmers will likely continue to struggle financially.

Asset quality among agricultural lenders[2] is being adversely affected by conditions in the sector. Regionally, the ratio of median agricultural past-due and nonaccrual loans to total loans increased to 1.04 percent in the third quarter of 1999 from 0.66 percent one year ago. Furthermore, the ratio of net loan losses to total loans jumped from 0.09 percent of average agricultural loans in the third quarter of 1998 to 0.16 percent one year later. Anecdotal evidence suggests that carryover debt is increasing. Forty-two percent of the FDIC-supervised agricultural lenders in the nation showed a sharp or moderate increase in the level of carryover debt from August 1998 through September 1999, up from 29 percent for the previous six-month period.[3]

Banking Conditions Remain Favorable, although Earnings Performance Declines

Banks and thrifts reported generally favorable financial conditions in the third quarter of 1999. Median leverage capital ratios remained virtually unchanged from one year ago at 9.7 percent. Asset quality indicators generally improved except among agricultural lenders, as previously noted. The ratio of median total past-due loans to total loans was 2.17 percent, down 21 basis points from the previous year.

In contrast, earnings performance declined during the same period. The median return on assets was 1.15 percent, down 9 basis points from the third quarter of 1998. Lower earnings are attributed to the continuing slide in net interest margins (NIMs). The median NIM was 4.23 percent, a 14-basis-point drop from one year ago; increasing competition for loans and funding is the primary factor contributing to this decline. In an effort to bolster slumping margins, many insured financial institutions are changing asset compositions to improve earning asset yields. In the process, they may be accepting increased credit risk and greater market sensitivity.

[1] Middle Tennessee State University, *Global Commerce: Tennessee and the International Economy,* 1999.

[2] Agricultural lenders are institutions reporting 25 percent or more of total loans in agricultural loans.

[3] FDIC, *Report on Underwriting Practices,* for the period ended September 1999.

Inherent Credit Risk Rises

Since the early 1990s, banks' asset composition has shifted from securities into loan portfolios. Average loan-to-asset ratios at established institutions rose from just over 50 percent at year-end 1992 to 62 percent as of September 30, 1999. Loans typically offer higher available yields than securities, but also usually represent higher credit risk.

Recent growth has been concentrated in traditionally higher risk loan types, such as C&I and commercial real estate (CRE) loans (see Chart 2). Although C&I and CRE loans accounted for less than one-third of aggregate loans at established community banks in the Region[4] on September 30, 1997, these two loan types comprised almost half of net loan growth during the subsequent two years. As a result, bank concentrations in these loan types are growing (see Table 2).

Strong Commercial Loan Demand Has Facilitated the Shift in Portfolio Composition

In the nation and the Region, businesses are turning more frequently to financial institutions for C&I lending. Businesses' capital expenditures have increased sharply since the last recession. In the initial phases of the expansion, cash flow rose in close correlation with capital expenditures. More recently, increases in cash flow have not kept pace, creating a widening financing gap for businesses (see "Recent Trends Raise Concerns about the Future of Business Credit Quality," ***In Focus***). This gap is being met, at least in part, by increased lending from insured financial institutions.

Demand for CRE loans also is strong. In the Region's metropolitan areas, CRE loan growth has been driven by active commercial development. Although commercial construction activity is slowing in response to growing supply-and-demand imbalances in some markets, many metropolitan banks and thrifts are adding aggressively to CRE loan totals. Outside metropolitan areas, CRE loans often represent financing of business

[4] Established community banks are banks with less than $1 billion in total assets that have been in operation for three or more years.

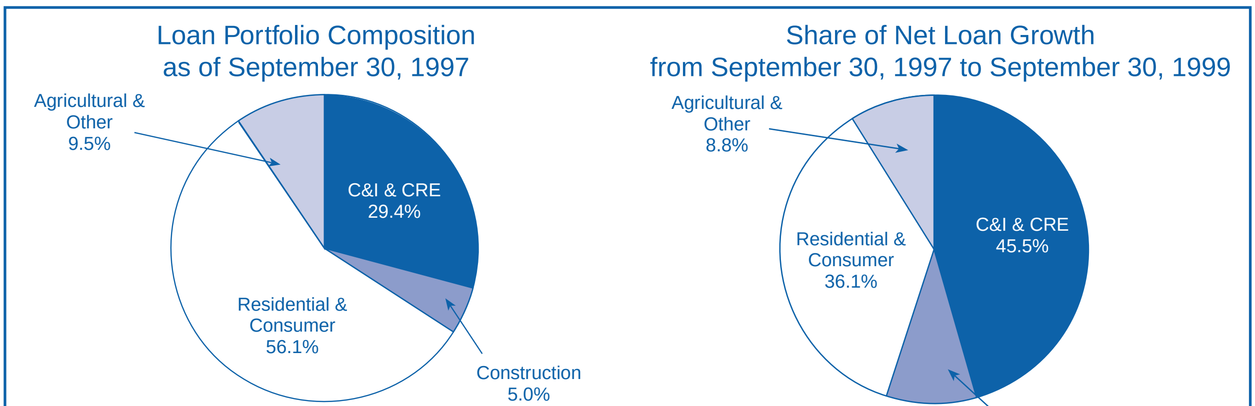
Table 2

Rapid C&I and CRE Loan Growth Increases Exposure

Loan Types	Percent of Total Loans		Average Annual Growth
	Sep 97	Sep 98	Over Period
Commercial	12.9	13.4	12.6
CRE*	16.5	18.9	18.2
Construction	5.0	5.8	19.3
Residential	39.2	37.0	7.3
Consumer	17.0	15.6	5.6
Agriculture	7.9	7.4	6.7
Other	1.6	2.0	23.7

C&I = commercial and industrial; CRE = commercial real estate
* Excludes construction
Source: Bank and Thrift Call Reports

Chart 2



C&I = commercial and industrial
CRE = commercial real estate
Source: Bank and Thrift Call Reports

firms' capital expenditures with repayment expected from the continuing operations of the business rather than from income produced by the property securing the loan. The growth in loans secured by real estate, whether in metropolitan or rural areas, is likely being driven by many of the same factors driving C&I loan growth.

Traditional Asset Quality Measures Remain Favorable

Despite the rapid growth in C&I and CRE loans, and perhaps even partially because of this growth, past-due loan ratios and loan loss rates at most insured institutions remain low. Aggregate C&I past-due loans at community banks were reported at 2.73 percent of total C&I loans as of September 30, 1999, down from 3.09 percent the prior year. C&I loan loss rates rose slightly in 1998, reaching 0.84 percent of average C&I loans. An aggregate C&I loan loss rate of 0.67 percent through the first nine months of 1999 was similar to the rate reported in the first nine months of 1998.[5] Past-due ratios for CRE loans declined in recent years and CRE loan loss rates remain stable.

Improvement in asset quality indicators also is evident for banks with high exposure to commercial lending.[6] Only among the Region's largest banks with concentrations in commercial lending (those with total assets of $1 billion or more) were past-due loan ratios higher in the third quarter of 1999 than in the previous year. Smaller commercial lenders reported a decline in both past-due loan ratios and loan loss rates through the first nine months of 1999. They also reported considerably faster loan growth than other community banks in the Region. C&I and CRE loans among smaller commercial lenders grew at an average of 19.2 percent and 26.3 percent, respectively, over the 12 months ended September 30, 1999.

The rapid growth in C&I and CRE loans, particularly among active commercial lenders, may mask to some extent changes in past-due ratios and loss rates for these loan types. As newly originated loans are unlikely to fail to perform initially, the large volume of new loans in portfolios would tend to lower reported past-due loan ratios and loss rates. As a result, these ratios likely understate credit quality concerns to some degree among institutions reporting rapid growth.

Although reported credit quality measures at insured institutions remain strong, credit concerns with some borrower sectors are rising, as discussed in "Recent Trends Raise Concerns about the Future of Business Credit Quality," ***In Focus.*** Overall, business conditions remain generally favorable; however, some industries face narrowing profit margins, declining cash flow, and rising leverage. These conditions contribute to a higher risk of companies defaulting on debt obligations.

The declining financial condition of certain borrower sectors could result in increased levels of credit risk. A ***Federal Reserve Board*** survey of senior lending officers conducted in mid-1999[7] noted concern for commercial loan portfolios in the event of an economic downturn. One-third of the banks surveyed stated that C&I loan portfolios have become more sensitive to periods of economic weakness. This sensitivity was most often attributed to borrowers' increased financial leverage, borrowers' narrowing profit margins, and previous easing of credit standards.

Regulatory Examinations Indicate Increased Concerns with Asset Quality

One potential indicator of future credit concerns is the increasing number of regulatory examination rating downgrades. Examination ratings are assigned to every institution to quantify supervisory concern. In determining a rating, regulatory agencies consider each institution's risk management practices, as well as performance and condition, during on-site examinations. Composite ratings range from 1, indicating the least supervisory concern, to 5, indicating the highest degree of supervisory concern. In 1998, the number of institutions receiving examination rating downgrades in the Region exceeded those receiving upgrades for the first time since 1990. This trend continued through the first nine months of 1999, with almost twice as many downgrades as upgrades.

[5] Calendar-year annual loss rates are typically higher than annualized loan loss for any partial-year period as many community banks and thrifts recognize a higher volume of loan losses at year-end.

[6] Commercial lenders are defined as institutions with C&I and CRE loans comprising 25 percent or more of total assets.

[7] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices,* August 1999.

The steep decline in the number of upgrades, however, is reasonable given the large number of financial institutions already rated as 1 and therefore not eligible to be upgraded. However, trends suggest rising supervisory concern even if institutions ineligible for either an upgrade or a downgrade are excluded from the analysis.[8] After fluctuating within a relatively narrow range throughout the mid-1990s, rating downgrades as a percentage of institutions eligible for downgrades increased sharply in 1998 (see Chart 3). By September 30, 1999, this ratio reached the highest level reported since 1991. Similarly, the ratio of rating upgrades to institutions eligible for upgrades has declined in recent years and is at its lowest level since 1990.

The majority of recent downgrades represent a change from a 1 to a 2 composite rating. While both ratings represent lower levels of supervisory concern, the shift indicates that examiners are encountering new or rising risk in these institutions. Also, the number of institutions that represent heightened supervisory concern[9] is rising, although remaining well below levels reported in the early 1990s.

The composite rating reflects banks' overall condition and encompasses several component factors; asset quality is but one of these factors. However, asset component downgrades have been typical among institutions with composite rating downgrades in recent years. Since 1997, asset quality component rating downgrades occurred in slightly more than two-thirds of examinations involving a composite rating downgrade. Also, asset quality component rating downgrades occurred at a higher rate than composite rating downgrades, with one in five asset component ratings eligible for downgrade being downgraded in 1998. These trends suggest that although aggregate loan loss rates and past-due loan ratios remain relatively low, examiners are increasingly concerned with how institutions are managing credit risk, the strength of loan underwriting practices, and the potential for future credit problems. Anecdotal evidence suggests that these concerns result largely from banks' efforts to maintain or increase loan volume in the current competitive environment.

Allowance Levels Lag Rapid Loan Growth

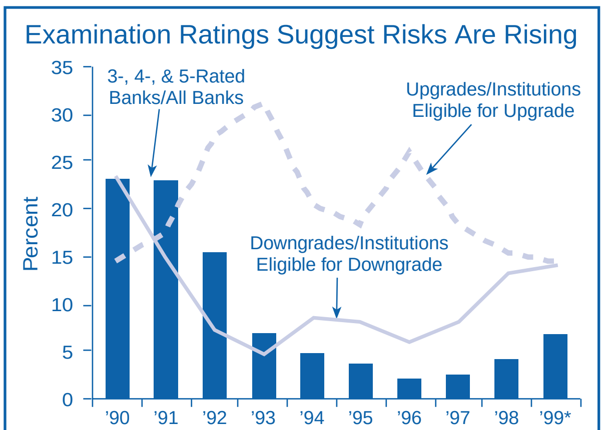
Insured institutions generally have not tempered growing C&I and CRE exposure with larger cushions for loan losses. Allowances for loan and lease losses have fallen in relation to both total loans and noncurrent loans in the Region, particularly among commercial lenders. The average allowance for loan and lease losses at commercial lenders with less than $1 billion in total assets declined to 1.29 percent of total loans, compared with 1.38 percent among other community banks.

The lower allowance level reported by commercial lenders appears somewhat inconsistent with the generally higher volatility in asset quality measures reported by these institutions since the mid-1980s (see Chart 4). While commercial lenders have made provisions for loan losses adequate to absorb actual loan losses in

[8] Because a 1-rated institution cannot receive a higher rating, these institutions are considered ineligible for an upgrade in this analysis. Likewise, a 5-rated institution is considered ineligible for an examination rating downgrade.

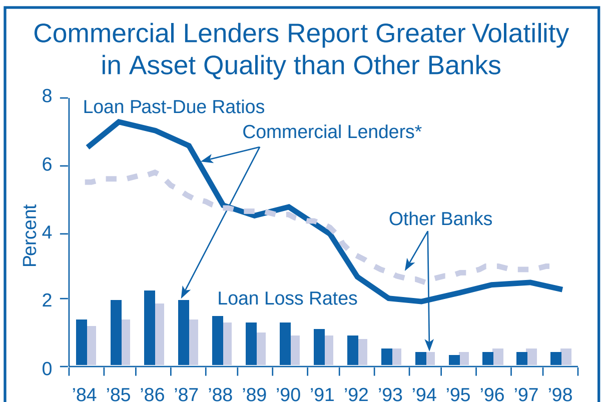
[9] Institutions representing heightened supervisory concern are those with a composite rating of 3, 4, or 5.

Chart 3



* Through September 30, 1999
Source: FDIC Research Information System

Chart 4



* 25 percent or more of total assets in commercial and industrial or commercial real estate loans
Source: Bank Call Reports

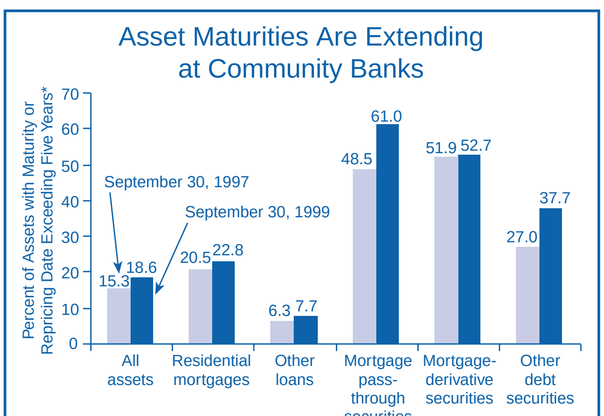
recent years, provisions have not been sufficient to grow allowance levels commensurate with loan portfolio growth. With greater historical variability in asset quality and recent rapid loan growth, some commercial lenders may wish to revisit how well current allowance levels provide a cushion for future potential credit losses.

Market Sensitivity Rises

Rising risk from asset composition changes may not be confined to credit quality concerns, as many banks in the Region appear increasingly vulnerable to changes in interest rates.[10] Banks historically have been funded with short-term liabilities supporting longer-term assets. As a result, bank liabilities reprice more quickly with changes in interest rates. Recently, a shift in asset composition toward longer maturities has increased this liability sensitivity at the Region's banks. The volume of assets with maturities in excess of five years has grown steadily since 1995 and is at its highest level this decade. Without a corresponding extension of funding sources, the lengthening of asset repricing opportunities (see Chart 5) may expose banks to greater risk of economic loss as interest rates rise. At a minimum, the lengthening of asset repricing opportunities highlights the need for strong interest rate risk management practices. Banks have appeared willing to accept increased market sensitivity in exchange for additional yield and improved near-term earnings performance.

[10] This analysis is based on aggregate balance-sheet data for community banks. The market sensitivity of individual banks is largely determined by banks' asset/liability management practices, which may mitigate rising asset or liability sensitivity.

CHART 5



* Mortgage derivatives with average life of three years or more are shown as having a maturity exceeding five years.
Source: Bank Call Reports

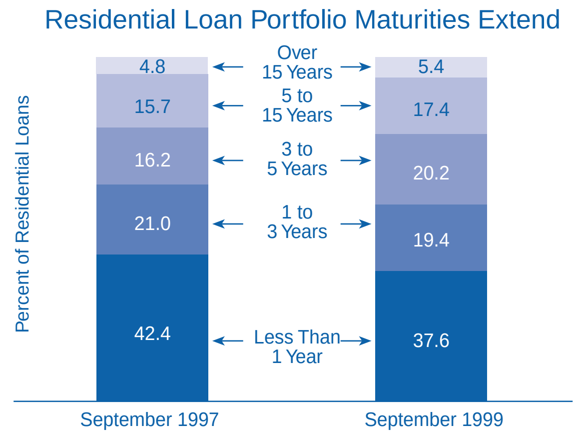
Efforts to improve earnings performance by accepting additional market sensitivity, however, may lead to a compression of NIMs following recent increases in interest rates. As assets and liabilities reprice to the new interest rate environment, funding costs are likely to rise faster than asset yields. Changes in interest rates in the second half of 1999 also have involved a widening of spreads between short- and long-term interest rates, although these spreads remain below ten-year averages. While the widening of the spread should benefit bank earnings, such gains likely will be more than offset by the adverse effects of rising interest rates on liability-sensitive balance sheets.

Residential Lenders' Earnings Could Fall

The earnings performance of residential lenders may be adversely affected by rising interest rates. Residential lending grew as a percentage of total loans among the Region's financial institutions throughout the early and mid-1990s, but residential loan exposure declined slightly in more recent years as banks and thrifts shifted into C&I and CRE loans. Although the relative share of residential mortgages is declining, market sensitivity of mortgage loan portfolios may have increased as institutions shifted to longer maturities or repricing opportunities on such loans. As shown in Chart 5, residential loans maturing or repricing in over five years increased slightly to 22.8 percent of total residential loans from September 1997 to September 1999.

Changes in residential loan portfolios are more pronounced than indicated by the increase in longer-maturity loan volume. Among loans maturing in less than five years, a shift has occurred from loans maturing and repricing within three years to those maturing in three to five years (see Chart 6). While this extension of maturities into intermediate-term time periods does not heighten asset sensitivity to the degree of risk presented by longer-term maturities, it may increase earnings volatility.

CHART 6



Source: Bank Call Reports

Although interest rates remain relatively low, recent increases are dampening mortgage activity. Mortgage interest rates are near their highest levels in two years, with the monthly average commitment rate for a 30-year fixed-rate mortgage up over 100 basis points from levels reported one year ago. The increase in mortgage rates is translating into a slowdown in originations. The ***Mortgage Bankers Association*** estimates that mortgage originations nationally will fall 14.8 percent in 1999 and drop another 23.8 percent in 2000. While slowing housing starts are a factor, the primary cause for lower expected originations is reduced refinancing activity, projected to decline 75 percent in 2000.

Some of the Region's residential lenders may see a greater decline in mortgage activity, as housing starts in certain areas are expected to fall more dramatically than at the national level. Although some MSAs experienced moderate growth in housing permits in 1999, permits in most major MSAs, with the exception of Lexington, are projected by ***Regional Financial Associates*** to drop substantially in 2000. Housing permits in **Jackson, Louisville, Memphis,** Nashville, and **New Orleans** are projected to fall a minimum of 20 percent in 2000; permits for **Biloxi** and **Little Rock** are projected to decline nearly 40 percent in 2000.

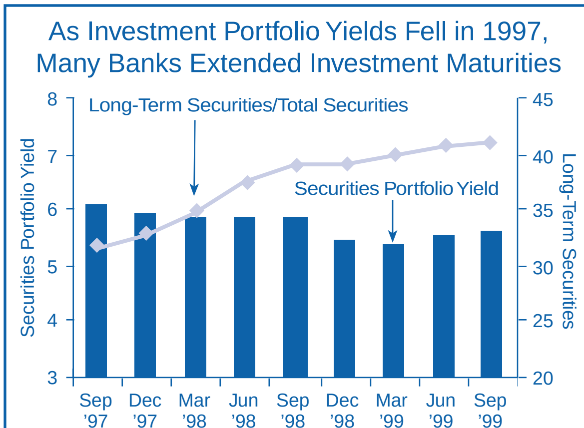
Residential lenders' earnings could also be hurt by lower mortgage activity. Institutions of all asset sizes have become increasingly reliant on mortgage origination fee income, from both loans retained by the institution and those sold into the secondary market. With fewer residential mortgage originations, fee income[11] from this source should decline. Institutions with significant residential lending may reduce pricing or weaken underwriting standards to maintain mortgage origination volumes. Alternatively, some institutions may emphasize or enter business lines with increased credit risk or with which they have limited experience.

Not all changes in mortgage activity will increase market sensitivity among residential lenders. Institutions may be able to reduce risk through the use of adjustable-rate mortgages (ARMs). In recent years, customers have preferred fixed-rate loans to ARMs because of the flatness of the yield curve and historically low interest rate levels. With the increase in rates and some widening of spreads between short- and long-term rates, customers may migrate toward adjustable-rate products. The ***Mortgage Bankers Association*** projects ARM volume to rise from 12 percent of total originations in 1998 to 31 percent in 2000. Institutions may find any repositioning of mortgage portfolios a slow process, however, because of the sharp decline in total originations.

Market Sensitivity in Investment Portfolios Has Increased

Many insured institution investment portfolios exhibit considerable maturity extension. As shown in Chart 5, maturities and repricing opportunities on securities lengthened considerably among community banks during the previous two years. Investment portfolio maturities likely were extended in an effort to stem falling yields on investment securities (see Chart 7) and improve earnings performance. While short-term profitability may have benefited from the extension, bank

CHART 7



Source: Bank and Thrift Call Reports

[11] Mortgage origination fee income is reported as additional loan yield for loans held in institution portfolios and is reported as noninterest income for loans sold into the secondary market.

earnings may be more sensitive to changes in interest rates in the longer term.

With increases in interest rates, the market value of bank investment portfolios has declined sharply.[12] As of September 30, 1998, community banks in the Region reported net *appreciation* equivalent to 3.7 percent of total equity capital. One year later, community banks reported net *depreciation* equivalent to 3.9 percent of total equity. This reversal was widespread among financial institutions, with 92 percent of community banks reporting depreciation or unrealized loss in their investment portfolios as of September 1999 compared with only 4 percent one year ago.

The number of banks reporting high levels of unrealized losses and depreciation is up sharply from previous years. Among the Region's almost 900 community banks, 80 reported unrealized losses or depreciation equivalent to 10 percent or more of total equity capital on September 30, 1999. One year earlier, only one bank reported this high level.

Aggressive lengthening in reinvestment horizons and heavy weighting in mortgage-related debt instruments were common among institutions reporting high depreciation levels. The effects of rising interest rates can be particularly pronounced for mortgage-backed and mortgage-derivative securities. Higher interest rates usually translate into slower prepayments on fixed-rate mortgage loans. As prepayments on the mortgage loans that comprise the source of cash flow for mortgage-related securities slow, these securities often experience a lengthening of their effective maturities. As a result, investors must wait longer to reinvest these funds at the new higher interest rates available on alternative investments, raising interest rate risk.

[12] The decline in market value includes both depreciation in securities designated as held to maturity and unrealized losses on securities designated as held for sale. In either case, the decline in market value represents the present-value recognition of future expected earnings losses resulting from the debt instrument being below market yield.

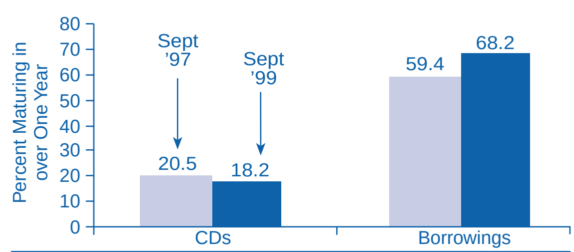
Efforts to Alter Funding Strategies Have Met with Limited Success

Sensitivity to market risk is not merely a function of asset selection, but also encompasses funding strategies and risk management. Increasing competition for deposits has somewhat limited the ability of banks to adjust funding strategies. With weak core deposit growth, many institutions now rely more heavily on alternative funding sources such as brokered deposits and Federal Home Loan Bank advances. In many cases, these alternative funds can be used to offset greater market sensitivity in assets. For example, community banks appear to have used an increasing volume of other longer-term borrowing sources, primarily Federal Home Loan Bank borrowings, to match longer-term assets, such as residential loans (see Chart 8). For additional details on changing funding strategies in the Region, see the ***Memphis Regional Outlook,*** Third Quarter 1999.

Although growing, the use of other borrowing sources remains limited as certificates of deposit (CDs) continue to be the primary source of funding for community banks. In this category, depositor preferences play a significant role in determining maturity and repricing frequency. In recent years, depositors have appeared unwilling to place their funds in longer maturities and the level of short-term CDs has increased. As a result, community bank funding remains short term.

CHART 8

Although Long-Term Borrowings Rise, Short-Term CDs Remain Primary Funding Source



	CDs as Percentage of Total Liabilities	Borrowings as Percentage of Total
Sept '97	51.1	2.5
Sept '99	50.0	3.9

CD = certificate of deposit
Source: Bank Call Reports

The Importance of Risk Management Rises

Recent changes in asset composition affecting credit risk and market sensitivity are prompting institution management to review their institutions' balance sheet positions in line with their own risk preferences. With the current favorable economic and banking environment, now may be an opportune time to perform some level of strategic risk assessment. As a part of this strategic review, managers may wish to consider the strength of internal risk management systems and the adequacy of earnings, allowances for loan losses, and capital positions as a cushion against potential risk. Going forward, managers will need to continue to balance the desire for current period earnings against the need for strong financial condition and performance in the future.

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