Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999

FDIC
MEMPHIS
REGION

DIVISION OF INSURANCE

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In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking*—This article provides an overview of economic conditions and banking industry trends, with a primary focus on potential risks to insured depository institutions.**

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

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

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

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

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

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

By the Analysis Branch Staff

Regional Perspectives

◆ ***Region's Economic and Banking Conditions*—Employment growth in the Region slowed throughout 1998 and is likely to remain slow in 1999 because of continuing tight labor markets, the potential for slowing real estate construction, and the cumulative effects of slowing world economies. Financial institutions reported generally healthy conditions, although earnings performance continues to be hampered by declining net interest margins.** *See page 16.*

◆ ***Effects of Global Weakness in the Region Are Evident in Lower Commodity Prices*—Many farm commodity prices fell dramatically in 1998, eroding some farmers' financial positions and resulting in an increase in past-due agricultural loans. Concerns over the asset quality of agricultural lenders could rise if the outlook for continued low prices in 1999 materializes. The energy, timber, and primary metals sectors in the Region also have been affected by weaker worldwide demand.** *See page 19.*

By the Memphis Region Staff

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Economic Conditions and Emerging Risks in Banking

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

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

Economic Developments

Conditions Have Improved Markedly since Late 1998

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

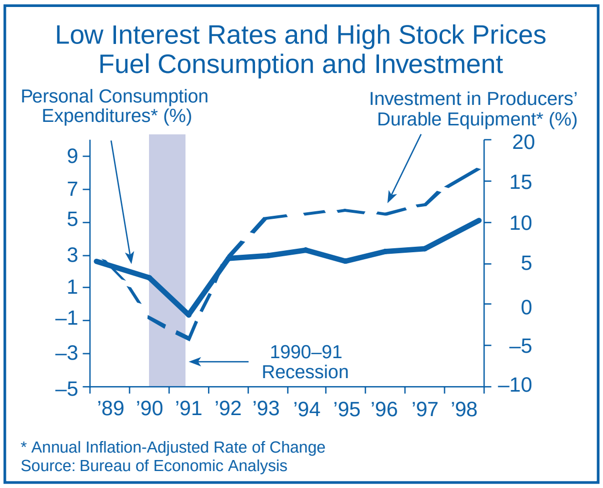
Consumer Spending and Business Investment Are Key to Economic Strength

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

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

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

CHART 1

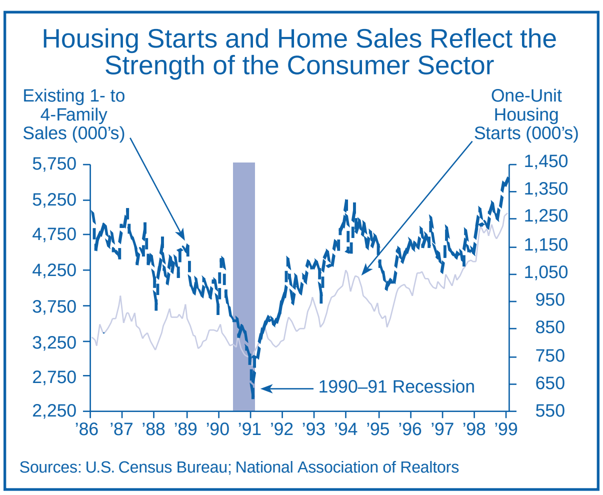


dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached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

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

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

CHART 2



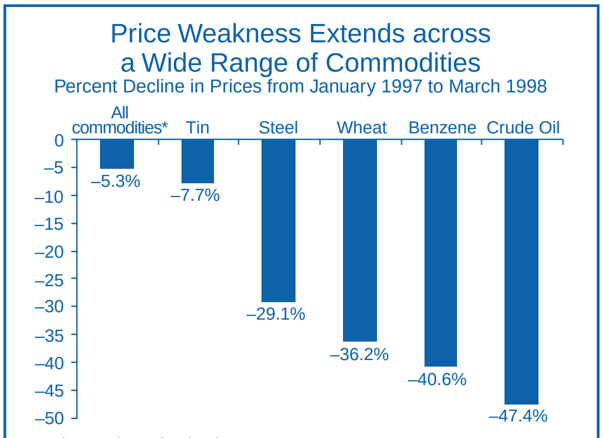
Conditions Vary across Industry Sectors

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

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

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

CHART 3



* Producer Price Index (PPI)
Source: *Journal of Commerce,* Bureau of Labor Statistics

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

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

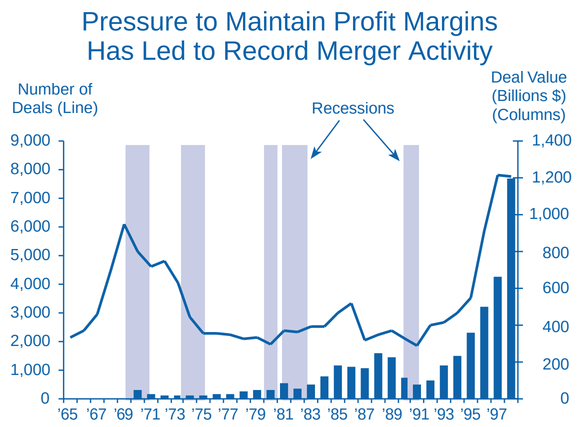
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record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

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

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

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

CHART 4



Source: Houlihan Lokey's Mergerstat

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

The Outlook for the Global Economy Remains Uncertain

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

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

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

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

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

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

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

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

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

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

Risks Remain despite a Positive U.S. Economic Outlook

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

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

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

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

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

Trends Affecting Banking Lines of Business

Overview

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

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

Consumer Lending

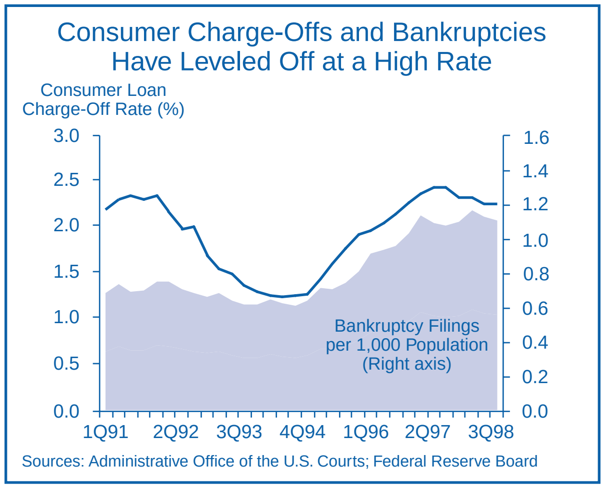
Debt Growth Sustains Consumer Spending but Could Contribute to Financial Strains under Less Favorable Economic Conditions

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

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

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

CHART 5

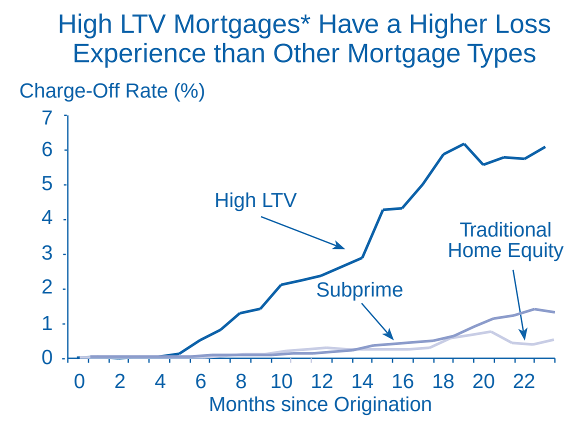


High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

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

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

Chart 6



* Includes home improvement loans
Source: Moody's Investor Services

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

Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

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

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

[6] "Moody's Home Equity Index Update." *Moody's Investor Services*, October 2, 1998, p. 3.

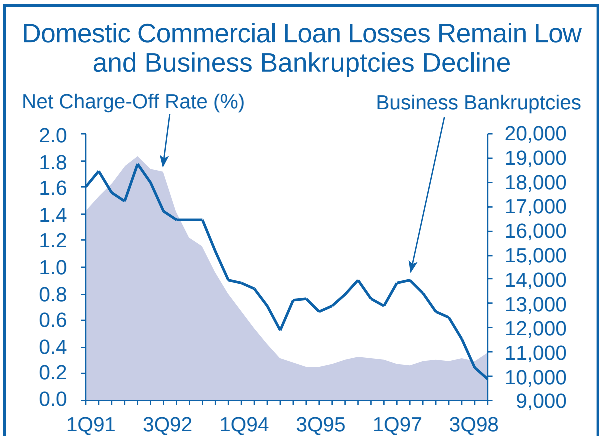
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[8] ***The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index*** indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.

[9] See the ***Bureau of Economic Analysis Corporate Profit Index.***

[10] "Covenants Provide Loan Repricing Opportunity." *Bank of America Report*, January 25, 1999.

Chart 7



Sources: U.S. Courts; Bank Call Reports

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

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

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

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

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

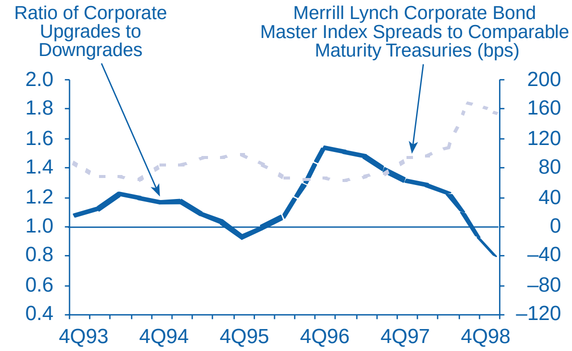
[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

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

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

CHART 8

Corporate Bond Ratings and Required Yields Reflect Greater Market Uncertainty



Sources: Moody's Investor Service; Merrill Lynch

Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

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

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

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

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

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

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

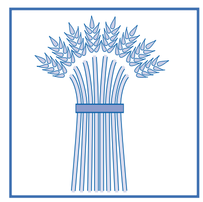
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger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

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

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

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



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

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

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

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

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

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

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

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

Interest Rate Changes Pose Asset/Liability Management Challenges

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

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

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

CHART 9

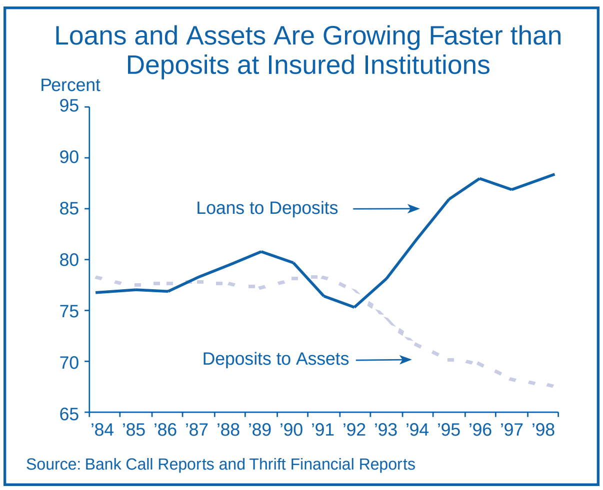
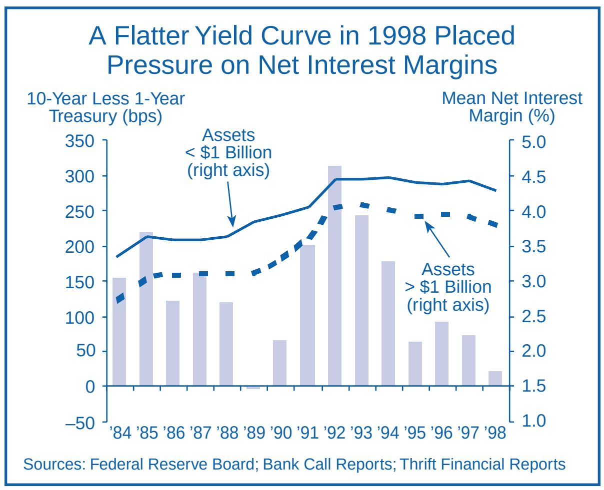


CHART 10



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

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

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

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

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

Bank Performance Remains Strong but Earnings Variability Is Increasing

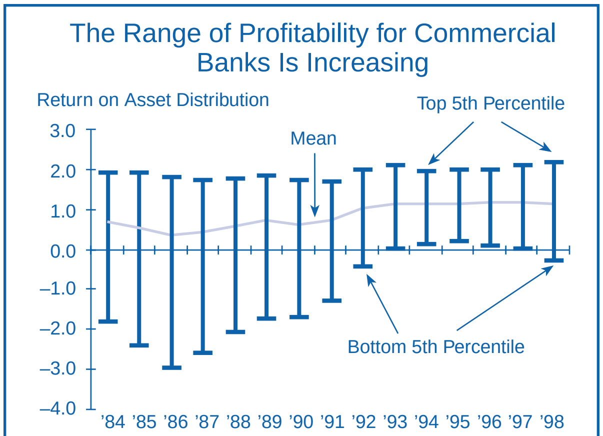
Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent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

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

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

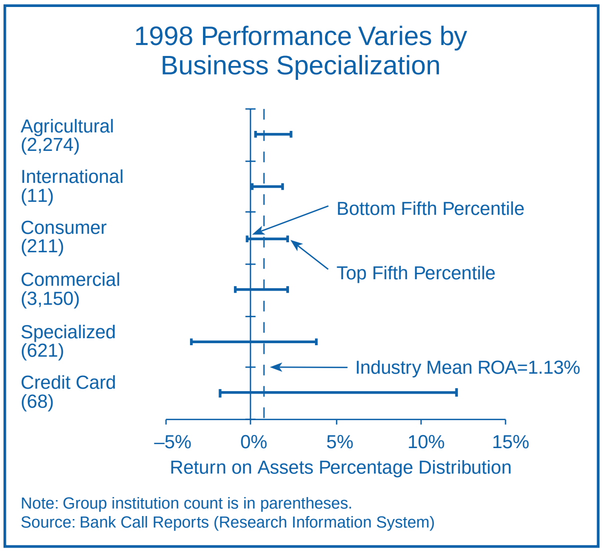
[22] *FDIC Quarterly Banking Profile,* Fourth Quarter 1998, www2.fdic.gov/qbp.

Chart 11



Source: Bank Call Reports

CHART 12



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

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.

[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.

[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.

[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

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

Summary

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

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

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

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

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

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Regional Perspectives

- **Employment growth in the Memphis Region continues to slow. The trend will likely continue throughout 1999 because of continuing tight labor markets, the potential for slowing real estate construction, and the cumulative effects of the economic crises in Asia, Russia, and Brazil.**

- **Banking conditions remain favorable, but earnings performance continues to be pressured by lower net interest margins. Asset quality indicators in 1998 were virtually unchanged from 1997.**

- **Effects of the weaker global economy on the Region are most evident in lower commodity prices. This is particularly true for agricultural producers, but these weaknesses also affect the energy, timber, and primary metals industries.**

Economic Overview

Employment Growth Continues to Slow

Using employment growth as an indicator, the Region's economy, while continuing to grow, is moderating (see Table 1). Year-over-year job growth has lagged behind the national average for the past two years. Employment growth in 1998 was hindered by slowing growth in the important service sector, which represents approximately 25 percent of the Region's total employment, and accelerating job losses in the manufacturing sector. During 1998, the Region lost almost 20,000 jobs in nondurable goods manufacturing, which were only partially offset by a gain of 5,000 jobs in durable goods manufacturing.

Table 1

Employment Growth Continues to Slow (Year-over-Year Percent Change)

	4Q 1997	4Q 1998
Arkansas	2.16	1.55
Kentucky	2.17	2.26
Louisiana	2.66	2.27
Mississippi	2.36	1.35
Tennessee	2.24	1.91
Region	2.32	1.94
Nation	2.72	2.33

Source: Bureau of Labor Statistics

Among the Region's states, only **Kentucky** reported better year-over-year employment growth in the fourth quarter of 1998 than in 1997. Kentucky's economy continues to be driven by strong gains in both **Louisville** and **Lexington;** however, employment growth in both cities has begun to slow. In the first quarter of 1999, Philip Morris announced the closing of its Louisville cigarette manufacturing facility, which will cost the city 1,400 high-paying jobs. The state's economy continues to benefit from strong sales by its automobile industry. Ford Motor Company announced plans earlier this year to build a new and larger sports utility vehicle at its Kentucky Truck Plant. The expansion of the plant is expected to create approximately 1,000 new jobs.

Other states in the Region experienced slower job formation in the fourth quarter of 1998. **Arkansas** and **Mississippi** reported the lowest year-over-year job growth, largely because of continued job losses in the nondurable goods sector and a significant slowdown in service employment growth. **Louisiana** and **Tennessee** also reported job losses in manufacturing. Both states reported stable growth in service sector employment and strong gains in construction-related employment. For the Region, construction employment growth reached 5.8 percent in the fourth quarter. Along with increasing government employment, construction was a major contributor to new job formation in the Region. Construction employment growth, however, could slow in response to slowing demand, as discussed below.

Construction Could Slow in Response to Weakening Demand

Many observers have become increasingly cautious in their views about commercial real estate development in the Region. Development in many metropolitan areas in

1998 was the highest in the past ten years. These high construction levels, coupled with slowing growth, are leading to rising vacancy rates and flattening rental rates for commercial real estate in some metropolitan areas (see also ***Regional Outlook,*** first quarter 1999). The **Nashville** market in particular is showing early signs of potential overbuilding, with office vacancy rates climbing from under 7 percent at the end of 1997 to approximately 10 percent at the end of 1998. Other metropolitan markets, such as the Mississippi Gulf Coast, are showing early signs of slowing supply and demand; construction there has already begun to slow with the maturing of the area's casino industry.

The outlook for commercial development through 1999 suggests additional risks are emerging for local economies and financial institutions. If development continues at its previous fast pace, some markets may become more vulnerable to overbuilding. In such a scenario, banks and thrifts that are active commercial real estate lenders may face elevated risks in their loan portfolios. If development slows in response to waning demand, local employment conditions could worsen with reduced construction employment. Although construction employment typically represents a relatively small segment of overall employment, it has been a significant aspect of recent employment growth in many metropolitan areas.

The residential housing market also is likely to be affected by the slowdown in job formation and slowing net in-migration. ***Regional Financial Associates*** forecasts net in-migration to the Region to decline to 4,300 people in 1999 from a reported 42,400 in 1997. While housing permit numbers continued to increase for most states in 1998, Arkansas reported an 8.2 percent decline in permits through November 1998. Further, ***Regional Financial Associates*** projects a reduction of approximately 25 percent in new residential housing permits for major metropolitan areas in the Region over the next two years, with those in Arkansas being most significantly affected.

Global Weaknesses Continue

Although the Region is less vulnerable to direct trade effects than the nation, weak global economic conditions are adversely affecting some sectors of the Region's economy. According to information from the ***Massachusetts Institute for Social and Economic Research,*** the Region's exports to the world declined 4.7 percent in 1998. This represents the first year of declining exports since 1993. Adding to the slowdown in demand from Asia and Russia, the economic crisis in Brazil has reduced demand for certain manufacturing and agricultural products. Previously, Brazil had been a fast-growing market for the Region's exports. Also, the devaluation of Brazil's currency has made its agricultural products, notably soybeans, less expensive, and thus more competitive, on the world market.

The effects of weaker global demand on the Region are most evident in lower commodity prices, particularly in agriculture, energy, timber, and primary metals. Each of these sectors is discussed in greater detail later in this article. Furthermore, the potential remains for continuing volatility in world financial markets and economies.

Banking Overview

Banking Conditions Remain Favorable

The Region's banks and thrifts reported generally healthy financial conditions as of December 31, 1998, although earnings performance declined. The Region's average return on assets (ROA) ratio was 1.06 percent for the year, down 6 basis points from 1997. Lower net interest margins (NIMs) were the driving factor in lower performance. The average NIM was 4.33 percent compared with 4.47 percent in 1997. The decline in NIMs is primarily attributable to the flat yield curve and increased price competition. Higher levels of noninterest income largely offset an increase in average noninterest expense in 1998.

A continuing trend among the Region's financial institutions is the divergence in earnings performance between large and small institutions. In 1998, the 47 banks and thrifts in the Region with total assets over $500 million reported higher average ROAs than the Region's 988 institutions with less than $500 million in total assets, despite lower NIMs (see Table 2). The stronger earnings performance of the larger banks is attributable to the higher level of noninterest income. Both groups reported similar ratios of noninterest expense to average earning assets.

Table 2

Average Earnings Performance in 1998 Is Stronger at Larger Institutions

	Assets >$500 Million	Assets <$500 Million
ROA %	1.26	1.05
NIM %	4.22	4.34
Noninterest Income/ Avg. Earning Assets %	1.62	1.11
Noninterest Expense/ Avg. Earning Assets %	3.57	3.55

Source: Bank & Thrift Call Reports

Financial institutions reported no significant changes in asset quality during 1998. Average total past-due loans were 2.97 percent of total loans at the end of 1998, comparable to 1997 levels. Within loan categories, commercial and industrial loan past-due ratios increased while consumer past-due ratios fell. Average loan losses in 1998, at 0.41 percent of average loans, were similar to 1997 loan losses.

The composition of financial institution assets shifted in 1998. Loans declined slightly as a percent of total assets for the first time since 1992. Within loan categories, average consumer loan levels continued to decline, while commercial real estate loans increased, particularly at institutions headquartered in metropolitan areas. Average holdings of one- to four-family residential loans declined slightly in 1998 to 28.6 percent of total loans following two years of solid growth. As discussed earlier, some analysts predict a considerable slowdown in the Region's net in-migration and home construction in 1999. As a result, banks and thrifts could experience escalating competition for fewer customers in this important loan category.

Agricultural Conditions

Agricultural Sector Weaknesses Continue in 1999

In 1998 some agricultural commodity prices important to the Region fell to their lowest levels in more than a decade because of abundant worldwide supplies and weaker demand. A strong U.S. dollar also contributed to a decline in agricultural exports. The ***United States Department of Agriculture*** **(USDA)** projects that the value of agricultural exports will fall for a second consecutive year in 1999. Prices for many commodities are expected to remain low, and according to the USDA, some crop prices, such as soybeans and cotton, will likely finish the year well below 1998 levels.

The USDA estimates that net farm income for the nation totaled $48 billion in 1998, down 3.8 percent from 1997 and down 10.0 percent from record results in 1996. The early 1999 forecast is for net farm income to total $44.6 billion, a decline of 16.4 percent from 1996. Both 1998 and 1999 farm income numbers benefit from increased government assistance, including the $6 billion economic assistance package for farmers approved in October 1998.

Net farm income in the Memphis Region in 1998 and 1999 will likely decline more substantially than forecast for the nation as a whole. Farm income in the Region in 1998 was disproportionately affected by dry growing conditions. During 1999, farmers of significant crops in the Region, especially soybeans and cotton, are likely to experience considerably lower cash receipts in addition to scheduled reductions in government payments. The ***USDA Economic Research Service*** projects that farmers in the lower Mississippi delta will be among those experiencing the greatest financial difficulty from 1998 to 2003.

Declining crop prices have not been a problem for all of the Region's agricultural producers. Livestock growers have benefited from lower feed costs. Poultry producers in particular reported considerable improvement in profit margins. Although poultry prices weakened in early 1999, continuing low feed costs should maintain the strong profit margins. Hog and cattle prices improved during 1998, although hog prices remain below the cost of production for most farmers.

Agricultural Lenders Report Higher Past-Due Loan Ratios

Banks with agricultural concentrations[1] remain in generally strong financial condition despite weaknesses in the farm sector during 1998. Reported average leverage capital ratios remain strong at 11.34 percent of assets, and average ROAs remain healthy at 1.21 percent, although they have declined from 1.28 percent in 1997. Agricultural loan losses remain low and reflect the strong financial condition of most farmers at the beginning of 1998, following high net farm income in 1996 and 1997. Certain other asset quality indicators, however, are showing the effects of lower commodity prices and poor crop production in 1998.

- *Total past-due agricultural loans are rising and equaled 2.43 percent of agricultural credits at year-end 1998, up from 1.92 percent at the end of 1997.* Although this level remains manageable, it is the highest reported by agricultural lenders since 1992, as shown in Chart 1 (next page). Driven by increases in past-due agricultural loans, total past-due loan ratios also rose in 1998.
- *Carryover debt[2] is increasing.* Anecdotal evidence from examinations, examiner surveys, and discussions with agricultural lenders in the Region suggests a moderate increase in carryover debt at the end of 1998. Carryover debt could increase further given the potential for another difficult year for farmers in 1999. Significant increases in carryover debt could not only impair asset quality but also lead to a tightening of agricultural banks' liquidity levels. Funding, liquidity, and related interest rate risk for all banks and thrifts in the Region, including agricultural lenders, will be further explored in the ***Regional Outlook,*** third quarter 1999.

As farmers are vulnerable to economic and weather effects, increases in carryover debt in any single year do not necessarily represent significant increases in risk for lenders. Greater concern arises, however, when the

[1] Defined as banks with 25 percent or more of total loans in agricultural production loans and loans secured by farm real estate. As of September 30, 1998, 121 banks in the Region met this definition, with $8.6 billion in total assets.

[2] Carryover debt discussed here describes situations in which farmers had insufficient cash flow to repay crop loans from the previous year, so the unpaid balance was added to the next year's crop production loan.

Chart 1

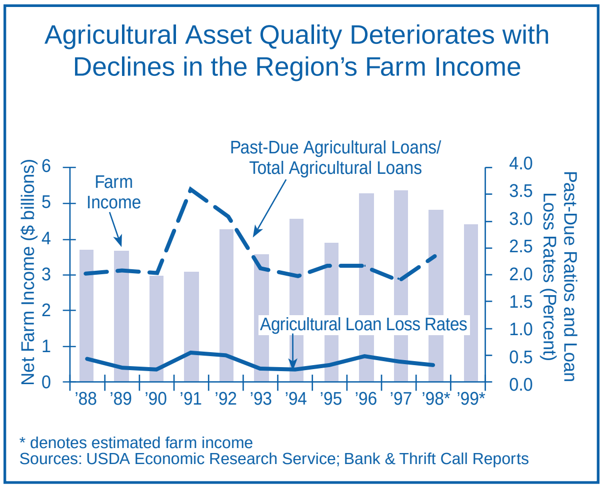
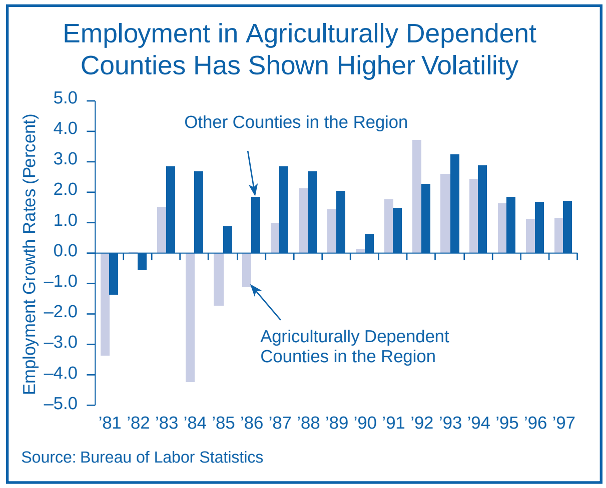


Chart 2



trend continues for longer periods. As shown in Chart 1, 1990 and 1991 represent two consecutive years of declining farm income preceded by two strong years. Past-due agricultural loans and agricultural loan losses at the Region's agricultural banks were unaffected in 1990 but rose substantially in 1991, the second consecutive year of lower farm income. Average past-due and nonaccrual agricultural loan ratios rose to 3.62 percent, and agricultural loan loss rates more than doubled to 0.55 percent. This downturn in farm income coincided with an overall economic downturn, which likely contributed to farmers' financial difficulties.

By comparison, declining farm income in 1998 and projected declines for 1999 follow strong years in 1996 and 1997. Although agricultural loan losses remained flat in 1998, past-due ratios for agricultural loans rose, signaling greater potential for higher losses in 1999. If farm income experiences a two-year decline similar to that of 1990 and 1991, the Region's agricultural lenders will likely experience a considerable decline in asset quality.

Lower Farm Income May Affect Other Insured Institutions in the Region

Low commodity prices and last year's poor growing conditions are affecting not only banks with agricultural loan concentrations but also commercial banks that do not have high agricultural loan concentrations but are located in agriculturally dependent counties.[3]

Economic conditions in agriculturally dependent counties historically have been more volatile than in other counties. While employment growth in these counties has closely trailed growth in other counties in the Region in recent years, agriculturally dependent counties have shown greater volatility in prior periods (see Chart 2). This volatility is most evident in sustained periods of declining farm income such as during the early and mid-1980s and the 1990 to 1991 period.

Similarly, per capita personal income growth for agriculturally dependent counties has shown greater variability, although it averaged slightly higher than for other counties from 1980 to 1996. Not surprisingly, per capita income in agriculturally dependent counties fluctuates with changing farm income levels. In every year[4] of declining farm income since 1980, the growth in per capita income for these counties has underperformed that of the remainder of the Region.

One stabilizing factor for agriculturally dependent counties is the high average level of transfer payments (e.g., Aid to Families with Dependent Children) in these counties relative to total income. According to the most recently available information, transfer payments represent 20 percent of personal income for the Region and 24 percent of personal income for agriculturally dependent counties. Transfer payments in these counties could be less of a stabilizing factor in the future as state governments continue to adjust their assistance programs.

[3] Agriculturally dependent counties are defined in this article as those with at least 15 percent of employment in agriculture.

[4] Farm income in the Memphis Region has declined in eight of the years since 1980.

Consistent with overall industry consolidation trends, the number of commercial banks in agriculturally dependent counties in the Region decreased from 406 in 1988 to 300 in 1998. As of December 1998, these banks hold 11.7 percent of the Region's total assets. These banks reported strong financial conditions with an average leverage capital ratio and ROA of 11.03 percent and 1.13 percent, respectively.

Farmland Values May Weaken

Although the USDA projects that overall farmland values will increase in 1999, weaknesses in the sector may begin to place downward pressure on land prices. Early indications of falling land values already have been reported in portions of some states in the Midwest. Declining land values indicate expectations of at least several years of lower farm incomes in the near future.

The value of Memphis Region farmland is more responsive to periods of longer term financial stress in the agricultural sector than to one-year variations. Area farmland values rose steadily throughout much of the 1990s despite one-year declines in farm income such as those reported in 1993 and 1995. However, **Mississippi, Arkansas,** and **Louisiana** reported declining average farmland values following the two-year period of lower farm income at the beginning of the decade. With the 1998 to 1999 period expected to represent another two-year period of lower farm income, land values could follow a similar pattern. Falling land values could erode collateral protection for banks as well as a primary source of farmers' net worth. Some farmers may have difficulty arranging financing in the coming years because of the combination of lower farm income, reduced collateral values, and declining net worth. Farmers nearing retirement may be unwilling to "farm on their equity" and could place their farms for sale, adding to the downward pressure on land values.

Some Farms Face Additional Debt Burdens

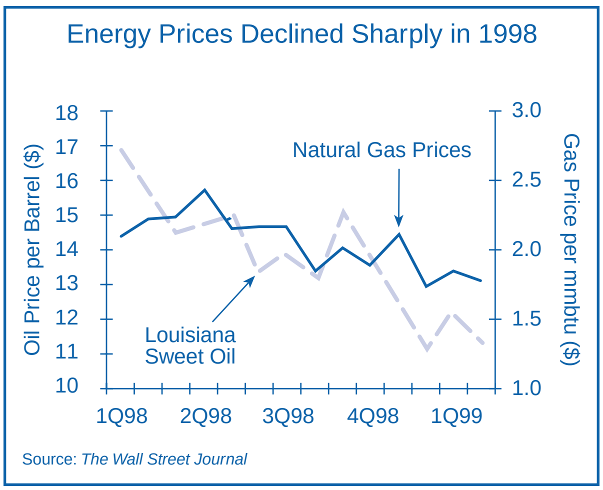
Some farmers may soon find themselves struggling to repay debt that was written down ten years ago through what were called "shared appreciation agreements." These agreements allowed farmers facing debt repayment problems to have the debt written down by the ***Farm Service Agency*** (formerly the Farmer's Home Administration); but the agreements provide for the possible recapture of the portion written down. The recapture amount is based on appreciation in the value of farmland securing the agreements during the subsequent ten years. These agreements first became available in 1989, and appraisals will be performed on the land securing these agreements this year. In cases where there has been a substantial appreciation in land values, the recaptured debt could add to the financial stress of farmers who are already feeling the effects of a weak farm economy.

According to the ***Farm Service Agency,*** approximately 1,700 farms in the Region currently are covered by these agreements, with two-thirds being subject to recapture in 1999 and 2000. Although the exact amount of the recaptures cannot be determined until appraisals are completed, the amount of debt previously written off in the Region totaled $271 million. Farmers in Arkansas, Mississippi, and Louisiana hold the majority of these agreements.

Lower Energy Prices Dampen Louisiana's Economy

Declining oil and gas prices in 1998, shown in Chart 3, led to a slowdown in Louisiana's energy sector. During 1998, the industry lost 3,000 jobs, mostly in **New Orleans, Houma,** and **Lafayette.** The state's rotary rig count, which provides an indication of production levels, also fell substantially, from an average of 216 in January to 147 in December. The drop in prices adversely affects more than oil and natural gas extraction employment in Louisiana, as the energy sector drives many supporting service and manufacturing sector jobs.

CHART 3



Energy prices rebounded somewhat in early 1999, and many analysts expect prices to remain stronger throughout the year. Higher prices should benefit energy sector employment. However, possible further slackening in worldwide demand and the potential inability of the ***Organization of Petroleum Exporting Countries*** to affect prices through production quotas create some uncertainty in the forecasts for higher prices. Even with a sustained recovery in energy prices, Louisiana could experience additional job losses as energy companies strive to improve their ability to compete by reducing costs.

Louisiana is less dependent on the energy sector now than in the past[5] (see ***Regional Outlook,*** second quarter 1998). Nonetheless, energy remains a significant component of the state's overall economy and is concentrated in the coastal parishes, where effects may be more pronounced. In these parishes, declining energy sector employment could compound concerns resulting from declining manufacturing employment and lower farm income. Financial institutions operating in these areas could begin to see declining loan demand and deteriorating quality in segments of their loan portfolios.

[5] Oil and gas extraction represented 14.6 percent of gross state product (GSP) in 1996 compared with 30.7 percent of GSP in 1981.

The Timber Sector Is Weakening

Despite the favorable effects of strong housing starts nationally in 1998, the sale of timber and timber-related products has been adversely affected by weaker global demand. Historically, the United States has been a heavy exporter of such products to Asian nations, principally Japan. The slowdown in exports to these nations has led to increased domestic inventories and lower timber prices. According to ***Random Lengths,*** a timber industry trade publication, the average annual price per thousand board feet of framing lumber declined from $417 in 1997 to $349 in 1998.

Within the Memphis Region, timber-related employment is concentrated in southwestern **Arkansas,** northwestern **Louisiana,** and much of **Mississippi.** This employment is primarily in the lumber industry, with 121,512 jobs reported in 1997, and the pulp and paper industry, with 70,259 jobs reported in 1997. The lumber industry has reported generally positive employment growth in recent years largely because of increasing demand resulting from higher housing starts. Employment growth in paper and allied products has steadily declined since 1992. In 1996 and 1997, job losses were reported in the industry. The slowdown in pulp and paper stems from industry overcapacity and increasing competition that existed before the slowdown in global economies.

In response to slackening worldwide demand, some lumber and pulp and paper layoffs were announced in the second half of 1998, mostly in Louisiana. The companies announcing layoffs ranged in size from large pulp and paper manufacturers, such as ***International Paper Corporation,*** to local sawmills. If prices of timber products remain low, this trend is likely to continue.

Both industry segments show significant vulnerability during economic downturns. The lumber industry is more cyclical than pulp and paper because of the close relationship of lumber demand and construction activity. During the last recession, for example, lumber employment in the Region declined by 2.8 percent.

The Region Is Coping with Lower Metal Prices

The U.S. primary metals industry[6] experienced a significant decline in overall prices during 1998 because of weakening worldwide demand, increased competition, and rising inventories. Aluminum cash prices, for example, declined approximately 25 percent, and scrap steel prices declined even more substantially.

The primary metals industry employs approximately 54,000 people in the Region. These jobs are concentrated in **Kentucky, Tennessee,** and eastern **Arkansas.** The industry contributes 0.9 percent of gross state product (GSP) in Tennessee and roughly 1.7 percent of GSP in both Arkansas and Kentucky.

Anecdotal evidence suggests that low prices resulted in stagnant employment growth in the Region's metal-producing industry. Recent industry news in the area, however, is generally positive, with expansions and new hiring plans being announced. The local primary metals industry possesses a competitive advantage over other metal-producing areas of the country because of lower labor costs and generally newer and more efficient production facilities. These factors should provide greater employment stability to the Region's primary metals sector than in the industry nationwide.

Memphis Region Staff

[6] The primary metals industry includes, but is not limited to, steel, copper, nickel, cobalt, zinc/cadmium, and aluminum.

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