Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION SECOND QUARTER 2000

FDIC
MEMPHIS
REGION

Regional Perspectives

◆ *Economic and Banking Conditions*—Employment gains in 1999 were centered in the urban-based service sector with the rural-based manufacturing sector reporting job losses. *See page 3.*

◆ *Agriculture in the Mississippi Delta May Struggle*—With a third consecutive year of low commodity prices, farm financial conditions in the Region may deteriorate. Farmers in the Mississippi Delta are expected to be among the most severely affected. *See page 6.*

◆ *Uncertainties Rise for the Region's Tobacco Economy*—Recent changes in the tobacco sector, primarily sharply lower demand, could affect farmers and communities dependent on tobacco production. *See page 9.*

By the Memphis Region Staff

DIVISION OF INSURANCE

GARY L. BEASLEY,
REGIONAL MANAGER

HARRY W. JOHN,
REGIONAL ECONOMIST

ROBERT L. BURNS,
SENIOR FINANCIAL
ANALYST

F. MIGUEL HASTY,
FINANCIAL ANALYST

In Focus This Quarter

◆ *Banking Risk in the New Economy*—This article summarizes current economic conditions, with a primary focus on potential risks to insured depository institutions. It explores the implications of long-term trends that have led to the *New Economy.* Recent high rates of economic growth with low inflation have been made possible by increases in productivity arising from new technologies, higher investment spending by businesses, and large-scale industrial restructuring. Underlying these trends has been a financial environment that has largely accommodated the growing borrowing needs of consumers and businesses. Market-based financing, provided in large part through securitizations and mutual funds, has made capital readily available to start-up "new economy" firms as well as mature companies that seek to merge or restructure. Despite the clear benefits of market-based financing in supporting economic activity, there are also concerns. A recurrence of financial market turmoil, such as that experienced in fall 1998, has the potential to quickly change the currently positive economic outlook to one that is far more challenging. Detail is provided on commercial credit quality, market sources of revenue, and other risks to watch in banking. *See page 15.*

By the Analysis Branch Staff

A Publication of the Division of Insurance

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, FJ, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Memphis Region's ***Regional Outlook,*** please call Gary Beasley at (901) 821-5234 or send an e-mail to *gbeasley@fdic.gov.*

Economic and Banking Conditions

- **Although moderating, employment growth led to the lowest unemployment rate of the decade at year-end 1999.**
- **Urban areas are outperforming their rural counterparts on the strength of the services sector.**
- **Banking conditions remain favorable; growth, although slowing, remains concentrated in commercial lending.**

Memphis Region's Unemployment Rate Is the Lowest in a Decade

The Memphis Region experienced generally favorable economic conditions during 1999, although employment growth lagged the nation for the fourth consecutive year, and some sectors outperformed others. The Region's average unemployment rate of 4.5 percent in 1999 is the lowest in a decade and only slightly above the national average of 4.2 percent.

More than 130,000 new jobs were added to the Region's workforce in 1999, an increase in total employment of 1.5 percent. The services sector added more people to employment rolls than any other sector in the Region, followed by retail trade (see Chart 1). Growth in these sectors reflects the ongoing strength of the booming national economy and robust consumer spending.

The Region's manufacturing sector lost jobs in 1999, with the decline in nondurable goods manufacturing continuing a longer-term trend (see Chart 2). Durable goods manufacturers continued to add jobs, benefiting from strong housing and commercial building markets. In addition, strong consumer spending stimulated the transportation equipment sector, boosting regional car, light truck, and auto parts producers. These gains were more than offset by weakness in nondurable manufacturing, however. In this segment, apparel and textile manufacturers accounted for more than one-third of all job losses, with chemicals and allied products and textile mill products companies accounting for a smaller share. Nondurable manufacturing job losses were concentrated in **Tennessee,** which accounted for over 50 percent of the decline in the Region's total nondurable jobs, and to a lesser extent **Kentucky** and **Mississippi.**

CHART 1

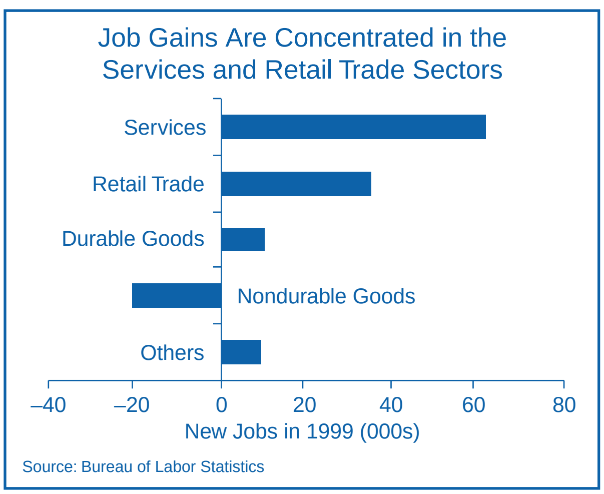
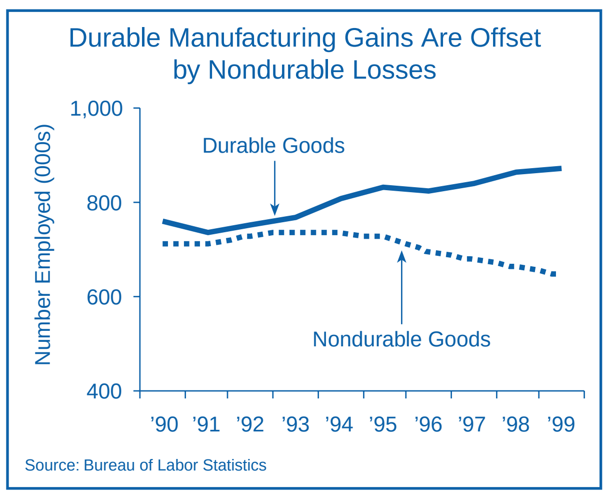


CHART 2



Disparities Grow between Urban and Rural Areas

The strength in urban-concentrated services employment compared with weaknesses in rural-based manufacturing (see Charts 3 and 4) has contributed to a growing economic disparity between urban and rural areas. While metropolitan areas reported an average unemployment rate of approximately 3.5 percent at year-end 1999, the average unemployment rate for rural counties was 5.4 percent. Furthermore, slightly over 10 percent of the Region's rural counties reported an unemployment rate that was more than double the national rate at year-end 1999.[1] Likewise, urban areas have reported much stronger job growth during the previous five years. This is a reversal from the first half of the 1990s, when rural areas reported robust job growth. Per capita income levels in urban areas also have risen much more rapidly than in rural areas in recent years.

Many people in the rural labor force depend on the manufacturing sector because of the relatively lower skill level required compared with the technical skills needed for many service-sector jobs. These lower-skilled, labor-intensive jobs historically have been a significant source of economic opportunities for many rural area residents. In recent years, however, plant closures, particularly in the apparel and textiles industry, have resulted in an increasing number of layoffs in rural areas.

The outlook for the apparel and textile industry is not favorable. Although industry analysts expect job losses to moderate after the weaker plants cease operations, producers will continue to move facilities offshore to take advantage of lower wages. The industry followed a similar trend decades earlier when it relocated from New England to the South to reduce labor costs. Continued plant closures and job losses could exacerbate already poor economic conditions in these rural areas, many of which also face poor agricultural conditions. Moreover, ongoing plant closures in many rural areas and continued economic vitality in metropolitan areas, spurred by strength in the services, retail, and construction sectors, will likely widen the gulf between rural and urban areas.

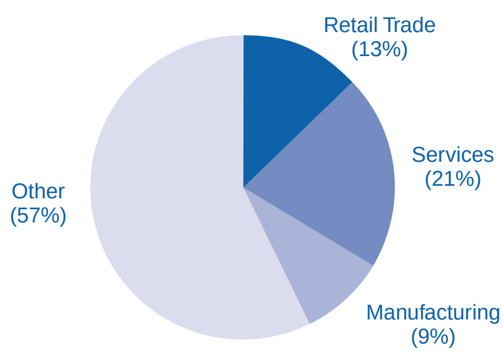
The disparity between urban and rural areas of the Region also is apparent in bank growth. Over the previous three years, banks headquartered in metropolitan areas[2] reported much stronger loan and core deposit growth than their counterparts in rural areas. Average annual growth during the period in both categories was approximately 65 percent higher in urban institutions.

Insured Financial Institution Performance Remains Favorable

The Region's banks and thrifts reported generally favorable financial conditions at year-end 1999. Capital levels remain strong. Asset quality indicators remain

CHART 3

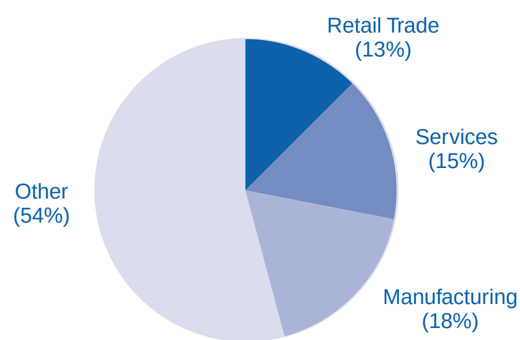
Urban Areas Benefit from the Strong Services Sector...



Source: Bureau of Labor Statistics

CHART 4

...While Rural Counties Are More Dependent on Manufacturing



Source: Bureau of Labor Statistics

[1] Bureau of Labor Statistics, seasonally adjusted.

[2] This merger-adjusted analysis included only institutions with less than $500 million in total assets that were in operation for the entire period reviewed.

generally positive, although some deterioration occurred in agricultural production loans, with continuing weaknesses in the sector. Earnings performance trends at year-end, although slightly lower than year-ago levels, showed some improvement over results reported in previous quarters. The median return-on-assets ratio among the Region's financial institutions in 1999 was down 5 basis points to 1.10 percent.

Overall asset growth among the Region's institutions slowed in 1999, although aggregate loan growth moderated only slightly. The modest slowing in loan growth was driven by slower growth among larger institutions in the Region. Institutions with less than $500 million in total assets reported accelerating loan growth. Strong demand for commercial real estate and commercial and industrial loans continued to drive growth among institutions of all asset sizes (see ***Memphis Regional Perspectives,*** first quarter 2000). Conversely, residential loan originations slowed with rising interest rates.

Memphis Region Staff

Agriculture in the Mississippi Delta May Struggle

- **Nationally, low commodity prices continue to plague the farm sector.**
- **The outlook for agriculture in the Mississippi Delta is more pessimistic than the outlook for the nation.**
- **The Region's agricultural lenders face potentially greater concern about credit quality in 2000 and 2001.**

The Farm Sector Faces Continued Weaknesses

Many segments of the nation's agricultural sector will likely experience a third consecutive year of sustained low commodity prices in 2000 that will further stress farm financial conditions. The ***U.S. Department of Agriculture (USDA)*** projects net cash income for the farm sector to drop $9.3 billion in 1999 to a total of $49.7 billion. This projection, if realized, would be approximately 10 percent below the average for 1990–99 and the lowest level since 1986.

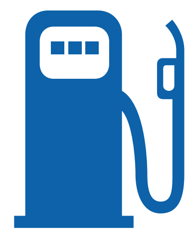
The projected drop in farm income is not evenly distributed across all farm sectors or all farm geographies. Weaknesses are centered in crop production, with receipts forecast to be the lowest since 1994. As discussed later in this article, the USDA projects farm income in the Mississippi Delta and eastern Kentucky and Tennessee to be among the hardest hit in the nation.

Estimated farm income for 2000 could be revised upward by any additional emergency funding approved by the federal government.[3] Government assistance, including emergency funding, was crucial in stabilizing farm incomes in 1998 and 1999. Direct payments to farmers in 1999 were the largest in history, in both nominal and real terms.

Some Macroeconomic Trends May Add to Farmers' Financial Stress in 2000

Overall economic conditions remain positive, but two trends may further stress farm financial conditions. Interest rates and fuel prices, both significant costs for farmers, rose during 1999 and the first quarter of 2000.

Although interest rates remain relatively low, borrowing costs have climbed as the Federal Reserve increased the Federal Funds rate by 100 basis points in 1999. With continued emphasis on curbing inflationary pressures, the Federal Reserve raised rates an additional 25 basis points in the first quarter of 2000. As new production loans are made at higher rates and as real estate loans reprice on renewal, interest expenses and debt service requirements for farmers will rise. Higher interest rates may also negatively affect farmland values, which tend to be inversely correlated with changes in interest rates in much the same way as other income-producing real estate.



Fuel costs also have climbed. Domestic oil prices have soared from under $12 per barrel at the beginning of 1999 to almost $30 per barrel at the beginning of the planting season in 2000. Although fuel costs are a smaller component of total expenses than interest expense, at approximately 4 percent of cash expenses, the dramatic spike in prices will negatively affect net farm income.

Problems for Memphis Region Farmers Are Likely to Worsen

The financial condition of the Region's farmers is weakening. The USDA projects that the Mississippi Portal and the Eastern Uplands[4] of the Memphis Region will be among the most adversely affected areas of the nation in 2000 and 2001. Concerns in the Eastern Uplands largely relate to changes in the tobacco sector, discussed more fully in the ***Regional Perspectives*** article "Uncertainties Rise for the Region's Tobacco Economy." Potential problems in the Mississippi Portal stem

[3] The current forecast does include emergency funding that was previously appropriated as well as estimated transition payments under the Federal Agricultural Improvement and Reform Act of 1996 and projected loan deficiency payments.

[4] The Mississippi Portal is a resource region defined by the USDA to include Mississippi, Louisiana, western Tennessee, and much of Arkansas. The Eastern Uplands are defined to include eastern Tennessee and eastern Kentucky.

from the heavy concentration of cotton, rice, and soybean production in the area and financial stress resulting from the combination of low commodity prices, disease, and poor growing conditions in recent years.

Specifically, the USDA projects the following:

- The Mississippi Portal will experience the largest drop in average net cash income in the nation over the next two years, with expected declines of 39 percent in 2000 and an additional 30 percent in 2001.

- Along with the Southeast, the Mississippi Portal will report the largest increase in the number of farms with negative cash flows.

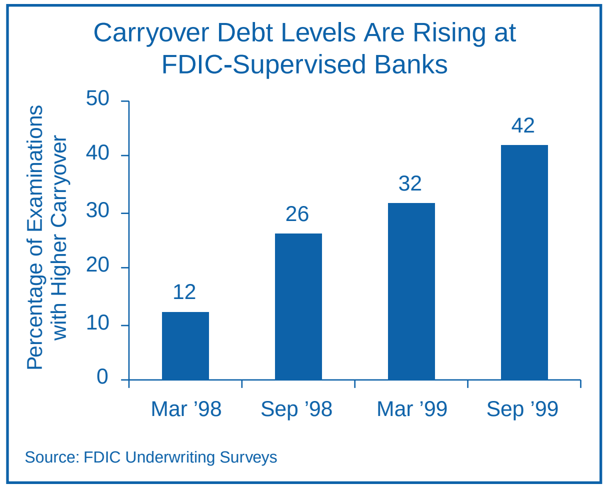
- Twenty percent of farm businesses in the Mississippi Portal will experience debt repayment difficulties in 2000, which would represent a substantial increase from prior years and the highest level anywhere in the nation.

Weather also is a perpetual concern for the agricultural sector. Moisture levels in some southern states, **Louisiana** in particular, were extremely low at the beginning of the year. This delayed some plantings and forced a rotation in some areas from corn to soybeans and cotton, which are planted roughly one month later, as farmers waited for rain. Long-term weather forecasts project dry growing conditions in the area to persist throughout 2000.

Credit Weaknesses Emerge in Agricultural Production Lending

Weaknesses in agriculture have led to rising credit concerns in the Region. One indicator of potential credit problems in the agricultural sector is the increasing level of carryover debt—annual crop production loans that cannot be repaid because of cash flow shortages and that are "carried over" into the following year's crop production loan. Historically, prolonged periods of increased carryover debt preceded periods of sharply higher loan losses. As shown in Chart 5, examiners[5]

CHART 5



throughout the nation are encountering more agricultural lenders with either moderate or sharp increases in carryover debt.

Total agricultural past-due loans and loan loss rates in the Region have risen only modestly over the previous two years; however, production loan performance measures are cause for greater concern. Among banks with agricultural loan exposure,[6] agricultural production loan past-due levels and loss rates grew steadily in 1998 and 1999, compared with averages reported over the previous five years (see Table 1, next page). This deterioration in agricultural production credits is largely masked by improvement in agricultural real estate loan performance when viewing total agricultural past-due and loan loss rates.

A combination of factors contributes to the stronger performance of farm real estate loans. Some borrowers, especially small farmers, have greater incentive to remain current on farmland real estate loans, as the mortgages often include their homes. More important, in the Mississippi Delta, the owner of farmland is often not the person who farms the land. Leasing arrangements are common and sharecropping is still used in some areas, and landowners are likely ensuring that lease payments are received before other payments are made from farm cash flows. Also, many landowners not actively engaged in farming have other sources of income that can be applied toward debt service on farm-

[5] FDIC, *Report on Underwriting Practices.* Determined from underwriting surveys completed with examinations of FDIC-supervised banks. The information shown in Chart 5 represents the percentage of agricultural lenders examined during the preceding six months at which the level of carryover debt had increased from the previous examination.

[6] Calculated on a merger-adjusted basis for a constant group of 290 banks in the Memphis Region with more than 10 percent of loans in agricultural loans.

Table 1

Agricultural Past-Due Loans and Loan Losses Rise at Banks with Agricultural Loan Exposure

	1993–97	1998	1999
Total Agricultural Loans			
Past-Due Ratio	2.06	2.31	2.11
Gross Losses Ratio	0.26	0.25	0.29
Agricultural Production Loans			
Past-Due Ratio	2.14	2.56	2.69
Gross Losses Ratio	0.40	0.48	0.56
Agricultural Real Estate Loans			
Past-Due Ratio	2.00	2.10	1.68
Gross Losses Ratio	0.13	0.05	0.07

Source: Bank Call Reports

land. As a result, weak commodity prices may not immediately affect all farmland owners.

However, the longer depressed crop prices persist, the more likely it is that lease values for farmland will weaken. A sustained decline in lease prices would likely lead to a drop in land values. The growing number of farmers either voluntarily leaving the sector because of poor economic prospects or being forced to exit through liquidation also may pressure farmland values. If lease income or land values weaken, the performance of farm real estate loans could follow the same trends currently exhibited by agricultural production loans.

Risks to Agricultural Lenders Are Likely to Rise

Agricultural loan problems could worsen in 2000 and 2001 as farm conditions in the Mississippi Delta deteriorate. Current negative trends underscore the need for strong loan portfolio management. Underwriting standards will take on added importance as lenders receive an increasing number of loan applications from less creditworthy borrowers. Banks' credit administration and loan review functions may require additional attention if existing loan portfolios experience rising delinquencies.

Lenders in many Mississippi Delta communities face additional economic and demographic hurdles. With off-farm employment opportunities a major factor in the continuing economic viability for many smaller farms, weaknesses in manufacturing sector employment may stress some rural communities. Also, many areas in the Mississippi Delta are losing population as people move to more economically vibrant areas of the nation. These trends could eventually have significant structural implications for many Mississippi Delta communities and the financial institutions serving them.

Memphis Region Staff

Uncertainties Rise for the Region's Tobacco Economy

- **Many rural areas in Kentucky and Tennessee remain dependent on tobacco, a sector under considerable external pressure.**

- **Recent events point to a potential decline in the tobacco farm economy.**

- **Banks in tobacco-dependent areas face potential credit quality problems, strategic planning issues, and funding concerns.**

While agricultural lenders throughout the nation face considerable anxiety over the outlook for farming, perhaps the greatest degree of uncertainty exists in the tobacco sector, and nowhere is this more apparent than in Kentucky and Tennessee. As with agriculture generally, these uncertainties affect not just farmers, but also their communities and banks operating in these communities.

Three major changes related to tobacco farming occurred in the first quarter of 2000. Two have significant implications for the entire tobacco farming sector, while the third affects only the Region's tobacco growers.

- On February 1, 2000, the USDA announced a historic reduction in the amount of tobacco that can be sold over the next year.

- In early February 2000, tobacco product manufacturers proposed a pilot program for direct contracting between growers and manufacturers.

- In mid-January 2000, farmers in Kentucky considered measures that could significantly change where tobacco is grown in the state.

Many Areas in the Region Remain Dependent on Tobacco

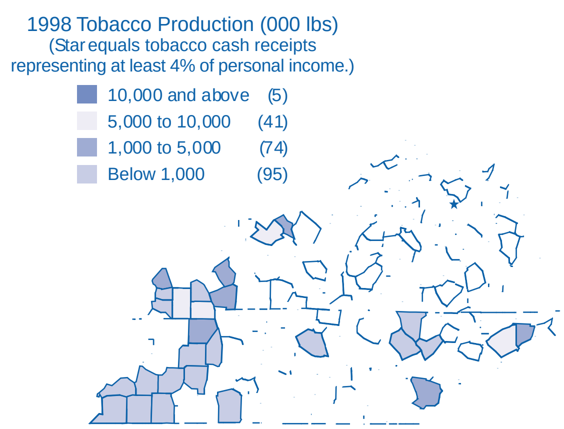
Domestic tobacco production is concentrated in two areas in the southeastern United States, which can be subdivided based on the variety of tobacco grown: the flue-cured tobacco belt centered in the Carolinas and Virginia and the burley tobacco belt in Kentucky and Tennessee. **North Carolina** and Kentucky[7] grow the majority of the nation's tobacco—over two-thirds of total production in 1998. Tennessee ranks a distant third among tobacco-producing states. According to the ***National Agricultural Statistics Service,*** tobacco contributed $1 billion to the Kentucky economy in 1998 and approximately one-fourth as much to the Tennessee economy (includes indirect effects).

In both Kentucky and Tennessee, tobacco production is concentrated in specific areas (shown in Map 1). In

[7] North Carolina produces slightly more tobacco, but Kentucky is more dependent on tobacco. Both states' economies have similar levels of dependence on agriculture, with Kentucky having a higher concentration of its agriculture in tobacco. In 1998, tobacco cash receipts represented 23.5 percent of all farm commodities and 46.8 percent of crop cash receipts for Kentucky.

MAP 1

Tobacco Production Is Concentrated in Eastern Kentucky and Northern Tennessee



Source: U.S. Department of Agriculture

Kentucky, most tobacco is currently grown in the eastern part of the state. In Tennessee, production is scattered in the eastern part of the state and along the northern border.

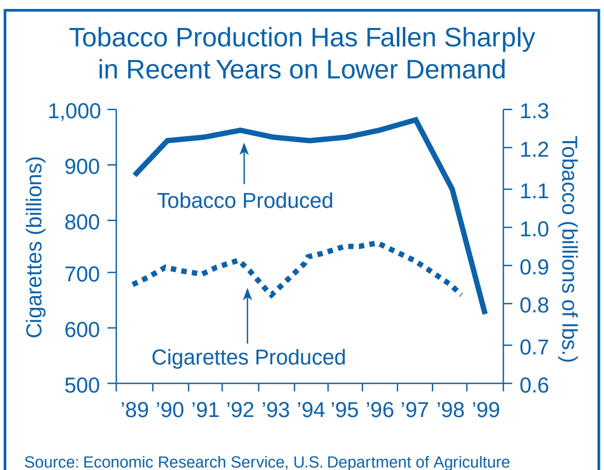
The Tobacco Sector Is Declining

The amount of domestic tobacco produced annually is down sharply, in part because of reduced cigarette production (see Chart 6). Cigarette production is also down because of slackening domestic demand and declining exports.

Many reasons have been given for the decline in domestic cigarette consumption, including price increases, widening restrictions on where smoking is allowed, and increased awareness of the links between smoking and health problems. The perceived price inelasticity of cigarettes is being seriously tested, as recent price increases appear to be a major factor in declining consumption. Since January 1998, wholesale prices of cigarettes have risen $1.05 per pack, an almost 80 percent increase. The higher prices are a combination of higher state and excise taxes and a recovery of costs incurred by manufacturers as a result of the November 1998 settlement with state governments. With excise taxes scheduled to rise again in 2001, domestic demand may continue to slide.

Exports of cigarettes also are down. Recently, U.S. manufacturers have expanded overseas manufacturing facilities to reduce production costs. Potential savings include not only reduced overhead and salary expenses, but also lower input costs, as world tobacco prices are considerably lower than domestic prices.

Chart 6



Increased use of imported tobacco is another factor contributing to declining domestic tobacco cultivation. The reduction in tobacco produced annually in recent years (shown in Chart 6) is much greater than declines in cigarette production alone would suggest is necessary. Domestic cigarettes are a blend of flue-cured, burley, and oriental tobacco leaf. Oriental leaf is a special variety grown only in certain overseas locations, and flue-cured and burley tobacco is grown primarily in the United States. Foreign-grown tobacco of these two varieties can be substituted, however. The share of foreign-grown leaf used in cigarettes produced domestically has grown steadily in recent years as U.S. manufacturers attempt to reduce costs.

Dramatic Changes Affect Tobacco Farming

On February 1, 2000, the USDA announced a third consecutive year of large reductions in the amount of tobacco that growers are allowed to sell, or quotas[8] (refer to the inset box for description of the quota system). Both flue-cured and burley tobacco farmers are affected by lower quotas (see Table 2) with burley growers experiencing a larger drop. The cumulative effect of the 1999 and 2000 quota cuts is a 60 percent drop in the amount of burley tobacco that can be sold compared with 1998. The quota cut for 2000 represents the largest reduction in quotas in the history of the tobacco program, with the previous record having been established in 1999.

The reduction in quotas equates directly to a decline in tobacco farm income. Lower tobacco quotas mean that individual growers must either (1) produce less tobacco or (2) lease other growers' quotas in order to continue

Table 2

Tobacco Quotas Slashed in Recent Years (Annual Percent Change in Marketing Quotas)

	1998	1999	2000
Flue-Cured	-17	-18	-19
Burley	-9	-29	-45

Source: U.S. Department of Agriculture

[8] On February 1, burley quotas were announced; flue-cured quotas for 2000 were announced in mid-December 1999.

Tobacco Program: Tobacco marketing quotas are designed to stabilize the price for domestically grown tobacco by limiting the supply. Marketing quotas are set each year to establish the amount of tobacco that growers are allowed to sell. The quota level is based primarily on announced manufacturers' purchase intentions, the level of existing supply, and export levels, with some limited discretion by the Secretary of Agriculture. Each year's marketing quota is apportioned among holders of base quotas. Base quotas were originally assigned to farmers who were growing tobacco in the 1930s, according to how much they were growing at the time. Quota-holders can, and often do, lease quotas to others rather than grow tobacco themselves.

Tobacco that is not purchased by manufacturers is purchased and held by tobacco cooperatives in "pools." As the cooperatives purchase the tobacco using loans from the federal government, the pools are frequently referred to as "tobacco under loan." One of the factors leading to the record burley quota cuts in 1999 and 2000 was the growth in the pool. Manufacturers typically attempt to reduce this excess supply and acquire inexpensive inputs by purchasing the pools at steeply discounted prices. Burley cooperatives declined to sell to manufacturers at these significantly discounted prices in 1999. Flue-cured pools were sold and the flue-cured quota was cut. Although the cut was large, it was less severe than the reduction in burley tobacco quotas. Many burley farmers and legislators from tobacco-producing states are seeking federal disaster relief that would allow the cooperatives to eliminate the existing pools without having to repay the government loans. Such action would help alleviate some of the downward pressure on burley quotas in the near term, but the longer-term negative trends, primarily waning demand for domestic tobacco, would remain.

producing the same amount of tobacco. Quota cuts signal either a considerable decline in individual farm revenues or a significant increase in production costs, as quota lease prices have risen sharply in response to the reduction in quotas.

The tobacco settlement between cigarette manufacturers and 46 state governments in November 1998 included provisions to help tobacco growers adjust to declining tobacco production. The settlement provided for funds to be distributed directly to tobacco farmers over a 12-year period to help them transition to alternative employment or agricultural production. However, the annual tobacco settlement payments to many farmers are so small as to be inconsequential.

Simultaneous with the announced burley tobacco quota cuts in February, Phillip Morris Corporation proposed a pilot program for direct contracting between tobacco growers and manufacturers that would operate outside the current cooperative system. While contracting has been used extensively in the production of other agricultural products, tobacco growers have long resisted direct contracting. However, emerging problems facing the tobacco sector may provide an incentive for farmers to discontinue the quota system and adopt direct contracting. Tobacco quota-holders will vote in 2001 to retain or discontinue the current tobacco program.

From a macroeconomic perspective, contracting may create a greater concentration of tobacco production in fewer farms. Manufacturers may be inclined to contract primarily with larger growers, limiting their expenses and exposure to a smaller number of farmers. Long term, this could lead to a sharp decline in the number of smaller tobacco farms.[9]

In addition to the complexities surrounding tobacco production nationally, Kentucky burley farmers faced additional uncertainty as they began planting in 2000. In mid-January 2000, Kentucky tobacco quota-holders approved a special referendum to allow quotas to be leased across county lines anywhere in the state. Previously, burley quotas could be leased to another grower only in the county where the base quotas were originally assigned.[10]

Although western Kentucky historically has produced less tobacco than eastern Kentucky, crop yields are much greater in that part of the state and farm sizes tend to be larger. If quotas were no longer restricted to county lines, farmers in many eastern counties could begin leasing their quotas to western Kentucky farmers. The

[9] The labor-intensive nature of growing tobacco has long served to limit the typical size of tobacco farms. However, the high revenue potential from even small tobacco operations has maintained the economic viability of these smaller farms. As a result, there are currently almost 45,000 tobacco farms in Kentucky alone, with a typical size of just five acres.

[10] An exception has existed for "disaster pounds." This exception allows farmers who lost tobacco crops to weather or disease to lease their marketing quotas anywhere in the state at year-end to other farmers who may have produced more tobacco (on speculation or strong yields) than they were allowed to sell under the quota system.

migration of tobacco production to the western part of the state would be a significant structural shift in the state's agricultural sector and could significantly affect communities in eastern Kentucky.

However, in late March, a federal judge blocked the referendum, because the total number of votes did not represent a majority of eligible votes. Many farmers, particularly those in western Kentucky, were preparing to plant additional acres by purchasing leases from other parts of the state. With that option no longer available, many tobacco growers faced significant last-minute changes in an already difficult season.

Tennessee quota-holders had approved a similar rule change in their state in the early 1990s. The effect was a shift in tobacco cultivation from eastern counties to the western part of the state. Although eastern Tennessee still produces a considerable amount of tobacco, most eastern tobacco-producing counties shown in Map 1 have experienced a decline in tobacco production since 1993. By contrast, most counties in the north-central and western portions of the state have reported growth in tobacco production during the period.

Rural Communities Will Be Disproportionately Affected

Lower marketing quotas, direct contracting, and cross-county quota leasing are all likely to adversely affect local economic conditions, but the severity will vary greatly. Some major tobacco-producing counties are located near metropolitan areas with strong local economies. In these areas, reliance on tobacco has steadily declined as cities expand over what was previously farmland and as employment opportunities grow. By contrast, dependence on tobacco production remains high in many rural areas. Map 1 depicts those counties with tobacco cash receipts equivalent to 4 percent or more of total personal income. Often, these rural communities have only limited opportunities for off-farm employment, and many face declining manufacturing bases. Textile and apparel employment, in particular, declined sharply in the 1990s in Kentucky and Tennessee, dropping from over 90,000 in 1993 to approximately 46,000 at the end of 1999.

Nicholas County, Kentucky, northeast of **Lexington,** is one rural area facing lost tobacco revenue and a declining manufacturing employment base. The reduction in quotas could result in over $5 million in lost revenue for the county (tobacco cash receipts were equivalent to 8.7 percent of total personal income in the county in 1998). The largest employer in the county, an apparel manufacturer, closed on December 30, 1999, resulting in 325 lost jobs, or approximately 10 percent of the county's total employment. This combination of declining farm revenue and job layoffs will adversely affect the local economy. Nicholas County is just one example of the many rural communities in Kentucky and Tennessee struggling with similar problems.

Banks Face Challenges in Coming Years

Banks operating in tobacco-dependent areas are subject to greater uncertainty because of the ongoing upheaval in the sector. Potential challenges include elevated credit quality concerns, declining overall loan demand, and additional funding pressures.

Borrowers' credit quality could deteriorate. With significant reductions in the amount of tobacco that can be grown, revenues will drop sharply for most tobacco farmers. Some may be unable to generate sufficient income to cover expenses and meet debt service requirements. Lenders have taken steps to bolster credit quality by acquiring additional collateral or using government guaranty programs, but concerns with direct lending remain. Also, the credit quality of other borrowers, such as downtown merchants, in communities that depend on tobacco dollars could be adversely affected.

With less tobacco likely to be grown by fewer farmers, structural changes may occur in the loan portfolios of banks that have traditionally loaned directly to tobacco growers.[11] Nonagricultural loan demand in or near urban areas such as Lexington or **Louisville** has been strong in recent years; banks operating in these areas should be able to easily replace tobacco loans with commercial, consumer, and real estate loans. However, management may need to revisit lending strategies and diversification efforts if loan portfolio composition changes significantly with the loss of tobacco-based credits. In rural communities, lenders may have limited options available for replacing lost tobacco loans in local mar-

[11] Among community banks (those with less than $500 million in total assets) operating in tobacco-growing areas of northeastern Kentucky, for example, agricultural-related loans represent an average 16 percent of total loans. While other farming activities are present, the majority of such loans are related to tobacco.

kets. In such areas, banks may experience a decline in total loans.

Deposits also could decline with the loss of considerable annual cash flow in some rural counties. This may in turn lead to funding complications for community banks in those areas. The use of alternative funding sources, primarily borrowings from the Federal Home Loan Bank, already was increasing among these institutions. Such borrowings often represent a more costly source of funding than locally generated core deposits. As a result, both liquidity and earnings could be affected. Core deposit growth at community banks headquartered in tobacco-dependent counties[12] slowed appreciably in 1999 (see Table 3) and was well below core deposit growth at community banks located in other rural areas in the Region.

Implications

The Region's tobacco farm economy currently is characterized by significant challenges and considerable uncertainty. Many financial institutions operating in areas that depend on tobacco revenues are faced with serious questions about borrowers' credit quality and the economic vitality of their communities, with the potential indirect effects perhaps posing the greatest challenges. The uncertain outlook for tobacco farming will require considerable effort by institution officers and directors to properly manage current risks and plan for future growth.

Memphis Region Staff

Table 3

Deposit Growth Slows in 1999 for Banks in Tobacco-Dependent Counties

	1997	1998	1999
Loan Growth	11.0	8.6	9.8
Core Deposit Growth	5.5	7.3	1.4
Loans/Deposits Ratio	76.3	77.7	83.3

Source: Bank and Thrift Call Reports

[12] Tobacco-dependent counties are those with tobacco cash receipts equivalent to 4 percent or more of total personal income; community banks are those with less than $500 million in total assets. All growth rates are merger-adjusted.

Banking Risk in the New Economy

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. At this time, the banking industry as a whole continues to enjoy record profits and solid financial ratios.[1] Much of the industry's strength derives from the remarkable performance of the U.S. economy, which has been expanding for the past nine years. This article explores factors that have shaped this unusually robust economic environment and discusses how changes in the economy may create new types of risks for insured depository institutions.

During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. This loss primarily resulted from an uptick in unanticipated and high-cost bank failures. Some of these failures were associated with high-risk activities such as subprime lending, and some were related to operational weaknesses and fraud. The emergence of these problems in the midst of a strong economic environment raises concerns about how the condition of the banking industry might change if economic conditions deteriorate.

The Longest U.S. Expansion

In February 2000, the U.S. economy entered its 108th month of expansion, making this the longest period of uninterrupted growth in U.S. history.[2] This record-setting performance has also been marked by a recent acceleration in the rate of real gross domestic product (GDP) growth, which has exceeded 4 percent in each year since 1997. Meanwhile, price inflation has remained relatively subdued. The core inflation rate, which excludes the volatile food and energy components, was just 2.1 percent in 1999, the lowest core rate since 1965.

Recent economic conditions have been highly conducive to strong loan growth, low credit losses, and record earnings for the banking industry. The important question going forward is how long these favorable conditions might last. Is this remarkable economic performance the result of some long-term upward shift in the pace of economic activity, or is it the temporary result of a few transitory factors? More important, are there new and unfamiliar dangers that, at some point, could significantly impair banking industry performance? To evaluate these questions, we must assess the factors that have contributed to recent economic performance and think ahead to possible developments that could end this expansion.

What Is the New Economy?

The term used most often to describe the recent period of economic performance has been somewhat controversial: the *New Economy.* Much of the controversy has arisen because people interpret the term in different ways. Wall Street analysts use the term to refer to the high-technology sectors of the economy, such as computers and software, biotechnology, and especially the Internet. Some of these New Economy firms have been able to raise large amounts of capital and command market valuations in the tens of billions of dollars well in advance of earning a profit or even booking significant cash revenues.

Economists tend to employ the term New Economy in a slightly different way. To them, it refers to evidence that some of the traditional economic relationships have changed. For example, intangible assets now appear to play a much larger role in the valuation of investments than they have in the past.[3] Firms in some industries now may exhibit increasing returns to scale (rather than diminishing returns), reflecting the fact that the value of their product rises as it becomes a de facto industry standard.[4] Individual decision making, too, may be changing. Some believe that investors have reduced the risk premium they demand to hold equity positions

[1] For a recent summary of financial performance and condition of the banking and thrift industries, see the FDIC *Quarterly Banking Profile,* fourth quarter 1999, http://www2.fdic.gov/qbp/.

[2] The chronology of U.S. business cycles is available from the National Bureau of Economic Research, http://www.nber.org/cycles.html.

[3] Nakamura, Leonard. Federal Reserve Bank of Philadelphia. July/August 1999. Intangibles: What Put the New in the New Economy? *Business Review.* http://www.phil.frb.org/files/br/brja99ln.pdf.

[4] Brown, William S. March 2000. Market Failure in the New Economy. *Journal of Economic Issues,* 219–27.

because of their perception that holding equity is not, after all, substantially riskier than holding debt.[5] Such a shift in investor attitudes could help explain why the price-to-earnings ratio for the S&P 500 index has recently approached all-time highs.[6]

Perhaps the most important underlying change in the economy is the relationship between high rates of economic growth and changes in inflation. Economists have long maintained that rapid growth in economic activity has a tendency to lead to excess demand for goods (thereby raising consumer and producer prices) and excess demand for labor (thereby raising wage rates). But during the late 1990s, as growth accelerated and inflation remained low, economists began to reevaluate their notions of these trade-offs. Some argued that the low rate of inflation during this expansion was the fortunate result of temporary factors, such as a strong dollar and low energy prices, both of which could diminish or reverse direction over time.[7] Only a few analysts were so bold as to suggest that the fundamental workings of the economy had changed in such a way as to allow a sustained period of high economic growth with low inflation.

An early Wall Street description of the New Economy appeared in an article released by ***Goldman Sachs*** in January 1997.[8] It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than they have in the past. At the same time, it warned that longer economic expansions might have a tendency to contribute to greater financial excess and the possibility of more severe recessions and more sluggish recoveries.

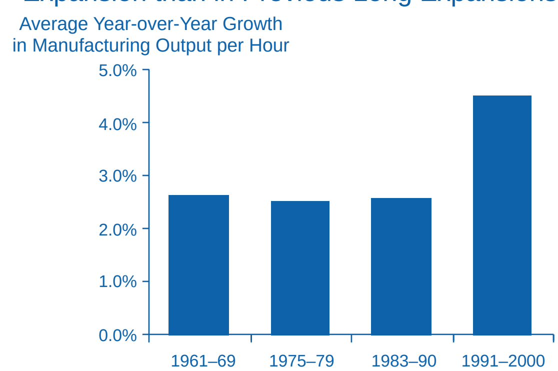
If this hypothesis is correct, and an emerging New Economy would contribute to longer expansions and more severe recessions, there may be implications for how banks manage risks. Since the Great Depression, U.S. business cycle recessions have not necessarily been catalysts for large numbers of bank and thrift failures. During the period from 1983 to 1989, when the U.S. economy was in the midst of a long expansion, some 1,855 insured banks and thrifts failed. This wave of failures has been attributed to a variety of factors, including severe regional economic downturns, real-estate-related problems, stress in the agricultural sector, an influx of newly chartered banks and banks that converted charters, and high nominal interest rates.[9] However, the potential for significantly more severe national recessions would represent largely uncharted territory that could cause losses and loss correlations to depart from historical norms, posing a new set of risk management challenges for the industry going forward.

The Productivity Revolution

As the essential element that links faster economic growth and low inflation, productivity growth is the cornerstone of the New Economy. Productivity refers generally to the amount of output that can be obtained from a fixed amount of input. Labor productivity is usually measured in terms of output per hour. Chart 1 shows that output per hour in manufacturing has risen at an average annual rate of 4.5 percent during the current expansion, compared with rates of just over 2.5 percent in the three previous long economic expansions. Moreover, productivity growth accelerated in 1999 to a rate of 6.3 percent. Why is productivity growing so fast now compared with previous expansions? Even economists who believe that economic relationships have funda-

CHART 1

Productivity Has Grown at a Faster Rate in This Expansion than in Previous Long Expansions



Source: Bureau of Labor Statistics (Haver Analytics)

[5] January 24, 2000. Has the Market Gone Mad? *Fortune.*

[6] September 1999. Earnings: Why They Matter. *Money.*

[7] Brown, Lynn Elaine. Federal Reserve Bank of New England. May/June 1999. U.S. Economic Performance: Good Fortune, Bubble, or New Era? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer399a.pdf, and Brinner, Roger E. Federal Reserve Bank of New England. January/February 1999. Is Inflation Dead? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer199c.pdf.

[8] Dudley, William C., and Edward F. McKelvey. January 1997. The Brave New Business Cycle: No Recession in Sight. *U.S. Economic Research,* Goldman Sachs.

[9] FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s,* 16–17. http://www.fdic.gov/bank/historical/history/contents.html.

mentally changed are hard-pressed to explain why all of the factors came together in the late 1990s and not before.[10] Still, explanations for the increase in productivity tend to focus on three main factors.

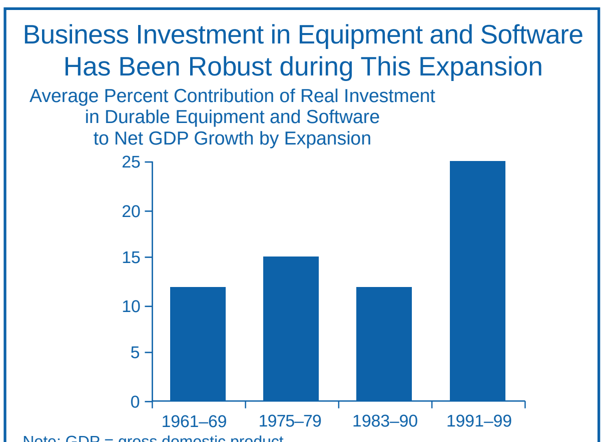
Increased Competition. Expanding global trade during the 1980s and 1990s has subjected U.S. firms to new competition from around the world. Annual U.S. exports of goods and services grew by over 230 percent (after inflation) between 1982 and 1999, while imports grew by 315 percent. The construction of new production facilities around the world in industries such as autos and chemicals has led to excess manufacturing capacity that has kept prices low. In other industries, including air travel, trucking, telecommunications, and banking, competition has been intensified through domestic deregulation. Facing intense competitive pressures and a low rate of general price inflation, firms cannot rely on annual price increases to help expand top-line revenue. Instead, there is pressure to continually cut costs in order to increase earnings. For many firms, this means adopting new technologies and new ways of organizing operations.

Expanded Investment. U.S. firms of all sizes have invested in new technologies at a rapid pace during this expansion. Chart 2 shows that business investment in equipment and software represents almost one-quarter of total net GDP growth during this expansion, compared with around 15 percent or less during previous long expansions. While this investment has been motivated by the need to cut costs, it has also been fueled by the availability of new computer technologies that have fallen in cost over time and by the ready availability of financial capital on favorable terms.

Industrial Restructuring. The third aspect of the productivity revolution is large-scale restructuring in the U.S. corporate sector. Chart 3 shows that both the annual number and dollar volume of mergers in the late 1990s far exceeded the pace of the so-called merger mania of the late 1980s. Two classes of firms are leading the new wave of mergers. First, companies in mature industries such as oil, autos, and banking are faced with excess productive capacity and intense price competition. For these firms, mergers are useful in expanding market share and removing redundant operations. Second, the largest dollar volume of mergers is in some of the most volatile emerging industries, including telecom, media, and the Internet. It is in these sectors of the economy, in particular, where the business models are evolving rapidly and where technological standards are still being determined. Firms in these industries that can grow rapidly through mergers have the chance to achieve long-term market dominance in what appear to be some of the fastest growing industries of the new century.

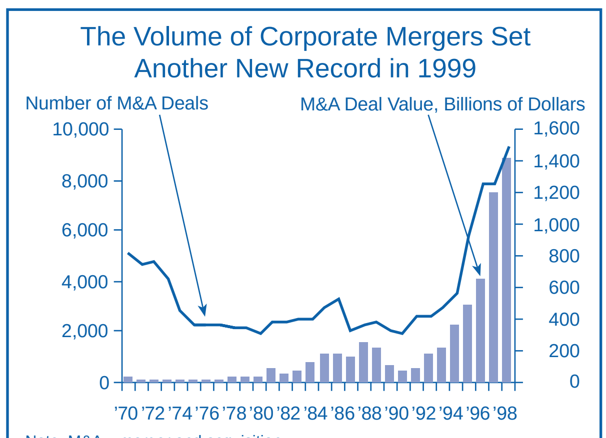
The implications of the productivity revolution for the banking industry have been decidedly positive. Higher productivity has allowed a long expansion and faster economic growth with low inflation, all of which are conducive to robust financial performance by depository institutions. Higher rates of business investment

CHART 2



Note: GDP = gross domestic product
Source: Bureau of Economic Analysis (Haver Analytics)

CHART 3



Note: M&A = merger and acquisition
Source: Houlihan Lokey's Mergerstat

[10] One possible explanation is that there is a learning curve for adopting new technologies and that technology diffusion is an inherently slow process. David, Paul A. Organization for Economic Cooperation and Development. 1991. Computer and Dynamo: The Modern Productivity Paradox in a Not-Too-Distant Mirror. In *Technology and Productivity: The Challenge for Economic Policy,* 315–47.

have generated demand for credit that is supplied, in part, by banks and thrifts. Perhaps most important, the recent large-scale industrial restructuring has been highly supportive of strong business credit quality. This process has moved economic resources to more productive uses in an orderly fashion, without the high levels of bankruptcies and defaults that often accompany industrial restructuring. Given the volumes of corporate assets that have changed hands in recent years (more than $1.4 trillion in 1999 alone), it is fortunate indeed that this restructuring has proceeded in this fashion.

The Role of the Capital Markets

A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the cost of capital for publicly traded corporations has been sharply rising stock prices. Many of these firms have been able to use equity shares as a currency with which to finance mergers. Furthermore, existing accounting rules do not always require the amortization of good will that comes onto the balance sheet as a result of a merger.[11]

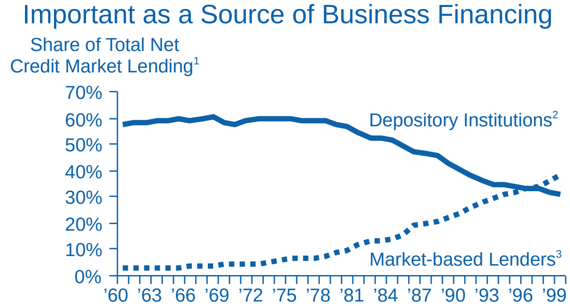
By far the largest amount of external business financing has been debt financing. U.S. nonfinancial corporations issued net debt in the amount of $535 billion in 1999 and repurchased equity shares, on net, for the sixth consecutive year. Businesses have used this debt to purchase capital equipment, finance mergers, and buy back equity shares. This increase in debt issuance has not been limited to highly rated corporations. Venture capital financing amounted to almost $15 billion in the fourth quarter of 1999 alone, with over 60 percent of that amount going to Internet firms.[12]

Banks have been active participants in nearly every facet of this financing activity. Syndicated loan origination volumes rose by 17 percent in 1999 to just over $1 trillion, despite relatively high credit costs and facility fees, factors that helped keep total volume below 1997's record $1.1 trillion in issuance. Syndicated loans to leveraged companies also rose 17 percent in 1999 to a record $320 billion. More impressive still was the growth in high-yield transactions, which rose nearly 50 percent in 1999 to $190 billion. It is difficult to determine precisely how much syndicated loan exposure resides on the books of insured institutions or, more important, how much high-yield exposure is retained by commercial banks. ***Loan Pricing Corporation*** estimates that 64 percent of high-yield volume in the first half of 1999 was retained by banks.[13] Insured commercial banks are the dominant originators of syndicated loans, with a 79 percent market share of investment-grade originations and a 56 percent market share of non-investment-grade originations in 1999. Commercial banks have also expanded their presence in the venture capital market. For some of the largest banks, profits from venture capital operations account for a large portion of total earnings. Chase Manhattan reported venture capital investment earnings of $2.3 billion in 1999, accounting for 22 percent of total net income.[14]

Innovation in the capital markets continues to provide new and more efficient vehicles for business financing. For example, issuance of asset-backed securities totaled $346 billion in 1999, up from only $50 billion in 1990. In this ongoing revolution in finance, market-based intermediaries, such as mutual funds and asset pools, have assumed an increasing role in the credit markets. Chart 4 shows that net holdings of credit market instruments by mutual funds, government-sponsored enterprises, and asset pools exceeded the debt held by depository institutions for the first time in 1997.

CHART 4

Market-based Lending Is Becoming More Important as a Source of Business Financing



[1] Total net credit market lending is defined as net holdings of open-market paper, government and municipal securities, corporate and foreign bonds, mortgages, and other loans.
[2] Depository institutions include commercial banks, savings institutions, and credit unions.
[3] Market-based lenders include mutual funds, closed-end funds, government-sponsored enterprises, and asset pools.
Sources: Federal Reserve Board (Haver Analytics); Regional Financial Associates

[11] April 17, 2000. Techdom's New Bean-Counting Battle. *Business Week.*

[12] May 2000. Venture financing data are derived from a PriceWaterhouseCoopers/Money Tree survey, as cited in *Upside,* 43.

[13] September 13, 1999. Junk Loan Market Is Feeling the Pinch of Oversupply and Rising Interest Rates. *The Wall Street Journal.*

[14] April 3, 2000.What's Really Driving Banks' Profits. *Business Week.*

While the expansion in market-based financing has made credit more available to business and consumer borrowers, it also creates some concerns. One issue is the susceptibility of the financial markets to periodic bouts of turmoil. These episodes, such as the one triggered by the Russian government bond default and the near-failure of the Long Term Capital Management hedge fund in the fall of 1998, can result in the interruption of capital flows even to creditworthy borrowers. During the 1998 episode, private yield spreads widened sharply as investors sought the safety of U.S. Treasury securities. Some companies that had planned to issue debt to the markets during that period were unable to do so. For companies whose business models depend heavily on a continuous supply of liquidity from the financial markets, the effects of these episodes can be catastrophic. For example, the relatively short-lived episode of financial turmoil during late 1998 resulted in significant liquidity problems for a number of commercial mortgage firms. Nomura, Lehman Brothers, CS First Boston, and others incurred losses, while Criimi Mae, Inc., was forced to declare bankruptcy.

Because market-based financing has played such a large role in facilitating the orderly restructuring of the U.S. economy through mergers and the formation of new businesses, a recurrence of financial market turmoil could contribute to the end of the current expansion. Moreover, such an event could have serious consequences for business credit quality. A prolonged interruption of market-based financing could, in this very competitive economic environment, prevent businesses from restructuring themselves through mergers and deprive them of capital needed to invest in cost-cutting technologies. The loss of financial flexibility would leave businesses much more vulnerable to the effects of competition and could result in more firms seeking bankruptcy protection. Such a scenario has the potential to bring about a significant increase in charge-off rates for business lenders.

Financial Imbalances

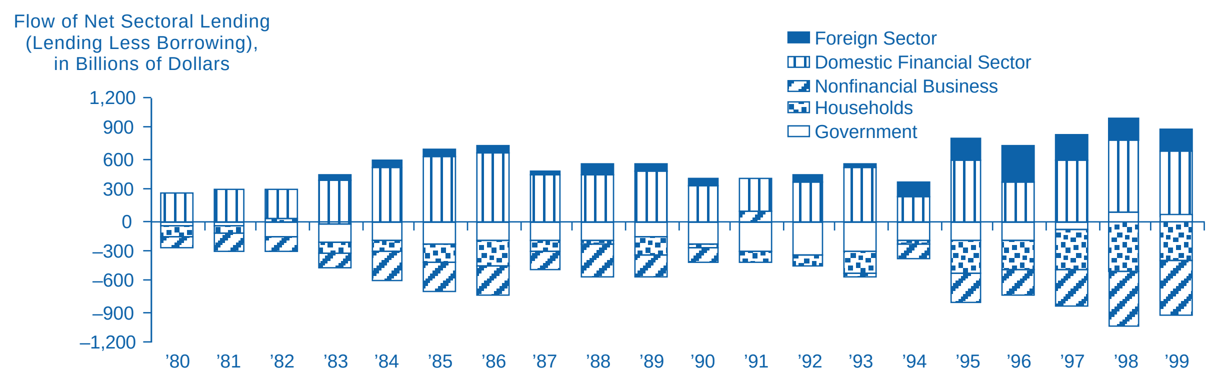
Another concern that arises from increased dependence on market-based financing is that it may contribute to the emergence of financial imbalances in the economy. These imbalances could, in turn, increase the potential for financial market turmoil as a result of some unforeseen shock to the markets.

As recently as 1993, the public deficit was near the top of the list of economists' concerns about the U.S. economy. During that year, the combined deficit of the federal, state, and local government sectors exceeded $300 billion. However, on the strength of a long economic expansion, lower interest rates, and lower federal spending on defense, the consolidated government sector posted its second consecutive surplus in 1999 (Chart 5).

As the government has moved from deficit to surplus, households and businesses have continued to borrow hundreds of billions of dollars every year. Taken together, the annual net borrowing of businesses and households has been referred to as the "private deficit." In 1999, the private deficit narrowed to $913 billion from a record $1.02 trillion the year before. Although this private borrowing indicates confidence on the part of consumers and businesses about future prospects, it also raises concerns about the ability to service debt if interest costs rise or if incomes level off or decline.

CHART 5

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



Note: "Nonfinancial business" includes farm and nonfarm, corporate and noncorporate businesses.
Source: Federal Reserve Board (Haver Analytics)

The largest part of the private deficit was again financed in 1999 by domestic financial institutions ($649 billion) and an inflow of capital from abroad ($207 billion). Both of these sources of financing are potential causes for concern. The rapid expansion in credit created by the financial sector raises questions about credit quality. Financial institutions theoretically serve as the gatekeepers of the economy, financing only the most creditworthy projects and rejecting those that are not viable. The sheer volume of credit extended to businesses and households—almost $1.4 trillion in new net lending over the past two years—raises the possibility that underwriting has become more lax and that average credit quality is slipping. (See the inset box on page 17 for a discussion of recent trends in commercial credit quality.)

Reliance on inflows of foreign capital raises a different set of issues. The fact that the U.S. economy has been growing significantly faster than the economies of its major trading partners has contributed to a U.S. trade deficit that reached $268 billion in 1999 and could exceed $300 billion in 2000. This deficit puts hundreds of billions of dollars annually in the hands of foreign investors. As long as foreign investors largely choose to reinvest their excess dollars in U.S. factories and financial instruments, as has been the case in recent years, the United States can continue to enjoy a strong dollar and relatively low inflation and low interest rates. However, if foreign investors should choose to invest elsewhere, they must sell their dollars in foreign exchange markets. Doing so would put downward pressure on the dollar and upward pressure on U.S. inflation and interest rates.

Recent Shocks to the U.S. Economy

Despite the potential for a declining dollar as a result of U.S. reliance on foreign capital, other adverse developments have confronted the U.S. economy over the past year. The two factors of most consequence to the macroeconomic outlook have been rising energy costs and rising interest rates. These trends have played a role in recent equity market volatility that may have implications for the future direction of the economy.

Rising Energy Prices. After declining to a low of around $10 per barrel in December 1998, oil prices have risen dramatically over the past year and a half. The spot price per barrel of West Texas Intermediate crude peaked in March 2000 at just under $30 before declining slightly in April. The rapid increase in oil prices during 1999 was sparked by a cutback in output by oil-producing nations that was instituted just as global economic growth was recovering from the crisis of 1998. The OPEC nations and other major oil producers reached a new agreement in March 2000 that provides for a production increase of some 1.5 million barrels a day. But, because demand is rising and gasoline inventories remain lean, analysts do not look for a significant decline in gasoline prices in the near term.[15]

The effects of higher oil prices on the U.S. economy at this time are uncertain. According to some estimates, the economy is only half as dependent on oil as it was 25 years ago, when the United States was experiencing the effects of its first "oil shock."[16] Still, higher oil prices were responsible for nearly all the increase in consumer price inflation during 1999. While year-over-year growth in the Consumer Price Index rose from 1.6 percent in December 1998 to 2.7 percent in December 1999, the core rate of inflation (excluding food and energy items) actually fell. The question now is whether higher energy prices will be passed along to the rest of the economy through rising wage and price demands during the remainder of 2000.

Rising Interest Rates. From low points at the end of 1998, both short-term and long-term interest rates have risen substantially, contributing to a higher cost of debt service for businesses and households. At the short end of the yield curve, the Federal Reserve (the Fed) raised the Federal Funds rate six times between June 1999 and May 2000, for a total increase of 175 basis points. While part of this increase merely reversed the reduction in rates that took place in late 1998, the Fed also voiced concerns that inflationary pressures might be emerging because of continued rapid U.S. economic growth. Given the stated commitment of the Federal Reserve to price stability, most analysts expect the Fed to continue to push short-term rates higher until growth in the economy slows to a more sustainable pace.[17]

Bond markets also pushed up long-term interest rates during this period. The yield on the ten-year Treasury

[15] Energy Information Agency (U.S. Department of Energy). April 2000. Short-Term Energy Outlook. http://www.eia.doe.gov/emeu/steo/pub/contents.html.
[16] March 11, 2000. Fueling Inflation? *The Economist.*
[17] See, for example, U.S. House of Representatives. February 17, 2000. Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services. http://www.federalreserve.gov/boarddocs/hh/2000/February/Testimony.htm.

As Commercial Credit Quality Indicators Slip, Trends in Commercial Lending Come to the Forefront

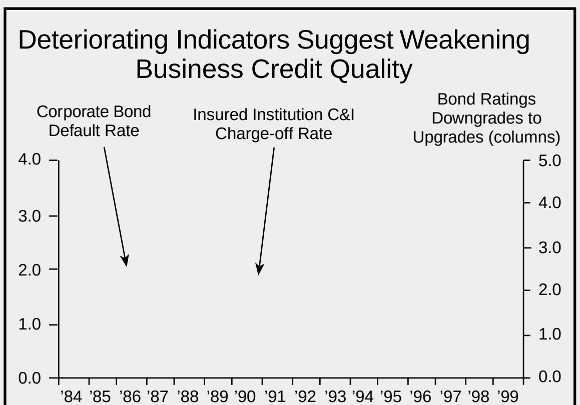
Commercial lending, which includes both commercial and industrial (C&I) and commercial real estate (CRE) loans, represents the greatest source of credit risk to insured institutions and the deposit insurance funds. C&I loan growth continued to be strong in 1999, although it did moderate from 1998 levels, and recent underwriting surveys have reported a slight tightening of terms.[18] Nevertheless, there are signs that commercial credit quality is deteriorating.[19] Most notably, as seen in Chart 6, C&I loan charge-off rates, corporate bond defaults, and corporate bond rating downgrades relative to upgrades have all been trending upward recently. For example, C&I loan loss rates rose to 0.56 percent of total loans in 1999, nearly double the rate of loss experienced in 1997. Although C&I loan loss levels are well below historical highs experienced throughout the 1980s and early 1990s, these signs of credit quality deterioration are occurring despite extremely favorable economic conditions.

At least three factors have contributed to weakening in corporate credit quality. First, corporate indebtedness has been rising, as businesses have been spending to increase productivity, cut costs, repurchase equity, and finance mergers and acquisitions. The second factor relates to a greater risk appetite in the financial markets. For example, originations of leveraged syndicated loans—in particular, highly leveraged loans—have tripled over the past five years. Finally, stresses within industry sectors hard hit by structural changes, global competition, and deflationary pressures have resulted in challenges for borrowers.

Construction and development (C&D) lending continues to be one of the fastest growing segments of banks' loan portfolios, while loss rates among CRE and C&D loans remain extremely low. However, there are indications that conditions could be worsening in some markets. In particular, as shown in Chart 7, strong office completions and construction activity have begun to outpace absorptions and are projected to continue to do so over the next several years. Moreover, these trends have implications for vacancy rates. The national office vacancy rate moved higher during 1999 for the first time since 1991 and is projected to climb higher.

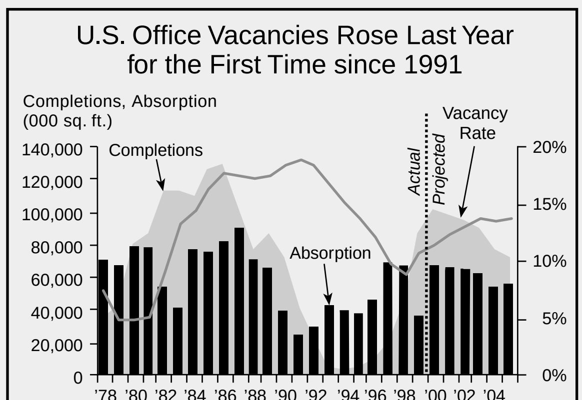
In addition, some local CRE markets continue to show signs of overbuilding. Last year, the FDIC's Division of Insurance identified nine markets in which the pace of construction activity threatened to outstrip demand for at least two property sectors.[20] Seven of these nine markets reported an increase in office vacancy rates in 1999.

Chart 6



Note: C&I = commercial and industrial
Source: Moody's; Bank and Thrift Call Reports (Research Information System)

Chart 7



Source: CB Commercial/Torto Wheaton Research

[18] Both the 1999 *Senior Loan Officer Opinion Survey* (Federal Reserve Board) and 1999 *Survey of Credit Underwriting Practices* (Office of the Comptroller of the Currency) point to more stringent C&I loan terms since the latter part of 1998. This tightening follows a four-year period of easing C&I loan standards and predominantly reflects an increase in loan pricing.

[19] For additional detail, see Sothoron, Arlinda, and Alan Deaton. FDIC Division of Insurance. First quarter 2000. Recent Trends Raise Concerns about the Future of Business Credit Quality. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro20001q/na/Infocus1.html.

[20] These markets are Charlotte, Orlando, Salt Lake City, Dallas, Las Vegas, Phoenix, Nashville, Atlanta, and Portland. See Burton, Steve. FDIC Division of Insurance. First quarter 1999. Commercial Development Still Hot in Many Major Markets, But Slower Growth May Be Ahead. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19991/na/Infocus2.html.

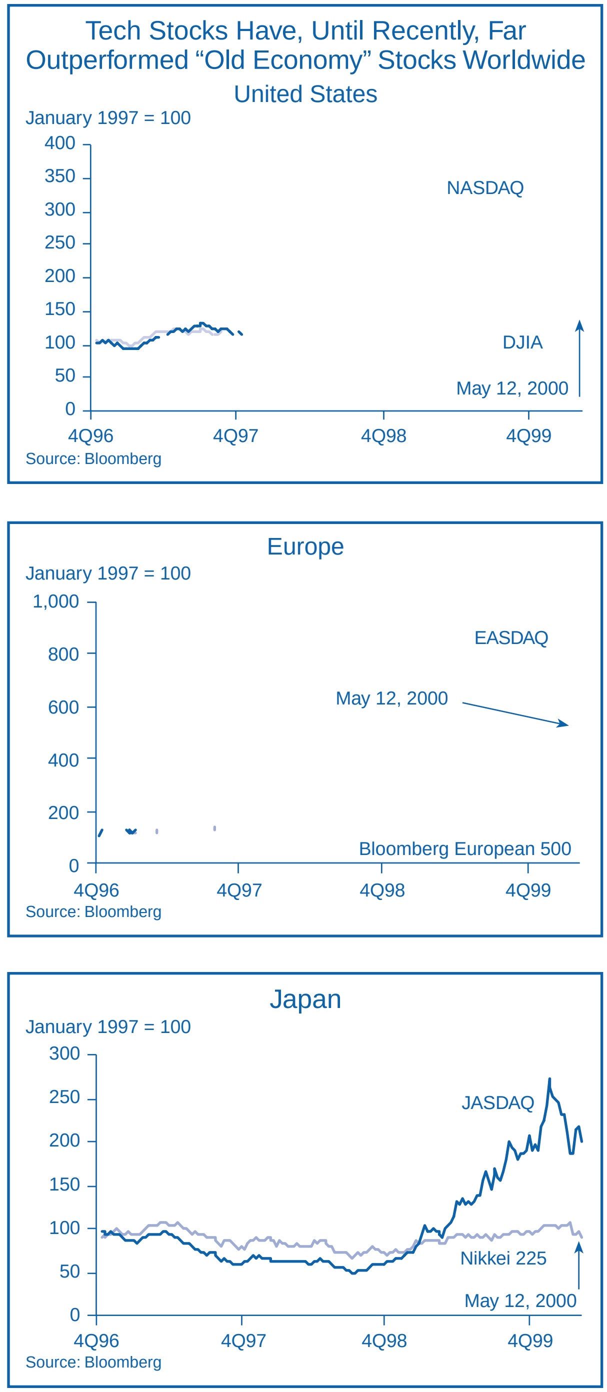
note rose from a low of 4.5 percent in October 1998 to 6.5 percent by May 2000. Analysts have cited renewed demand for credit by a recovering world economy as well as concerns about inflation arising from the increase in energy prices as factors behind the rise in long-term rates.

Higher energy costs and higher interest rates do not appear to have significantly slowed the pace of U.S. economic activity during the first quarter of 2000. The preliminary estimate of real gross domestic product growth during the quarter was 5.4 percent—a slowdown from the 7.3 percent rate of the fourth quarter of 1999 but still well above what is considered a sustainable pace. Home construction, usually a sector that is particularly sensitive to movements in long-term interest rates, has remained surprisingly resilient. Still confident of their future prospects, homebuyers have increasingly turned to adjustable-rate mortgages to avoid some of the immediate costs of higher fixed mortgage rates.

As for the business sector, higher costs for energy and debt service are most significantly affecting "Old Economy" firms that purchase commodity inputs and carry significant debt on their balance sheets. Airline companies in the S&P 500, for example, posted a year-over-year decline of 27 percent in net income from continuing operations during the first quarter of 2000.[21] Analysts have argued that New Economy firms, by contrast, are less vulnerable to recent economic shocks because they tend to carry little debt and consume relatively little energy.

Equity Market Volatility. The notion that New Economy firms are less vulnerable to the effects of higher energy costs and higher interest rates may be one of the reasons that equity shares of firms in the technology sector began to dramatically outperform the broader market, beginning around the middle of 1999. Chart 8 shows that the technology-heavy NASDAQ index performed more or less in tandem with the Dow Jones Industrial Average between the end of 1996 and the middle of 1999, but thereafter the NASDAQ soared far ahead of the Dow. Between October 1, 1999, and February 29, 2000, the NASDAQ rose by 72 percent while the Dow declined by 4 percent. Moreover, this striking divergence between the equity returns of Old and New Economy companies was not limited to the U.S. markets. Parallel trends were observed in Europe, Japan, Korea,

CHART 8



and Hong Kong. The similarity in performance of the high-tech sectors across three continents suggests a worldwide flow of liquidity from investors to the shares of technology firms.

However, emerging concerns about the technology sector contributed to significant volatility in technology

[21] Bloomberg. The S&P 500 airline industry is composed of AMR Corp., Delta Air Lines, Southwest Airlines, and U.S. Airways Group.

shares during March and April 2000. The NASDAQ index lost 30 percent of its value between March 10 and May 12, 2000. Analysts cited the Justice Department finding against Microsoft and doubts about the ultimate profitability of business-to-consumer Internet firms as two factors in the sell-off.

Equity market volatility also poses a threat to the economic outlook. One concern is the so-called "wealth effect" that a declining stock market may have on consumer spending. Since 1995, rising stock prices have helped raise the market value of equities held by U.S. households, plus their holdings of mutual funds, by some $5.7 trillion. This windfall is an important reason that households have continued to reduce annual personal savings (to just 2.4 percent of disposable income in 1999) and increase spending on homes, autos, and other consumer goods. Although it is uncertain what effect a prolonged stock market correction might have on consumer spending, the potential wealth effect has surely grown as more households hold a higher percentage of wealth in corporate equities and mutual fund shares. (See the inset box at right for a discussion of how financial market volatility could affect banks.)

The Economic Outlook

Despite the effects of rising energy costs, increasing interest rates, and equity market volatility, the U.S. economy continues to grow at a robust pace. The consensus forecast of 50 corporate economists surveyed by the May 1999 ***Blue Chip Economic Indicators*** suggests that the economy will grow by 4.7 percent in 2000, while consumer prices are projected to rise by 3.0 percent from 1999 levels. Short-term interest rates are projected to rise only slightly by year-end from early May levels. In short, the consensus forecast indicates that the New Economy formula of rapid economic growth combined with low inflation will continue for the foreseeable future. If actual events conform to this forecast, the result will likely be another year of generally low loan losses and solid earnings for much of the banking industry. (See the inset box on the following page for a discussion of other risks to watch in banking.)

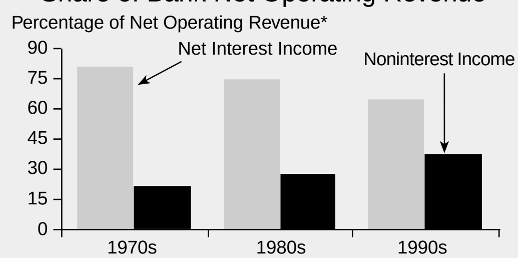
Clearly, risks are associated with the economic outlook. Recently, higher oil prices and higher interest rates have been the most visible signs of trouble for the economy. New Economy companies may be less vulnerable to these effects, but even these firms have experienced a sharp decrease in equity valuations as investors reeval-

Financial Market Volatility Could Pare Earnings for Banks Most Reliant on Market Sources of Revenue

FDIC-insured banks are deriving an increasing proportion of earnings from noninterest sources (see Chart 9), particularly market-sensitive sources of revenue. This is especially true for larger institutions. According to ***Deutsche Banc Alex. Brown,*** the 18 most active generators of market-sensitive sources of revenue earned over 25 percent of net operating revenue from these potentially volatile business lines.[22] While market-sensitive sources help to diversify revenue streams, they can also introduce increased income volatility in the event of financial market turbulence. Deutsche Banc Alex. Brown also reports that for those 18 banks that generated the largest amounts of market-sensitive revenues during the third quarter of 1998, the share of total revenue derived from market-sensitive sources declined from 23 percent to 13 percent. Thus, a more sustained downward trend in the financial markets could particularly affect the earnings of large banking companies that rely heavily on income from sources such as venture capital, asset management and brokerage services, and investment banking.

CHART 9

Noninterest Revenues Account for a Growing Share of Bank Net Operating Revenue



* Net operating revenue is the sum of net interest income and noninterest income.
Sources: FDIC Historical Statistics on Banking; FDIC Quarterly Banking Profile

[22] Net operating revenue is the sum of interest income and noninterest income less interest expense. According to Deutsche Banc Alex. Brown, these companies are Bank of America Corporation; Bank of New York Company, Inc.; Bank One Corporation; Bank Boston; BB&T Corporation; Chase Manhattan Corporation; Citigroup, Inc.; First Union Corporation; FleetBoston Financial; JP Morgan; KeyCorp; Mellon Financial Corporation; National City Corporation; PNC Bank Corp.; SunTrust Banks, Inc.; US Bancorp; Wachovia Corporation; and Wells Fargo & Company.

Other Risks to Watch in Banking

Subprime Lending

- ***Subprime consumer loan portfolios contributed to the large losses associated with recent high-cost bank failures.*** During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. The loss was primarily the result of an uptick in unanticipated and high-cost bank failures. FDIC-insured institutions with at least 20 percent of Tier 1 capital in subprime loans accounted for 6 of the 13 bank failures that occurred between January 1998 and March 2000. Fraud and inappropriate accounting for residuals also played a role in some of these failures.[23]

- ***Subprime lending remains an area of concern.*** Insured depository institutions that engage in subprime lending represent a disproportionate share of problem institutions. Of the 79 banks and thrifts on the problem bank list as of year-end 1999, 21 percent were institutions with at least 20 percent of their Tier 1 capital in subprime loans.[24]

Agricultural Lending

- ***While a majority of agricultural institutions remain relatively strong, external conditions have put pressure on some agricultural producers***. Many agricultural areas are experiencing low commodity prices as well as weather- and disease-related problems. Strong global competition and high worldwide production over the past several years have resulted in increasing inventories of many crops and poor prospects for a price turnaround in the near term. Moreover, in spite of record government farm payments in 1999, the U.S. Department of Agriculture projects that in the year 2000 one in four farms will not cover cash expenses, up to 20 percent of farmers will experience repayment problems, and 5 percent of farmers will be "vulnerable."[25]

- ***Some signs point to growing stress for agricultural institutions.*** Forty-two percent of FDIC-supervised banks active in agricultural lending showed a moderate or sharp increase in the level of carryover debt during third quarter 1999, compared with just 26 percent during third quarter 1998.[26] In addition, net loan loss rates for agricultural production loans increased in 1999 to the highest level since 1991. However, at 0.32 percent, the 1999 net loss rate is just one-tenth the rate experienced during the height of the agricultural crisis of the mid-1980s.[27]

Operational Risk

- ***Operational risks are becoming more prominent in the banking industry.*** Driven by consolidation and expansion into new product lines and markets, financial institutions are seeing an increase in operational complexity. Operational risk encompasses a host of factors not related to credit or market activities, including risks associated with processing transactions, legal liability, fraud, strategic missteps, and internal control weaknesses. Operational risks tend to be more pronounced when institutions engage in rapid growth, far-flung operations, and complex business processes.

- ***Greater attention is being paid to operational risks in the financial industry***. Recently, analysts have noted that the pressure to meet ambitious postmerger earnings predictions can result in cost-cutting measures that jeopardize the comprehensiveness and integrity of risk-management systems. In addition, the role that fraud has played in recent bank problems and failures reinforces the importance of adequate internal controls and audit procedures. The significance of operational risks to financial institutions has been noted in industry surveys and information-sharing efforts among financial firms.[28] NetRisk Inc., a Greenwich, Connecticut, consulting firm, recently estimated that operational losses among financial institutions have exceeded $40 billion over the past five years.

[23] See Puwalski, Allen. FDIC Division of Insurance. Second quarter 1998. Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings. *Regional Outlook.* http://fdic01/division/doi/outlook/2q1998/atlanta/infocus1.html.

[24] The problem bank list includes all insured depository institutions rated a composite "4" or "5."

[25] "Vulnerable," as defined by the U.S. Department of Agriculture Economic Research Service, applies to institutions that have debt/asset ratios above 0.40 and negative income such that they cannot meet current expenses or reduce existing indebtedness.

[26] September 1999. *FDIC Report on Underwriting Practices*.

[27] See Anderlik, John M., and Jeffrey W. Walser. FDIC Division of Insurance. Third quarter 1999. Agricultural Sector Under Stress: The 1980s and Today. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/agricult.html.

[28] For additional detail, see March 2000. Operational Risk: The Next Frontier. *RMA/PricewaterhouseCoopers Survey.* April 6, 2000. Tech Bytes: Banks Join Forces Against Operational Risk. *American Banker.*

uate the long-term prospects. Equity market volatility threatens to dampen consumer confidence and the ability of businesses to continue to merge, restructure, and invest.

The economy has become particularly dependent on financing delivered through the capital markets. In this more permissive financial environment, rising debt levels and greater dependence on foreign capital have emerged as financial imbalances that may contribute to future problems for the economy. Businesses and households with high levels of debt are more vulnerable to problems if interest rates continue to rise or income growth falters. Rapid credit creation by the domestic financial sector suggests the possibility of lax credit underwriting standards. Reliance on foreign capital raises concerns about what would happen to the value of the dollar and to domestic inflation if foreign investors decide to invest elsewhere.

Some analysts suggest that the New Economy, driven by increased productivity, heightened competition, and robust investment, may be characterized by longer expansions. Financial market imbalances may, however, contribute to deeper recessions and more sluggish recoveries compared with earlier business cycles.

For the banking industry, it is clear that a recession would mean slower loan growth, deteriorating credit quality, and impaired profitability. But the biggest threat to the banking industry is a recession that is tied to disruptions in the financial markets. The ready availability of financing to start new businesses and restructure old businesses has been key to the New Economy. The process by which businesses have invested and restructured in response to competition has been orderly from the perspective of bank creditors. If this process should be disrupted, we could see a much more disorderly process, with more bankruptcies and higher losses to lenders.

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

Maureen E. Sweeney, Associate Director
Paul C. Bishop, Senior Financial Economist
Richard A. Brown, Chief, Economic and Market Trends Section
Steve Burton, Senior Banking Analyst
Steven C. Cunningham, formerly Chief, Financial Institutions Section
Alan Deaton, Economic Analyst
Diane Ellis, formerly Senior Financial Analyst
Mary L. Garner, Senior Financial Analyst
Brian Kenner, Financial Analyst
Thomas A. Murray, Senior Financial Analyst
Allen Puwalski, Senior Financial Analyst
Arlinda Sothoron, Senior Financial Analyst
Ronald Spieker, Chief, Regional Programs and Bank Analysis

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________

Contact Person ______________________

Telephone ______________________

Street Address ______________________

City, State, Zip Code ______________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta ________	Dallas ________	New York ________	National ________
Boston ________	Kansas City ________	San Francisco ________	All ________
Chicago ________	Memphis ________		

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE MAIL
Postage & Fees Paid
FDIC
Permit No. G-36