Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1999

FDIC
MEMPHIS
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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.**

- ***Indicators of Industry Performance***—**The reported financial condition of insured banks and thrifts is strong. However, despite projected growth in earnings, bank and thrift stocks underperformed the broader market through October 1999.** ***See page 3.***
- ***Economic Conditions***—**The economy remains generally strong, and the outlook calls for continued growth. Growth is likely to slow, however, in order to correct financial imbalances that have developed as a result of a rapid creation of household and commercial credit and borrowing from abroad. There is a threat that the adjustment process could be a volatile one.** ***See page 4.***
- ***Emerging Risks in Banking***—**Rising indebtedness on the part of businesses and households raises concerns about future loan performance. Industry responses to intense competition have created greater credit, market, and operational risks.** ***See page 8.***

Consumer Lending—**Banks and thrifts are becoming increasingly involved in subprime consumer lending, which has raised some supervisory concerns.** ***See page 8.***

Commercial and Industrial Lending—**Signs of deterioration in corporate credit quality can be found in rising loss rates, slower profit growth, and rising corporate bond defaults. At the same time, banks are expanding their lending to heavily indebted companies in the syndicated loan market.** ***See page 11.***

Commercial Real Estate and Construction Lending—**Loans for real estate construction and development are growing rapidly. Despite an uptick in commercial vacancy rates, loan losses remain low.** ***See page 12.***

Agricultural Lending—**Low commodity prices are hurting farm operating incomes, but widespread effects on farm banks have yet to materialize.** ***See page 13.***

Funding and Interest Rate Risk—**Lagging deposit growth has led to a greater reliance on more volatile, market-based funding, and some institutions are taking on greater interest rate risk to maintain loan growth.** ***See page 14.***

By the Analysis Branch Staff

Regional Perspectives

◆ ***Economic and Banking Conditions***—**The Region's economy continues to underperform that of the nation. Payroll employment growth has slowed sharply with job losses in the manufacturing and energy sectors. The agricultural sector continues to deteriorate as the Region's important rice and cotton crops experience substantial price declines. Banking conditions remain favorable, but weaknesses in net interest margins persist.** ***See page 18.***

◆ ***New Bank Activity and Performance***—**Institutions established since the last recession represent almost 11 percent of all insured institutions in the Region. New banks' earning performance has worsened from the middle of this decade, and these newly chartered institutions are taking slightly longer to become profitable than in prior periods. Historically, new banks have reported considerably higher failure rates during periods of economic stress than established banks have.** ***See page 22.***

By the Memphis Region Staff

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Economic Conditions and Emerging Risks in Banking

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. Overall, conditions in the economy and banking industry are favorable at this time. However, signs point to vulnerability in the economy and in the banking industry that may make the years ahead much more challenging. Three broad themes emerge from this assessment:

- *Households' and businesses' debt levels are on the rise.* Spending by households and businesses is growing faster than cash income, resulting in rapidly increasing indebtedness. Consumer spending has been driven, in part, by large increases in the net worth associated with stock holdings and home equity. Businesses are restructuring and investing in new technologies to raise productivity and cut costs. Both consumer and business spending has been assisted by ready access to financing. Rising interest rates or slower economic growth could make debt service more difficult for borrowers.

- *Intense competition in banking is driving business strategies.* Competitive pressures have affected nearly every facet of the banking business. These pressures are evident in net interest margins, which have suffered from tighter loan pricing and higher funding costs. To maintain profits, some institutions are lending to less creditworthy borrowers, expanding into new or higher-yielding activities, creating more complex balance sheet structures, or cutting costs. These strategies may lead to greater credit, market, and operational risks.

- *The currently benign economic environment is vulnerable to rapid deterioration in the event of financial market instability.* During the 1990s, we have witnessed recurring, and perhaps more frequent, episodes of financial market turbulence. Recent episodes have arisen mainly overseas and have had little adverse effect on U.S. economic activity. However, the current economic expansion is closely tied to the ready availability of market-based financing for households and businesses and to wealth generated with the help of rising stock prices and falling interest rates. For this reason, the currently strong economic outlook may be subject to sudden deterioration in the event of market shocks that sharply raise interest rates or lower stock prices.

The analysis that follows explores these themes in more detail in the following sections: 1) indicators of industry performance, 2) economic conditions, and 3) emerging risks in banking.

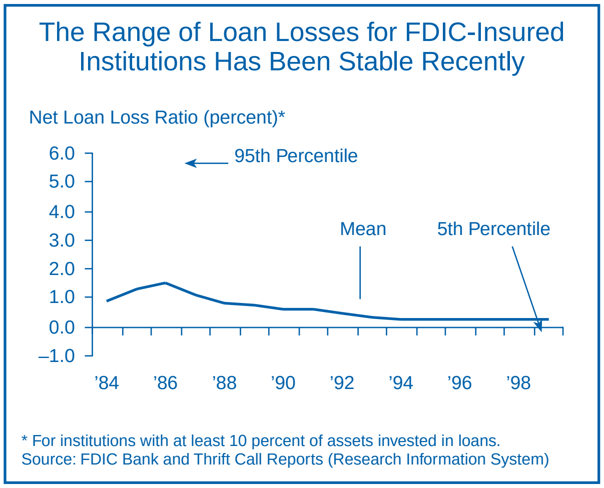
Indicators of Industry Performance

Industry Financial Performance Is Strong

According to reported financial information, the banking and thrift industries are performing well. As summarized in the ***FDIC Quarterly Banking Profile,*** second quarter 1999, both the commercial banking and thrift industries report near-record earnings, strong capital levels, and manageable volumes of problem assets and loan losses. Return on assets (ROA) for all insured institutions in the second quarter was 1.21 percent and return on equity (ROE) was 14.07 percent. ROA and ROE were down slightly from the first quarter despite improvement in the industry net interest margin (NIM) and a decline in provision expense. However, the majority of the decline in net earnings resulted from a $1.5 billion loss posted by one large bank.

The low overall level of net loan losses has been a key contributor to strong industry performance. Chart 1 (next page) shows that the average net loan loss ratio for the industry has been low and stable in recent years. Similarly, the range between the worst and best 5 percent of net loan loss ratios has narrowed considerably since the early 1990s. More than 95 percent of insured institutions reported a net loan loss ratio of less than 1 percent in 1998, continuing a five-year trend.

CHART 1



Bank Stocks Underperform Despite Projected Earnings Growth

Analysts expect continued earnings growth for banks and thrifts in 1999 and 2000. Median growth in earnings per share is projected to be 16.9 percent for publicly traded banks and 19.4 percent for publicly traded thrifts for 1999.[1] Ratings agencies also view the industry positively. The ratio of upgrades to downgrades for ratings issued by ***Moody's Investors Service*** improved in the second quarter, with nine companies receiving upgrades versus four receiving downgrades.

Nonetheless, bank and thrift stocks have underperformed the broader market in the first three quarters of 1999. The ***SNL Securities Bank Stock Index,*** which tracks more than 450 publicly traded commercial banks, declined 6.7 percent between January 1 and September 30, 1999. The ***SNL Securities Thrift Stock Index,*** which tracks the performance of about 350 publicly traded thrifts, fell 13.7 percent during the same period. By contrast, the ***Standard & Poor's (S&P) 500*** index gained 4.6 percent. Analysts cite rising interest rates, concerns about problems with corporate credit quality, and a decline in bank merger activity as reasons for the recent performance of bank and thrift stocks.

Economic Conditions

Overview

The U.S. economy has remained generally strong during 1999, the ninth year of the current economic expansion. If growth continues through February 2000—as most analysts expect—this expansion will become the longest in U.S. history. What is also remarkable about this business cycle expansion is the fact that the highest rates of growth have occurred during the past two years, 1997 and 1998. Even as growth has accelerated with unemployment declining to 4.2 percent, wage and price inflation has remained unusually subdued. While low inflation has helped prolong the expansion, it has imposed intense price competition on a wide range of industries. The currently positive economic outlook is subject to possible sudden deterioration in the event of financial market shocks that could raise financing costs, reduce the availability of financing, or destroy investor wealth.

Commodity Industries Have Faced Pricing Pressures

One disadvantage of low inflation during this expansion has been that firms in certain commodity industries have suffered from falling prices. Profit margins have declined in agriculture, mining, and some manufacturing sectors because of weak or negative revenue growth during 1997 and 1998.[2] Firms operating in these industries have aggressively cut costs to preserve profit margins. Nonetheless, profit growth has been flat or negative for a large proportion of ***S&P 500*** firms in the mining, textiles, chemicals, iron and steel, and oil and gas sectors since 1997. In response, some firms in these industries have chosen to consolidate through mergers. According to ***Mergerstat,*** the dollar volume of merger and acquisition transactions involving U.S. firms was a record $1.2 trillion in 1998, more than 80 percent above 1997 levels.

Business Investment Is Outpacing Cash Flow

Analysts recently have become concerned about increasing levels of debt on corporate balance sheets.

[1] Based on estimates as of November 4, 1999, for 98 commercial banks and 33 thrifts that have at least five analyst estimates.

[2] Richard A. Brown and Alan Deaton, "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality," ***Regional Outlook,*** Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

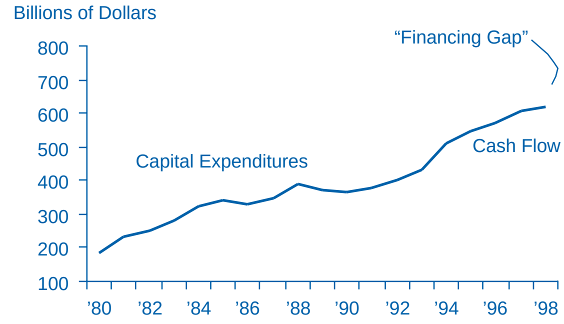
Chart 2 tracks the steady growth of fixed investment by U.S. corporations during the current expansion. It also shows, however, that growth in cash flow available to finance investment has slowed in recent years. This "financing gap" has grown steadily, reaching a record $86 billion in 1998.

As a result, corporations must finance an increasing portion of investment spending by issuing either net new equity or net new debt. In recent years, firms have overwhelmingly chosen debt financing. Net issuance of corporate debt was $219 billion in 1998, while corporations repurchased equity shares on net for the sixth straight year. Corporate borrowing has also continued at a brisk pace; domestic commercial and industrial (C&I) lending rose by 12.5 percent in the year ending June 1999.

A widening financing gap and increasing debt levels could pose future problems if there are adverse changes in the financial environment. For example, a sharp rise in interest rates would increase the debt burden of businesses, hurt their profitability, and impair their creditworthiness. Under such a scenario, firms might decide to curtail their capital expenditures, which would tend to reduce the rate of growth in the rest of the economy.

CHART 2

The Financing Gap Has Widened for Nonfinancial Corporations



Source: Federal Reserve Board (Haver Analytics)

Rapid growth in consumer spending also warrants attention. Despite the highest rates of real income growth in nine years, consumer spending has grown more quickly than disposable personal income. The divergence in growth has resulted in a falling personal savings rate, which reached a record low in 1999.[4] The recent decline in the personal savings rate continues a trend that has been under way for more than a decade (see Chart 3, next page).[5]

Analysts cannot fully explain the reasons for the falling savings rate, although the "wealth effect" associated with the accumulation of capital gains by households is believed to be a significant factor. Since 1995, the total value of equities, mutual funds, and pension funds owned by households has risen by $6.8 trillion, while the value of owner-occupied housing net of mortgage debt has increased by $812 billion. This accumulation of wealth apparently has emboldened consumers to spend, as evidenced by data that show aggregate spend-

Consumer Spending Continues to Grow

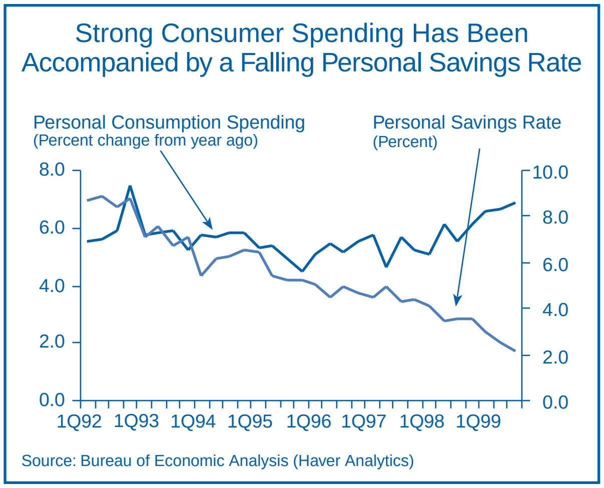
Strong growth in consumer spending continues to propel the economic expansion. Spending has accelerated in recent quarters, in contrast to previous expansions when the strongest growth in consumer spending occurred early in the recovery. One factor supporting the robust pace of spending is housing activity. Single-family housing starts rose to an annualized rate of more than 1.3 million units in fourth quarter 1998 and have remained near that level through third quarter 1999. Existing home sales also have maintained a record pace of 5.3 million units on an annualized basis during the second and third quarters. Low mortgage interest rates and real income gains have combined to push housing affordability to its highest level in many years.[3]

[3] The housing affordability index published by the ***National Association of Realtors*** equals 100 when the median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. The value of the index as of the third quarter of 1999 was 127.1.

[4] *Personal savings* is calculated as the difference between *disposable personal income* (DPI, or total income net of taxes) and *consumption expenditures.* The *personal savings rate* is equal to personal savings divided by DPI. It should be noted that capital gains, even when realized, are not included as income in this calculation, although taxes paid on capital gains are deducted from DPI. Consequently, large-scale realization of capital gains by households will tend to push down the personal savings rate.

[5] The ***Bureau of Economic Analysis,*** which tabulates the personal savings rate, has recently revised its methodology, leading to a large revision in the savings rate data. Earlier estimates reported the personal savings rate to be around negative 1 percent, suggesting that households were spending more than their disposable (after-tax) income. Revised estimates show that the savings rate for the third quarter of 1999 was 2.1 percent. Although higher than previously reported, the revised personal savings rate data continue to show a downward trend similar to earlier savings rate estimates.

CHART 3



ing growth exceeding income growth. For the most part, when consumers have chosen to convert capital gains to spendable cash, they have done so by borrowing—often against the equity in their homes or their 401(k) accounts.

The increasing indebtedness of consumers could substantially raise the costs of debt service relative to income, especially if interest rates rise or income growth slows. Moreover, analysts express concerns about a reversal of the wealth effect if there is a significant and sustained decline in equity prices. Any resulting decline in consumer confidence could substantially slow the pace of consumer spending, leading to a reduced pace of economic growth.

The Growing Private Deficit Raises Concerns

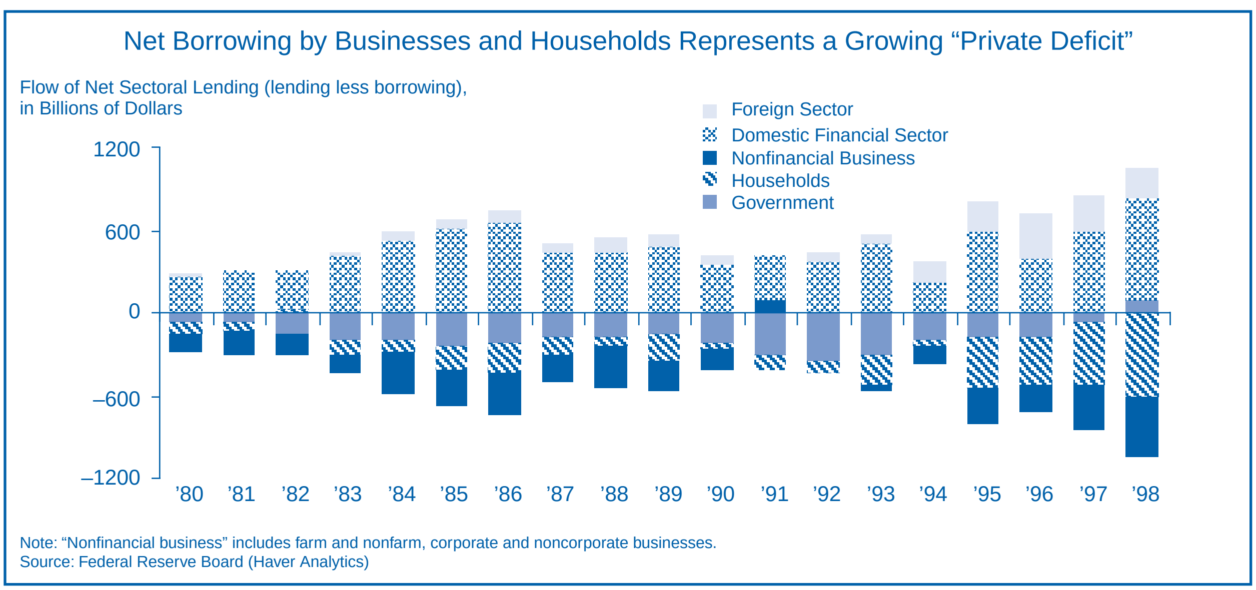
Taken together, the sum of annual net borrowing by businesses and households has been referred to as the "private deficit." During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it nearly doubled from $550 billion to $1.02 trillion (see Chart 4).

The private deficit was financed from three sources in 1998. One source was the $73 billion surplus in the government sector, the first surplus in 28 years. The largest portion of the 1998 private deficit was financed by the creation of credit by the domestic financial sector and by an inflow of foreign capital. The rapid creation of credit raises concerns about credit quality, an issue that is explored in more detail under *Emerging Risks in Banking,* below. Dependence on foreign capital raises questions about what might happen if the foreign sector becomes less willing to export capital to the United States.

Recovery Abroad Is Changing the Terms of Trade

During the past three years, the U.S. economy has experienced consistently strong growth with low inflation, while the economies of some of its major trading partners have grown more slowly or not at all. Japan was mired in its worst recession in decades, while a number of countries in Asia, Latin America, and Eastern Europe

CHART 4



have experienced the harsh fallout resulting from financial market and exchange rate crises. The euro-zone economies, Germany and France in particular, have grown slowly following the imposition of tight fiscal and monetary policies in advance of the introduction of the euro on January 1, 1999.

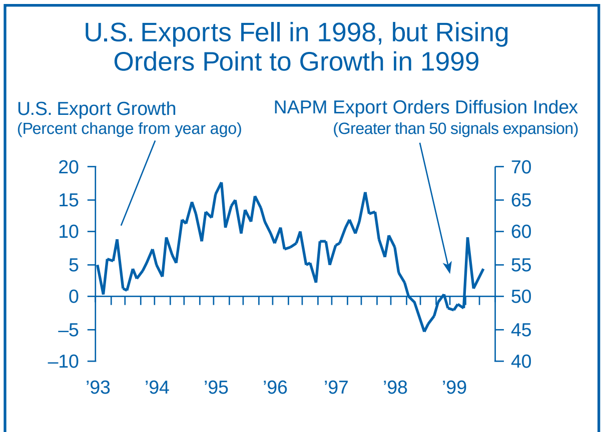
The net effect of this disparity in growth rates has been a growing U.S. trade deficit. The deficit rose by 57 percent in 1998 to $164.3 billion, reflecting a small decline in exports and a 5 percent increase in imports. The adverse effects of the trade deficit on the U.S. economy have been felt primarily by the commodity industries—farming, mining, and basic manufacturing. In addition, the large trade deficit has resulted in the transfer of billions of dollars to foreign investors. During 1997 and 1998, many foreign investors used their excess dollars to purchase dollar-denominated stocks and bonds. This inflow of capital helped keep U.S. equity and bond prices high, while pushing up the value of the dollar.

A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent in 2000.[6] Foreign investors, in anticipation of stronger growth and greater investment opportunities abroad, have started to convert excess dollar holdings to other currencies, including the yen and euro. This change in investment strategy has put downward pressure on the value of the dollar. Between July and September 1999, the dollar lost approximately 10 percent of its value against the yen.

A falling dollar will likely contribute to a recovery of U.S. exports in coming months. The index of export orders compiled by the ***National Association of Purchasing Managers*** points to future growth in shipments abroad. The index has signaled growing export orders for nine months through October 1999. As Chart 5 shows, increasing export orders tend to lead the actual rise in exports by several months.

A lower dollar could also place upward pressure on U.S. inflation and interest rates. A steady decline in the dollar would make foreign goods more expensive, while higher export demand would raise manufacturing output at a time when U.S. labor markets are very tight. The prices of several important industrial commodities have

CHART 5



Source: Bureau of the Census; National Association of Purchasing Managers (NAPM) (Haver Analytics)

risen in dollar terms during 1999, led by a doubling in the price of oil during the first nine months of 1999. Domestically, the producer price index has risen by approximately 4 percent since the beginning of the year following a two-year decline, reflecting an increase in oil and intermediate goods prices.

Interest rates have risen in step with renewed concerns about inflation. The constant maturity yield on 10-year Treasury bonds increased by approximately 140 basis points in the year ending October 1999, while the Federal Reserve instituted two 25-basis point increases in short-term rates during the summer of 1999.

The Economic Outlook Calls for Continued Growth

One scenario for the year ahead is that the U.S. economy will continue to grow at much the same rate as it has during the past few years. As discussed above, however, continued rapid growth would lead to even greater imbalances in the domestic economy and in the foreign sector. For this reason, most economists do not believe that rapid growth can continue indefinitely. Instead, analysts suggest two possible scenarios for the economy.

The ***Blue Chip Economic Indicators*** consensus outlook for the U.S. economy calls for a "soft landing." Gross domestic product is projected to grow at a rate of 3.8 percent in 1999 with somewhat slower growth of 2.8 percent in 2000.[7] Rising wage pressures, reflecting tight

[6] International Monetary Fund, ***World Economic Outlook,*** October 1999.

[7] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

labor markets across the nation, and economic recovery abroad are expected to increase the risks of higher U.S. inflation. Improving growth prospects in the global economy may also lead to a stabilization of commodity prices, reversing a trend of falling prices that has until recently contributed to lower U.S. inflation. In response to expectations of higher inflation, medium-term interest rates are also expected to rise modestly. Slower U.S. growth and faster expansion abroad would result in a rebalancing of global growth that should narrow the U.S. trade deficit and reduce downward pressure on the dollar.

Although the consensus forecast calls for continued expansion, an alternative scenario suggests the possibility of a steep decline in economic growth leading to a "hard landing." Sharply higher interest rates, in response to a weak dollar and an unexpected acceleration of U.S. inflation, could lead to declining capital investment and reduced consumer spending. Rising interest rates would increase the debt burden for households and businesses even as measures of indebtedness are rising. A significant and sustained decline in equity prices may occur if investors become pessimistic as the economy slows. The response of the world economy to a U.S. recession is difficult to assess. As the past several months have shown, growth in the U.S. economy has been an important factor in supporting growth abroad. If the U.S. economy were to enter a recession, overall global growth could also slow, depending on the extent to which recoveries in Europe, Asia, and Latin America offset any shortfall in U.S. growth.

Emerging Risks in Banking

Overview

Favorable economic conditions continue to support strong loan growth and healthy loan performance among insured institutions. Net loss rates remain low relative to the early 1990s for almost every major loan category except consumer loans. Loss rates in domestic commercial loans, previously at low levels, rose modestly during the first half of 1999. Agricultural loan loss rates appear likely to rise in the future due to the effects of weak commodity prices on farm incomes. Strong loan growth and low loan losses have helped banks achieve record and near-record high quarterly profits. However, rising indebtedness on the part of businesses and households raises concerns about future loan performance, particularly if economic conditions were to deteriorate or if interest rates were to rise.

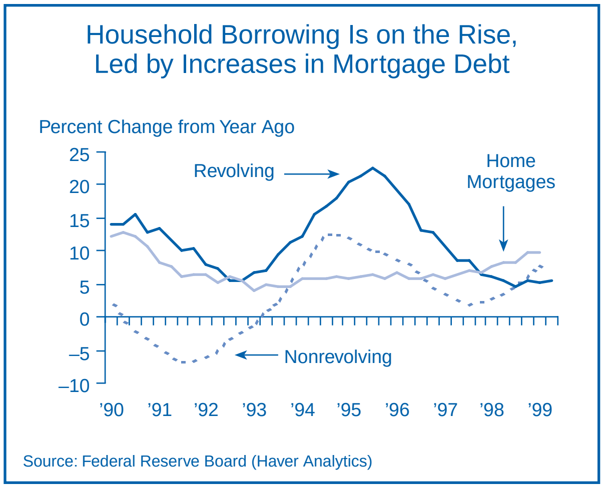
Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured institutions are expanding into activities such as subprime consumer lending, high loan-to-value mortgage lending, and lending with minimal or no documentation requirements. Rapid growth in syndicated lending to leveraged companies also indicates that large commercial lenders have increased their tolerance for risk. Competition has made funding with deposits more difficult. As a result, some institutions are relying increasingly on securitizations and more expensive, market-based sources of funds, which can alter an institution's liquidity position, interest rate risk profile, and operational needs. Institutions have also responded to competitive pressures by cutting costs or merging in an attempt to achieve greater efficiencies. In some cases, deep reductions in operating costs support profits at the expense of less effective operational controls.

Consumer Lending

Household Borrowing Is on the Rise

Household borrowing is growing rapidly, consistent with high reported levels of consumer confidence and strong consumer spending. Mortgage debt, which grew by 10.4 percent in the second quarter from year-ago levels, is the fastest-growing segment of household debt (see Chart 6). Mortgage loan growth has been particularly strong, in part because of rising homeownership, the availability of more low-down-payment loans, and the use of mortgage loans to consolidate revolving debt balances. Nonrevolving debt grew by 7.3 percent in the year ending June 1999, largely because of strong sales of new cars. In contrast, credit card and other revolving debt increased by only 5.7 percent during the same period—a much slower rate of growth than during the mid-1990s.

CHART 6



A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

A key component of the recent shift by consumers from credit card debt to mortgage debt has been a surge in mortgage refinancing in 1998 and early 1999. The ***Mortgage Bankers Association's Refinancing Index*** peaked at over 4,300 in October 1998, compared with an average monthly index value of 527 during 1997.[8]

Many households have refinanced their mortgages to obtain cash to pay down credit card and other high-cost consumer debt, thereby lowering their monthly financial obligations. According to a ***Freddie Mac*** survey of 1998 refinancing transactions, more than 3 million homeowners, or 51 percent of all mortgage-refinance borrowers, generated net cash proceeds when they refinanced their loans.[9] On average, these borrowers cashed out 11 percent of the equity in their homes. On the basis of this survey, ***Bank One Corporation*** estimated that cash out refinancing added about $60 billion in cash flow to consumer pocketbooks last year. This extra cash flow could help explain recent quarterly declines in personal bankruptcy filings, mortgage delinquencies, and consumer credit charge-offs.[10] Rising interest rates appear to have ended this mortgage refinancing boom. The lower volume of mortgage refinancings raises questions about whether consumers again will increase their use of credit cards to finance purchases. If so, there may be negative consequences for future consumer debt service burdens and consumer credit quality.

Credit Card Lenders Face Declining Returns

After several years of rapid growth in the mid-1990s, the credit card industry has become characterized by overcapacity and declining margins. At the same time, the high level of mortgage refinancings and rising household incomes have reduced the dependence of consumers on credit card debt. Consequently, credit card lenders are struggling to maintain volume as consumers pay off their credit card balances more quickly.

Overcapacity and declining margins have led lenders to search aggressively for new ways to increase revenues. One method they have adopted is to charge new fees that are triggered by cardholder behavior. Lenders are now charging fees for inactive accounts, fees to close accounts, and even customer service fees. In addition, they are reducing grace periods, curtailing leniency periods, and imposing higher penalty interest rates. According to ***RAM Research,*** banks' income from credit card fees has grown 79 percent over the past two years, while card interest income rose only 10 percent.[11]

Shrinking margins have also prompted consolidation in the credit card industry. Today, the top five issuers control about 60 percent of the total managed assets in the credit card sector, up from just 35 percent in 1990.[12] Amid this changing competitive landscape, credit quality has improved. Credit card charge-off levels at insured commercial banks hit an all-time high of 5.5 percent in the third quarter of 1997 but have declined steadily to a level of 4.1 percent in the second quarter of 1999. This decline has been attributed to tighter underwriting standards, more aggressive collection efforts, and extra household cash flow generated through mortgage refinancings.

[8] Index is seasonally adjusted where the week of March 16, 1990 = 100.

[9] Survey cited in a study by the Joint Center for Housing Studies at Harvard University, "The State of the Nation's Housing: 1999."

[10] Tristan Mabry, "This Boom, Some Say, Is on the House," ***The Wall Street Journal,*** July 6, 1999.

[11] Miriam Kreinan Souccar, "Consumer Groups Up in Arms Over Card Penalties," ***American Banker,*** February 26, 1999.

[12] James C. Allen, "Tarnished Platinum," ***SNL Securities Bank Mergers & Acquisitions,*** June 1999.

Subprime Lenders Have Riskier Characteristics than the Industry

Subprime lending to consumers has grown dramatically in recent years. Subprime mortgage originations have grown from 5 percent of the total mortgage market in 1994 to 15 percent in 1997.[13] The percentage of originations fell somewhat in 1998 to 10 percent—not because the volume of subprime mortgage originations fell but because the volume of prime mortgage originations was at a record high. In fact, in terms of dollars, subprime originations grew by 20 percent from 1997 to 1998, to $150 billion. That figure is up significantly from the $35 billion in subprime originations in 1994. Estimates of the size of the subprime automobile loan market vary somewhere between $50 billion and $75 billion, but one source estimates that subprime automobile originations jumped from about 8 percent of all automobile loan originations in 1990 to over 18 percent in 1998.[14] Analysts also have indicated that the subprime credit card market is the fastest-growing segment of credit card lending today. According to ***RAM Research,*** subprime receivables are growing 45 percent annually, compared with 16 percent or less for other segments of credit card lending.[15]

Intense competitive pressure has contributed to the expansion of bank and thrift participation in subprime consumer lending. These loan programs offer higher margins than prime consumer lending products and have become an attractive alternative for banks and thrifts that have experienced shrinking margins in credit cards, mortgage lending, and other consumer product types. Moreover, the shakeout in the subprime specialty finance industry has provided new opportunities for insured depository institutions seeking to enter the subprime lending market. In 1999, several insured depository institutions acquired, or announced plans to acquire, a subprime specialty finance company. Bank and thrift involvement in subprime lending is expected to increase. In fact, some industry analysts predict that insured depository institutions with subprime affiliates will overtake finance companies as leaders in the subprime industry.

Subprime lending poses entirely new challenges in risk management for insured institutions. Not only are expected credit losses higher than for prime consumer lending, but a number of factors suggest that losses are also less predictable:

- *Subprime borrowers are more likely to default than prime borrowers and may be more vulnerable to economic shocks, such as a recession.* Borrowers' previous credit problems suggest that they have limited financial resources to withstand economic difficulties.

- *Credit-scoring and pricing models used to underwrite subprime loans are untested in a recession.* Analysts have noted that credit-scoring models are less effective in predicting the likelihood of default for subprime borrowers than they are for prime borrowers.

- *Operational risks are greater in subprime lending.* Because defaults occur sooner and more often than in prime lending, subprime portfolios require a greater investment in servicing and collections resources. Subprime lenders run a greater risk that these resources could become severely strained if the level of defaults is not correctly anticipated.

- *Liquidity risks are greater in subprime lending.* Some large-volume subprime lenders heavily depend on the ability to securitize and sell loans to the secondary market. But investor demand for paper backed by subprime loans may be volatile, as was demonstrated during the financial market turmoil of late 1998. A number of nonbank subprime lenders experienced a liquidity crunch as a result of that market turmoil, and several opted for—or were forced into—bankruptcy.[16]

- *Reputation, legal, and compliance risks also are important for subprime lenders.* Subprime lenders generally run a greater risk of violating, or being accused of violating, consumer protection laws or regulations. The public perception of subprime

[13] ***The Mortgage Market Statistical Annual for 1999,*** Inside Mortgage Finance Publications, 1999.

[14] Ron Feldman, ***An Introduction to Subprime Auto Lending for Examiners,*** Federal Reserve Bank of Minneapolis, April 1998, and data supplied by CNW Marketing and Research.

[15] Lisa Fickenscher, "Credit Card Issuers Panning for Gold Among Tarnished Credit Histories," *American Banker,* October 22, 1998.

[16] Dominic DiNapoli and Ron Greenspan, "The Next Industry Crisis Could Be Even Bigger," *American Banker,* June 15, 1999.

lenders could be tarnished if a recession were to result in substantially higher default rates.

The growing involvement by insured depository institutions in subprime lending has raised significant concerns for bank and thrift supervisors. To address those concerns, FDIC Chairman Donna Tanoue recently announced that the FDIC will propose to the other federal financial institution regulators that insured depository institutions with concentrations in subprime lending be held to higher minimum capital requirements than the current rules dictate.[17] The FDIC proposal includes a common supervisory definition of subprime lending and ties capital adequacy to the types and levels of risks that individual subprime lenders have in their portfolios. This proposal will be shared with other federal regulators to refine a final approach.

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

Insured institutions continue to accommodate the credit needs of business borrowers. Domestic C&I loans grew almost 12.5 percent during the year ending in June 1999 and accounted for 40 percent of all net new loans booked during that period.

Although commercial loan losses are low, there are signs that credit quality in C&I portfolios is deteriorating. Net domestic C&I charge-offs during the first half of 1999 more than doubled from 1998 levels, while noncurrent domestic C&I loans rose by 26 percent. Examiners also have reported increasing problems in commercial portfolios. The ***Office of the Comptroller of the Currency*** recently reported that the dollar volume of classified and special-mention Shared National Credits rose 70 percent during a recent annual review.[18]

Slower profit growth and rising corporate bond defaults also point toward somewhat weaker business credit quality. While corporate profits grew by an average of 15 percent per year between 1993 and 1996, economists polled by *Blue Chip Economic Indicators* project growth of 6.7 percent for all of 1999, followed by growth of only 3.5 percent in 2000.[19] ***Standard & Poor's*** reported that 55 rated issuers defaulted on $20.5 billion in debt during the first six months of 1999.[20] This pace of defaults is already nearly double levels experienced in the first half of 1998 and does not include more recent large defaults such as Iridium and Daewoo Group. Approximately 85 percent of the defaults that occurred during the first half of 1999 were among speculative-grade issuers. According to ***Moody's,*** junk bond defaults rose to 5.8 percent of issues outstanding during the 12 months ending in September 1999, the highest level since 1991.

Rising Losses May Be Attributable to Loose Underwriting

Analysts attribute the recent deterioration in commercial credit quality to weak underwriting standards in the corporate debt markets during 1997 and early 1998.[21] Bank underwriting was reported to be particularly accommodating at that time. The ***Federal Reserve Board*** reported in its May 1998 *Senior Loan Officer Opinion Survey on Bank Lending Practices* that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." Subsequently, the November 1998 *Survey* reported a "broad tightening of business lending practices" associated with the financial market turmoil in progress at that time. However, regulators have continued to express concern about the assumptions underlying bank lending decisions. A Supervision and Regulation Letter sent by the ***Federal Reserve Board of Governors*** to its examiners in September 1999 noted the recent tightening of standards, but stated that "certain deeper issues remain," which relate mainly to overoptimistic assumptions about the future repayment capacity of business borrowers.[22]

[17] FDIC Chairman Donna Tanoue in a speech before America's Community Bankers, Orlando, Florida, November 2, 1999 (http://www.fdic.gov/news/news/speeches/chairman/sp02Nov99.html).

[18] "OCC Says Big Commercial Loans Suffering from Lax Underwriting," *American Banker,* October 6, 1999, p. 1. The shared national credit program is a cooperative interagency program to review large credits held at several institutions. Loans subject to review include commitments in excess of $20 million that are shared among three or more participating lenders.

[19] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

[20] "Defaults Soar in First Half 1999," *Standard & Poor's,* August 12, 1999.

[21] See, for example, "Under Boom Economy, Strain Over Debt," *The Wall Street Journal,* August 18, 1999, Section C, p. 1.

[22] SR 99-23, September 28, 1999. "Recent Trends in Bank Lending Standards for Commercial Loans" (http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9923.HTM).

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

Banks appear to be taking on more risk in the syndicated loan market by expanding their lending to heavily indebted companies. During the first half of 1999, leveraged lending was the fastest-growing segment of syndicated commercial lending.[23] While overall syndicated loan volume was down slightly compared with the first half of 1998, syndicated lending to leveraged companies rose $7 billion, or 5 percent, on the strength of a record volume of "highly leveraged loans."[24] As shown in Chart 7, loans to leveraged companies are making up a growing proportion of syndicated loan originations.

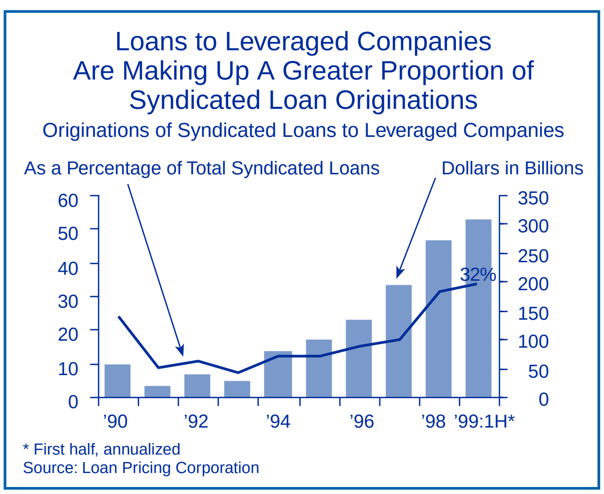
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank investors, a substantial portion of these credits remains on bank balance sheets. ***Loan Pricing Corporation*** has reported that as much as 64 percent of the value of "highly leveraged" loans originated in the first half of 1999 was retained by banks.[26]

[23] Syndicated loans are credits extended to large or medium-sized corporate borrowers that are originated by a group, or syndicate, of lenders. One type of syndicated lending is leveraged lending, in which the borrower's debt-to-equity ratio is significantly higher than the industry average. Loan Pricing Corporation defines "leveraged loans" as those for which pricing exceeds 125 basis points over LIBOR.

[24] Loan Pricing Corporation defines "highly leveraged loans" as those for which pricing exceeds 225 basis points over LIBOR.

[25] According to ***Mergerstat,*** the value of mergers and acquisitions (M&A) was almost $400 billion during second-quarter 1999. According to ***Loan Pricing Corporation,*** syndicated loans originated in the second quarter to finance M&A activity totaled some $69 billion—a 43 percent increase over issuance in the first quarter.

CHART 7



Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

Loans for real estate construction and development (C&D) represent one of the fastest-growing segments of bank balance sheets, increasing 24 percent during the year ending June 1999. Compared with construction activity in the mid-1990s, spending on new commercial construction has shifted somewhat away from the industrial and retail markets and toward office and hotel construction. Residential construction growth was also strong during the first half of 1999, with single-family completions increasing 17 percent from a year ago. In the midst of this growth in loan volume, loss rates and past-due ratios for construction and development loans remain very low by historical standards, as indicated in Chart 8.

Office Vacancy Rates Are Rising in Many Top Markets

In previously published reports, Division of Insurance analysts identified nine metropolitan real estate markets where rapid development threatened to produce near-term oversupply conditions.[27] These cities were identified based on the pace of current construction activity, commercial space demand indicators, and independent market analysts' projections. Six of the metropolitan areas identified—Atlanta, Phoenix, Orlando, Portland, Dallas, and Nashville—subsequently experienced large increases in office vacancy rates during the first half of 1999. These areas have also experienced reduced employment growth and slowing net in-migration. Higher vacancy rates are often accompanied by slower

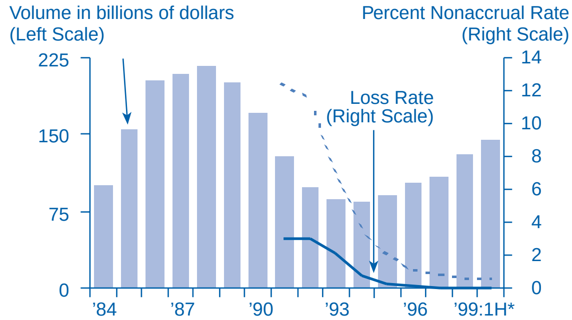
[26] "Junk Loan Market Is Feeling the Pinch of Oversupply and Rising Interest Rates," *The Wall Street Journal,* September 13, 1999.

[27] Steven K. Burton, "Commercial Developments Still Hot in Many Major Markets, but Slower Growth May Be Ahead," *Regional Outlook,* First Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19991q/na/infocus2.html) and "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," ***Bank Trends,*** FDIC Division of Insurance, October 1998 (http://www.fdic.gov/bank/analytical/bank/bt9807.html).

CHART 8

Construction Loan Volume Continues to Rise, but Problem Loans Remain Low

Construction and Development Loans



* First half

Source: FDIC Bank and Thrift Call Reports (Research Information System)

rental-rate growth, which may lead to lower real estate values. For example, Atlanta's vacancy rate rose 1.5 percentage points to 10.3 percent, while growth in rental rates slowed noticeably from the pace of the previous three years.[28]

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

Evaluations of bank loan underwriting suggest a recent tightening of lending standards for commercial real estate loans. The August 1999 ***Federal Reserve Board*** *Senior Loan Officer Opinion Survey* reported a net tightening of commercial real estate underwriting standards, continuing a trend begun in late 1998. The ***FDIC's*** March 1999 *Report on Underwriting Practices* also found fewer instances of risky lending practices with respect to commercial real estate and construction lending than in prior reports. The FDIC's September *Report* showed no significant changes in lending standards.

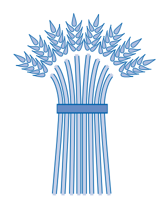
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to very low levels, particularly compared with the 1980s. In some instances, lenders have responded to competitive pressures by making structural concessions on loan-to-value, cash equity, and recourse terms, particularly for large borrowers. However, underwriting standards generally have not been as aggressive as practices observed in the 1980s.

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

Low prices for wheat, corn, hogs, cotton, and oilseeds are creating financial difficulties for farmers in the nation's midsection. Several consecutive years of high worldwide production have resulted in large inventories of grains and oilseeds, which have depressed prices. Prices not only have fallen from mid-1990s levels, but are also low by historical standards. The ***United States Department of Agriculture (USDA)*** forecasts for 2000 show little likelihood of improvement in prices.[30]

The financial outlook for significant portions of the farm sector has deteriorated. The USDA projects that farm income from operations will decline by around 15 percent in 1999 from year-ago levels. However, total net farm income is projected to decline less than 1 percent. A projected $16.6 billion in government payments is expected to make up most of the difference between operating income and total net income.[31] Legislation passed in October 1998 provides for $8.7 billion in emergency aid to affected farmers.



Farm Banks Continue to Perform Well Overall

Despite the difficulties created by low farm prices, the overall financial condition of the 2,250 FDIC-insured farm banks continues to be strong.[32] Farm banks reported an annualized ROA of 1.21 percent and an equity capital-to-assets ratio of 10.5 percent at mid-year

[28] Vacancy rates and rental growth rates were obtained from ***REIS Reports.***

[29] Steven K. Burton, "Recent Trends in Construction Lending Practices," *Bank Trends,* FDIC Division of Insurance, July 1999 (http://www.fdic.gov/bank/analytical/bank/bt9901.pdf).

[30] "World Agricultural Supply and Demand Estimates," USDA, October 10, 1999.

[31] "Potential Impacts of an Agricultural Aid Package," ***Agricultural Outlook,*** USDA, September 1999.

[32] Farm banks are defined by the FDIC as those with over 25 percent of their loans in agricultural production or secured by agricultural real estate.

1999.[33] Loan loss reserves, which stood at 1.58 percent of total loans in June, remain high compared to historical levels. Loan performance at farm banks also appears to be strong at this time. Total past-due loans made up just 2.66 percent of total loans at farm banks in June, a level that is only 9 basis points higher than a year ago. Moreover, this increase in past-due loans is attributable entirely to nonagricultural loans; the level of past-due farm loans has not risen over the past 12 months. At the same time, higher-than-average nonperforming loan levels have been reported by farm banks in the upper Midwest and the South.

There are reasons to believe, however, that it will take time for financial distress among farm producers to significantly affect loan performance at farm banks. One such reason is the increasing use of carryover debt to restructure and extend operating loans that cannot be fully retired by borrowers during the current crop year. The most recent *Survey of Agricultural Credit Conditions* conducted by the ***Federal Reserve Bank of Kansas City*** indicated an increase in the use of agricultural carryover debt by Tenth District banks.[34] An increase in carryover debt was also noted in the ***FDIC's*** March 1999 *Report on Underwriting Practices,* which indicated that almost one-third of FDIC-supervised farm banks experienced at least a "moderate" increase in agricultural carryover debt during the preceding six-month period.[35] Although the use of carryover debt is not an uncommon practice in agricultural lending, it can be a leading indicator of declining loan performance. Chart 9 shows that increases in carryover debt by Tenth District farm banks in 1995 preceded increased loan losses during 1996.

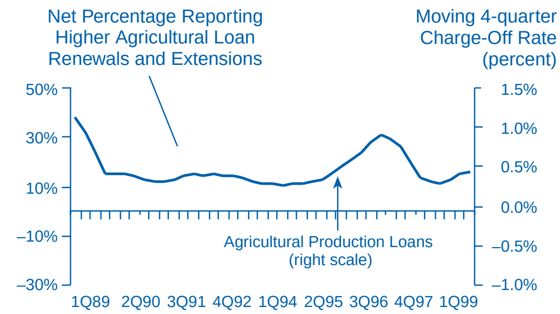
[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported profitability, farm bank ROA levels may not be comparable with ratios from prior periods.

[34] *Survey of Agricultural Credit Conditions,* Federal Reserve Bank of Kansas City, June 29, 1999 (http://www.kc.frb.org/PUBLICAT/RED/PDF/2q99AgCrPress.pdf). The Tenth District comprises significant agricultural areas in Colorado, Kansas, Nebraska, Oklahoma, Wyoming, northern New Mexico, and western Missouri.

[35] John M. Anderlik and Jeffrey W. Walser, "Agricultural Sector Under Stress: The 1980s and Today," *Kansas City Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/k3q1999.pdf).

CHART 9

Rising Levels of Carryover Debt Suggest Future Increases in Loan Losses at Farm Banks



Source: Federal Reserve Bank of Kansas City; FDIC Bank and Thrift Call Reports (Research Information System)

Funding and Interest Rate Risk

Lagging Deposit Growth Has Led to Greater Reliance on Market-Based Funding

For most of the 1990s, banking industry asset growth has outstripped growth in deposits, creating greater reliance on more expensive and less stable market-based sources of funding. The trend in the loan-to-deposit ratio for commercial banks, which reached a record high of almost 90 percent at June 30, 1999, reflects this shift. Deposit growth has not kept pace with asset growth, in part because of a low rate of personal savings by households and competition for depositor funds from higher-yielding investment alternatives and nonbanks. Lagging deposit growth is particularly important for community banks because these institutions traditionally rely more heavily on deposits to fund assets than do larger banks.[36] Greater dependence on market-based funding can alter the liquidity and interest rate risk positions of institutions and may require heightened attention to, and expertise regarding, asset-liability policies and procedures.

Growth in Securitization Affects Underwriting and the Structure of Bank Balance Sheets

Banks, and nonbanks in particular, continue to employ the securitization market to fund lending activities.

[36] Allen Puwalski and Brian Kenner, "Shifting Funding Trends Pose Challenges for Community Banks," *Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

Issuance of asset-backed securities and commercial mortgage-backed securities (CMBS) totaled $223 billion through the first six months of 1999, and is on pace for another record year. Including participation through credit card companies and CMBS conduit programs, bank-related issuance amounted to about 25 percent of total issuance in 1998, a decline from 1997 levels. Although insured institutions are not dominant players, growth in the securitization market can influence loan underwriting practices and the structure of bank balance sheets.

The securitization market competes to originate loans that could be made by insured institutions. This competition may tend to erode underwriting standards if securitizers ease terms to maintain sufficient volume to support lending pipelines. Recent trends indicate that this competition has intensified. For example, market observers note that the subordination levels in the CMBS market have been declining, which allows securitizers to increase lending volume for a given level of capital.[37]

When banks do securitize, it is not always clear how much risk is transferred. The issue of credit risk transference by commonly used securitization structures continues to receive attention from the markets and rating agencies. For example, many analysts agree that revolving structures, such as those used to securitize credit cards, eliminate only the most catastrophic credit risks for issuers.[38] In addition, assets created by gain-on-sale accounting rules when loans are securitized can be volatile and can lead to unstable earnings and capital if not properly controlled and administered.

Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

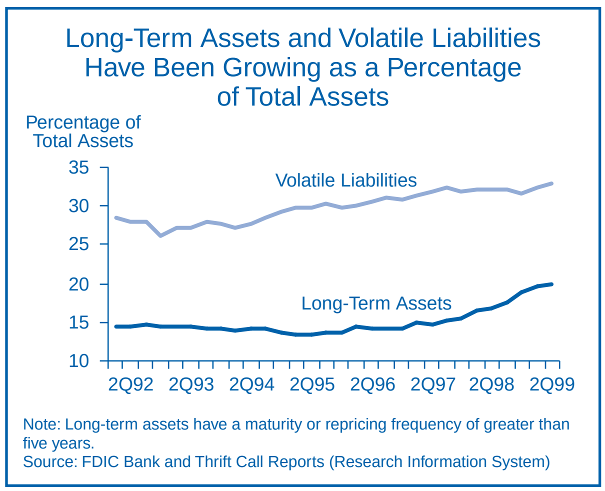
Potentially volatile liabilities and long-term assets have been growing as a percentage of banking assets. Consistent with reduced deposit funding by insured institutions, more market-based and potentially volatile liabilities have been supporting an increasing proportion of banking assets in recent years (see Chart 10).[39] At the same time, the lengthening maturity of insured institution mortgage portfolios has increased the percentage of total bank assets with maturities or repricing frequencies of greater than five years. This trend in mortgage portfolios is primarily responsible for the thrift industry's increasing interest rate sensitivity. According to the ***Office of Thrift Supervision's*** *Quarterly Review of Interest Rate Risk,* interest rate sensitivity for the median thrift rose in the second quarter of 1999 for the third consecutive quarter.

[37] Securitizations are often structured in tranches such that a subordinated security bears the credit risk for a senior piece. The relative size of the subordinated piece affects not only funding costs for the issuer, but also the amount of effective leverage achievable through securitization.

[38] A common feature of a revolving securitization structure is the provision for an "early amortization." When a triggering event occurs, such as a negative three-month average excess spread, all available cash flows are used to pay off bondholder principal. This event causes receivables related to the deteriorating accounts to remain on the balance sheet of the issuer. Unless the deterioration in account credit quality is very rapid and severe, the bondholders will be repaid completely, and the credit risk will be borne by the issuer.

[39] Volatile liabilities include borrowings, federal funds purchased, repurchase agreements, jumbo certificates of deposit, foreign deposits, and trading liabilities.

CHART 10



Operational Risks

Insured banks and thrifts face numerous business- and process-oriented operational risks on a daily basis. At the same time, recent industry developments and bank failures have highlighted the importance of maintaining strong operations. The ***Basle Committee on Banking Supervision*** reported in late 1998 that "awareness of operational risk among bank boards and senior management is increasing."[40]

The competitive environment and shareholder expectations have led many insured institutions to search for greater efficiency by cutting costs. In some cases, deep cuts in overhead expenses may weaken the effectiveness of operating and monitoring systems as well as internal controls. Anecdotal evidence from banking regulators suggests that internal control and recordkeeping weaknesses are on the rise. Moreover, industry consolidation and new business activities are creating bigger, more complex, and more decentralized operating environments, especially for the largest institutions. These issues are important since operational weaknesses may leave institutions more vulnerable to adverse economic conditions, insider abuse, or fraud.

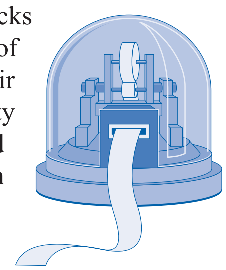
Implications

This article has summarized the generally favorable current condition of the U.S. economy and banking industry. The economy is in the ninth year of a remarkable economic expansion that has been conducive to a high level of financial performance on the part of the banking industry. There are, nonetheless, areas of vulnerability that could contribute to a less favorable economic environment and less robust financial performance for insured institutions in the future.

One issue raised by this report is rising indebtedness on the part of households and businesses, which represents a growing private deficit. Rising interest rates could increase the debt service burden for consumers and businesses, making them more vulnerable to a slowing economy. An increasing private deficit is problematic also because the two major sources of financing—foreign capital inflows and domestic credit creation—have the potential to create problems for the economy and for lenders. Dependence on foreign capital makes U.S. inflation and interest rates highly subject to changes in the decisions of foreign investors and the value of the dollar. The rapid pace of credit creation by the financial sector threatens to impair credit quality. The intuition that loose underwriting standards can lead to credit quality problems is supported by recent signs of rising credit losses in a strong economy.

The second issue that cuts across this report is the effect that competition is having on banking strategies and exposures to credit, market, and operational risks. There has been an increase in lending to less creditworthy borrowers, including subprime consumer borrowers and leveraged corporate borrowers. There is also evidence that institutions are pursuing asset-liability structures with higher levels of interest rate risk to maintain loan growth and meet funding needs. Finally, some of the innovations banks have used to counter competitive pressures may introduce new risks associated with complex accounting valuations, weakening internal controls, and the need for more intensive loan servicing.

The third issue is the increasing potential for financial market instability, which leaves the economy and the banking system vulnerable to sudden shocks. Events from fall 1998 showed some of the more damaging aspects of these crises, as market-based financing went from abundance to scarcity virtually overnight. The financial imbalances associated with the rapid creation of credit and borrowing from abroad not only create the need for the economy to slow down eventually, but also threaten to make that adjustment process a volatile one. Financial market shocks could quickly alter the confidence of consumers and businesses and their access to financing. Such instability could end the current expansion and expose underlying weaknesses in bank risk-management practices.



[40] "Operational Risk Management," Basle Committee on Banking Supervision, September 1998 (http://www.bis.org/publ/bcbs42.pdf).

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

- **The Region's economy continues to underperform the nation's economy because of declining manufacturing employment and weaknesses in the agricultural sector. Conditions in the agricultural sector worsened considerably in 1999.**

- **Insured institutions reported healthy financial conditions and strong loan growth, although earnings performance continues to decline. Asset quality indicators remain positive; however, agricultural and commercial lenders reported slightly higher past-due levels.**

- **New bank activity is increasing, with almost 11 percent of the Region's existing banks established since the previous economic downturn in 1991. Earning performance of new banks appears to have weakened in recent years.**

Overview of Economic Conditions

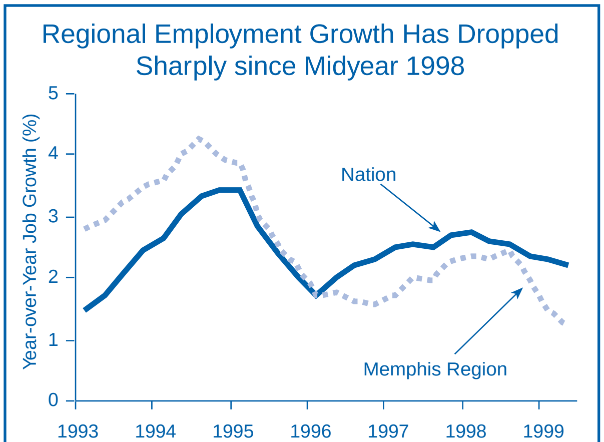
Employment Growth Slows

The Region's economic activity remains sluggish relative to the nation's, as measured by nonagricultural payroll employment growth. Total job growth has dropped sharply since mid-1998 (see Chart 1). Although regional job creation has trailed the nation's since 1996, the divergence in performance widened considerably in the past nine months. Second-quarter employment growth for the Region's states was below the national average, although considerable variability was reported among states (see Table 1).

Kentucky reported the strongest year-over-year job growth in the Region, driven by solid gains in all sectors except nondurable manufacturing. In **Arkansas,** employment growth slowed moderately as a result of continued job losses in manufacturing. Arkansas remains highly dependent on manufacturing with 22.3 percent of total employment in the sector, compared with 14.4 percent nationally.

Mississippi reported the fewest new jobs, with little gain reported from one year ago. Modest gains in the construction and government sectors were offset by continued losses in manufacturing, especially in the apparel and textile industry. In the service sector, gains in hotel and casino employment were offset by losses in the state's health care industry.

CHART 1



Source: Bureau of Labor Statistics, Payroll Establishment Survey

TABLE 1

EMPLOYMENT GROWTH IS LOWER THROUGHOUT THE REGION

	2Q98 (%)	2Q99 (%)
Arkansas	1.7	1.2
Kentucky	2.5	2.1
Louisiana	2.8	1.1
Mississippi	2.6	0.1
Tennessee	2.0	1.2
Region	2.6	1.2
Nation	2.3	2.2

Source: Bureau of Labor Statistics, Payroll Establishment Survey, year-over-year growth

Job growth continued to slow in **Tennessee** as well, influenced by losses in manufacturing and overall labor market tightness. Manufacturing industry payrolls are declining at an increasing pace as the state's apparel and textile firms continue their flight from the United States for lower-cost overseas locations. While these job losses were more than offset by gains in the construction, retail trade, and service sectors, the rate of growth in the retail and service sectors declined. Despite the slowdown in the manufacturing and services industries, job creation continues to exceed the number of people entering the workforce, with Tennessee reporting the lowest unemployment rate among the Region's states. The unemployment rate in Tennessee fell from 4.3 percent in second quarter 1998 to 3.7 percent in second-quarter 1999. Although generally a positive development, the declining unemployment rate may constrain future economic growth because of a shortage of workers.

Louisiana's job growth at 1.1 percent slowed appreciably from one year ago, primarily because of job losses in the energy sector. The state's mining segment shed almost 6,000 jobs from June 1998 to June 1999. Although petroleum prices recovered in the first half of 1999, energy-sector employment has been slow to respond and the extraction segment of the industry continues to lose jobs. Recent increases in the number of operating oil rigs could signal an end to these extraction job losses. However, employment in the sector remains at risk from further cost-cutting measures and consolidation.

The Region's lackluster payroll employment growth may not fully describe the current slowing in economic conditions, as the farm sector is not included in these statistics. Problems in this sector, described more fully below, are worsening. In addition to lower expected agricultural revenues, current conditions could result in an exodus of people from farming.

Agricultural Sector Conditions Worsen

The outlook for much of the agricultural sector is becoming increasingly unfavorable. Several factors are creating additional pressure on an already-stressed farm economy, including:

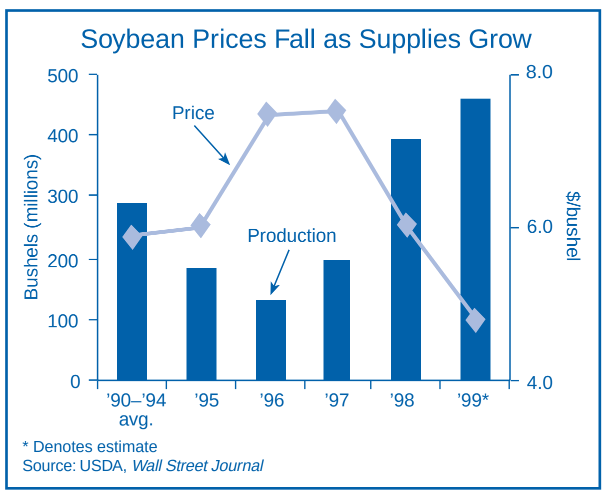
- a second year of adverse growing conditions in some areas;
- continued low prices for soybeans and corn; and
- the collapse in prices for the Region's important rice and cotton crops.

Some area farmers again suffered from dry growing conditions. While the lower Mississippi Delta states reported more severe weather-related problems in 1998, Tennessee and Kentucky reported worse conditions in 1999. Both states were designated for disaster relief in late summer. Despite lower expected production in these and other southeastern states, strong nationwide production forecasts have kept prices relatively low.

Prices for soybeans and corn remain extremely low for a second consecutive year and below break-even levels for most producers. Soybean prices reached 27-year lows in July before recovering somewhat in late summer on weather-related concerns. The oversupply resulting from high yields and production both nationally and worldwide in recent years is driving the low prices. Chart 2 demonstrates the inverse relationship between commodity prices and existing supply, using soybeans as an example. The current situation for corn, cotton, and rice is similar.

Prices are unlikely to improve substantially in the near term absent a supply shock. U.S. farmers can be expected to plant high soybean acreage in 2000, as the level of crop loan deficiency payments should decline only slightly next year. Loan deficiency payments represent minimum amounts subject to a cap that farmers can receive on crops placed into the program based on average price levels over several preceding years. Thus, these payments maintain a relatively stable price floor for most domestic producers. While lower prices may discourage competing producers in other areas of the

CHART 2



world, the late summer price rally may harm U.S. farmers by encouraging more fall planting by South American growers, thus exacerbating oversupply problems.

A substantial price decline for cotton and rice in 1999 may severely affect area farmers. Prices for both commodities were high relative to other crops throughout much of 1998 and provided some stability to farm cash flows suffering from low prices for soybeans, corn, and winter wheat. As a result, Memphis Region farmers increased cotton acreage by 16 percent during 1999. The resulting large expected increase in production, continued modest demand, and high existing stocks have led to a slump in prices. Late summer cotton prices were down over 25 percent from the prior year. In a similar situation, rice production, both nationally and in the Region,[1] is forecast to reach record levels in 1999. As a result, the average price for the crop is expected to end 1999 between $5.50 and $6.00 per hundredweight compared with an average price of $8.80 per hundredweight in 1998.

Current farm problems are not limited to weather and commodity prices, however, as rising interest rates also may hurt the sector. Farm cash flows in 1998 were aided by a significant drop in average loan rates. While interest rates remain relatively low, the increase in rates since June 1999 will place additional stress on farm financial conditions as interest costs and debt service requirements rise. Higher interest rates could also adversely affect farmland values. With cash flows and property values likely to be negatively influenced by higher rates, some farmers may find refinancing more difficult.

Performance of the Region's agricultural lenders is being affected by the unfavorable conditions in the sector. During the first six months of 1999, agricultural loan losses were up somewhat from levels reported during the same period in 1997 and 1998. As a result, provision expenses increased (see Table 2), contributing to a decline in return on assets (ROA).

Agricultural lenders face growing credit concerns. Aggregate past-due loans were reported at 3.2 percent on June 30, 1999. While this ratio suggests that past-due loan levels remain manageable, it does represent a moderate increase from levels reported one year ago. Many lenders are minimizing potential losses by acquiring additional collateral or obtaining government guarantees on renewed or reworked loans and encouraging farmers to use subordinated borrowing sources such as chemical companies. However, agricultural lenders and their communities remain dependent on a farm sector that is currently in decline.

Table 2

Credit Concerns Affect Earnings Performance of Insured Agricultural Lenders

	1997	1998	1999
Return on Assets	1.40	1.31	1.12
Provisions/Loans	0.24	0.30	0.44

Source: Bank and Thrift Call Reports, annualized from June 30 each year

[1] Three states in the Memphis Region (Arkansas, Louisiana, and Mississippi) are expected to produce more than 68 percent of the nation's rice crop in 1999.

Overview of Banking Conditions

Banking Conditions Remain Favorable

The Region's banks and thrifts reported generally healthy financial conditions through the second quarter of 1999, although earnings performance measures remain below year-ago levels. The average ROA ratio for the first six months of 1999 was 0.99 percent, down 19 basis points from the same period in 1998. The major factor contributing to lower earnings was a falling average net interest margin, which declined to 4.21 percent from 4.40 percent. Increasing competition for loans and funding sources contributed to the decline in margins.

Other financial ratios reflect improvement over results reported in the first six months of 1998. Average leverage capital ratios were slightly higher at 11.36 percent compared with 11.14 percent at the end of the second quarter of 1998. Second-quarter 1999 reported slightly improved asset quality over one year ago as past-due loans declined to an average 2.69 percent of total loans. The Region's slowing economic growth has not yet affected the reported asset quality of insured financial institutions, although some bank groups reported modest increases in past-due ratios.

Agricultural and commercial lenders are the primary bank and thrift groups to report higher past-due loan ratios from one year ago (see Chart 3). The same factors affecting aggregate past-due ratios at agricultural lenders are likely influencing the slight increase in past-due ratios at other nonspecialized banks, many of which operate in agriculturally dependent areas.

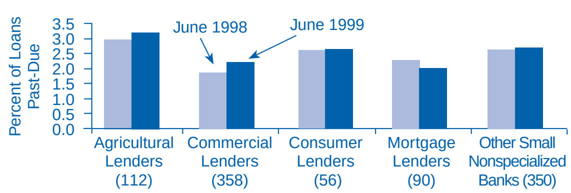
Commercial and Industrial Loan Levels Are Growing

Commercial and industrial (C&I) loans continue to drive loan growth in the Region and represent an increasing share of bank and thrift loan portfolios. Aggregate C&I loans have grown at double-digit rates since 1994, exceeding overall loan growth (see Chart 4). While much of this increase has been driven by institutions with more than $500 million in total assets, smaller banks also report considerable growth in commercial credits. As a result, C&I credits are increasing as a share of loans, rising from an average 13.31 percent of total loans two years ago to 14.11 percent as of June 30, 1999. Factors contributing to this growth will be discussed further in the ***Memphis Regional Outlook,*** First Quarter 2000.

C&I loan asset quality indicators remain favorable. While aggregate past-due C&I loans have risen somewhat since mid-year 1997, this ratio is heavily influenced by higher past-due ratios at some of the Region's larger financial institutions. C&I loan past-due ratios for banks with under $500 million in assets as of June 30, 1999, are slightly lower than at the same period in both 1997 and 1998.

Chart 3

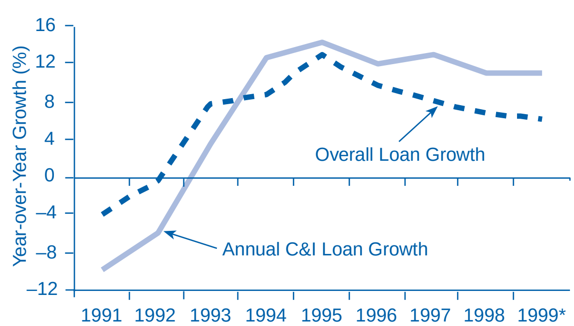
Aggregate Past-Due Loans Rise at Agricultural and Commercial Lenders



Note: Agricultural Lenders = agricultural production plus farm real estate loans > 25 percent of total loans.
Commercial Lenders = consumer and industrial loans plus commercial real estate loans > 25 percent of total loans.
Consumer Lenders = one- to four-family mortgage loans plus loans to individuals > 50 percent of total assets.
Mortgage Lenders = one- to four-family mortgage loans plus mortgage-backed securities > 50 percent of assets.
Excludes a limited number of small specialized (57) and large nonspecialized (8) banks.
Source: Bank and Thrift Call Reports

Chart 4

Commercial and Industrial (C&I) Growth Outpaces Total Loan Growth



* Growth from June 30, 1998, to June 30, 1999
Source: Bank and Thrift Call Reports

Results of recent underwriting surveys[2] are consistent with current favorable asset quality indicators, but note some concern in the event of an economic downturn. These surveys suggest that C&I underwriting standards have remained fairly stable since late 1998. Interestingly, one-third of the banks surveyed by the Federal Reserve Board in August 1999 stated *their C&I loan portfolios have become more sensitive to periods of economic weakness.* This sensitivity was most often attributed to borrowers' increased financial leverage, borrowers' narrowing profit margins, and previous easing of credit standards. If these findings are consistent across geographies, the Region's economic slowdown may begin to affect commercial loan portfolios.

New banks[3] report much higher concentrations of C&I loans, with an average 21 percent of total loans in C&I loans as of June 30, 1999, than do established institutions. Such high concentrations are likely attributable to the relative ease of bringing in business credit lines compared with more specialized commercial real estate underwriting or more labor-intensive creation of a retail customer base for consumer and residential mortgage loans. The considerable increase in new bank activity in the Region, discussed below, could heighten competition for business loans and pressure underwriting standards.

[2] Surveys reviewed include the August 1999 Federal Reserve Board ***Senior Loan Officer Opinion Survey on Bank Lending Practices*** and the FDIC ***Report on Underwriting Practices*** for the period ending March 1999.

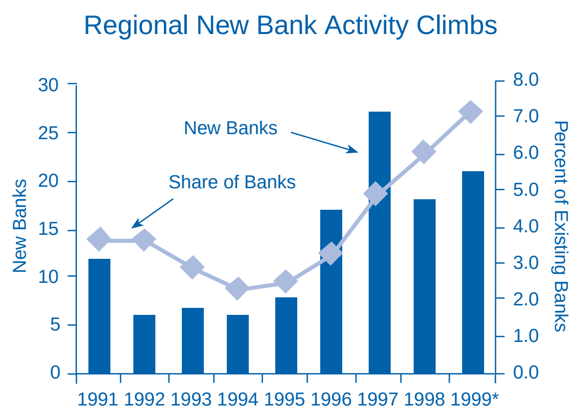
[3] For purposes of this article, new banks are those established within the preceding three years.

New Bank Activity and Performance

New Bank Formation Remains High

Although the pace of new bank and thrift formation cooled slightly in 1998 from the prior year, activity rose sharply during the first half of 1999. Twenty-one new insured institutions were established through the first six months of 1999, exceeding all of 1998 (see Chart 5). Through September 1, 1999, six additional banks received regulatory approval to open, with ten more new bank charter applications pending approval. If these applications are approved, the Region would experience a record number of new bank openings in 1999.

CHART 5



* Six months only
Source: Bank and Thrift Call Reports

Not only are the numbers of new banks established during this economic expansion surpassing prior periods, *new banks represent a higher portion of the Region's existing banks than at any other time in the previous 30 years.* Among other areas of the nation, only the southeastern United States and the West Coast report higher levels of new banks relative to existing banks. Almost 11 percent of the Region's insured institutions have been established since 1991 and have not experienced an economic downturn.

Factors Influencing New Bank Formation

Several factors may be contributing to the rising level of new banks, including:

- record industry profitability in the mid-1990s;
- strength and longevity of the current economic expansion; and
- significant industry consolidation in recent years.

However, a recent study by the FDIC's Division of Research and Statistics[4] concluded that the correlation between industry consolidation and new bank formation

[4] Steven Seelig and Timothy Critchfield, FDIC Division of Research and Statistics, "Determinants of De Novo Entry In Banking," 1999.

may be less of a factor than previously thought, at least in the same market areas. This study reviewed new bank activity in metropolitan markets from 1995 through 1997 and found that acquisitions tended to correlate negatively with new bank formation. In the Memphis Region, new bank formation appears to be more closely linked to local economic conditions and the level of competition for banking services.

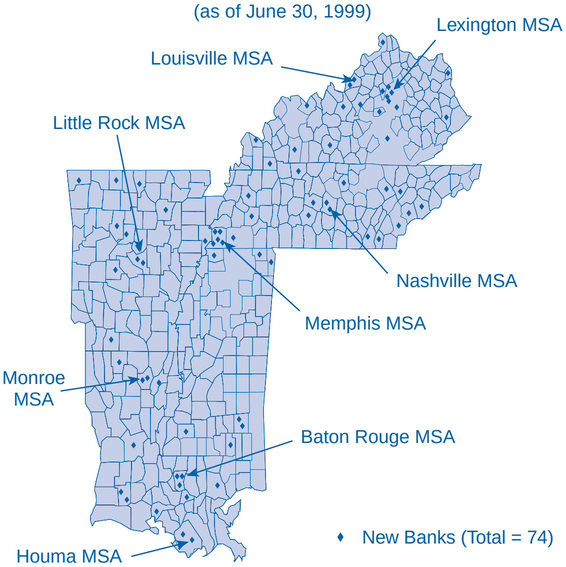
As shown in Map 1, pockets of new bank formation are clustered in or around metropolitan areas. Almost 60 percent of banks established since June 30, 1996, are located in metropolitan areas. One explanation for this is that metropolitan areas are characterized by larger and more diversified economies. In addition, many metropolitan areas have enjoyed greater economic prosperity during this expansion, which may be attractive to new bank entrants.

The three largest metropolitan areas in Tennessee are home to multiple new banks, thanks in large part to these cities' strong economies in the mid-1990s. The **Memphis** metropolitan area has experienced the greatest number of new banks. Eight banks opened since June 30, 1996; one new bank charter was approved but has not yet opened; and two new bank applications are pending. Three banks also have opened in both **Nashville** and **Knoxville** in the past three years. These three cities, particularly Memphis and Nashville, have been major drivers in Tennessee's economy and have reported strong employment and income growth throughout much of the decade. Opportunity to provide banking services also appears favorable in these metropolitan areas. The core counties in these metropolitan areas, **Shelby, Davidson,** and **Knox counties,** reported the three highest market shares of the state's total deposits among Tennessee's 95 counties.

MAP 1

New Bank Formation Is Concentrated in Metropolitan Statistical Areas (MSAs)

(as of June 30, 1999)



Source: FDIC Research Information System

Other metropolitan areas with significant new bank activity include **Lexington,** Kentucky, with six new banks opened since June 30, 1996, and **Baton Rouge,** Louisiana, with four new banks. These cities continue to lead their states in economic development.

One measure of both economic strength and banking opportunity is the ratio of personal income to the number of bank branches in a market. A relatively low ratio of personal income per branch indicates that a market may be saturated with banking services or may hold more limited opportunity for banking services. As a result, the market may be a less desirable location for a new bank. A relatively high ratio of personal income per branch indicates that a new banking entrant has ample opportunity to attract customers.

Most of the Region's new banks opened in counties with relatively high levels of personal income in relation to the number of branch banking offices. Eighty percent of the new banks chartered in the past three years were opened in counties that reported a higher than median level of personal income to bank branches on June 30, 1996. Areas with multiple new bank openings over the past three years all reported significantly higher than normal levels of personal income to bank branches. For example, Shelby County, at the center of the Memphis metropolitan area, reported the highest level of personal income to branches in the Region on June 30, 1996, more than double the Region's average. More new banks have opened in this county than in any area in the Region since that time.

New Bank Financial Performance

New banks typically report operating losses followed by gradual improvement in profitability. Weak initial earnings performance is attributable in part to high start-up costs and overhead expenses relative to a smaller earning assets base. Even after at least one complete year of operation, new banks in the Memphis Region reported a median ROA one-third of that reported by established banks (using data as of June 30, 1999). Higher interest expense as well as higher overhead expense (see Table 3) contributed to the lower ROA. The higher reported interest expense to earning assets ratio is attributed to a greater reliance on higher-cost noncore funding, such as large certificates of deposit.

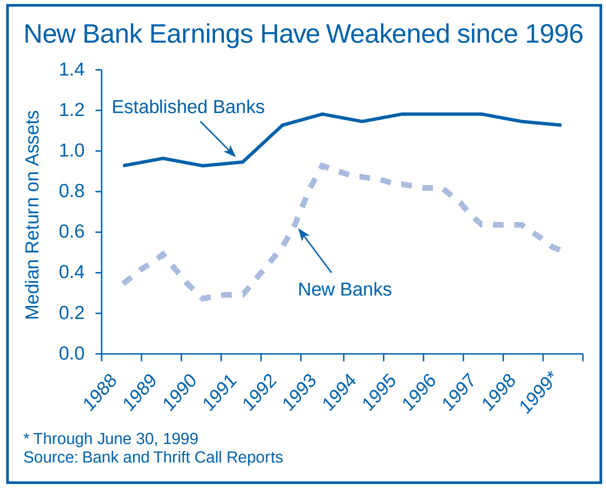
New banks take time to grow into their initial overhead and replace higher cost funding with more stable deposits. A 1996 Office of the Comptroller of the Currency study[5] found that while new banks report rapid improvement in profitability during the first three years of operation, these institutions do not attain levels of profitability enjoyed by established banks for an average of nine years.

The rate of new institutions' initial earnings improvement appears to be slowing. Nationally, new banks' median ROA during the third year of operation (see inset box) declined in recent years from impressive levels established in the mid-1990s (see Chart 6). This trend suggests that the climate for new bank earnings performance has worsened since the middle of this decade. Despite the recent decline in new bank ROAs, earnings levels are slightly above those reported prior to the 1990 to 1991 recession.

Consistent with banks' declining profitability in the third year of operation, new banks in the Memphis Region are taking slightly longer to reach breakeven than in prior periods. Banks established between 1995 and 1997 on average required six quarters of operation before reaching breakeven. By comparison, banks established during the previous expansion (1983 to 1989) reached profitability in four quarters on average. This trend is likely being influenced by growing competition from other financial service providers in the 1990s.

[5] Robert DeYoung and Iftekhar Hasan, Office of the Comptroller of the Currency, "The Performance of De Novo Commercial Banks: A Profit Efficiency Approach," ***Journal of Banking and Finance,*** 1998.

Chart 6



New institutions also report a lower allowance for loan and lease losses than reported by established institutions. As of June 30, 1999, the median allowance for new banks in operation for at least one year was 1.06 percent of total loans, compared with 1.25 percent for established institutions. The lower allowance level may be cause for concern as new banks report higher concentrations in loan types that historically have demonstrated higher risk of loss, such as C&I loans.

New Banks May Be More Susceptible to Economic Downturns

New banks in the Region failed at considerably higher rates during periods of economic stress than have estab-

Table 3

New Banks Report Higher Interest Costs as well as Higher Overhead

(as % of Earning Assets)	New Banks	Established Banks
Interest Income	8.15	7.89
Interest Expense	4.10	3.69
Overhead Expense	4.00	3.07
Noninterest Expense	0.61	0.74

Source: Bank and Thrift Call Reports; as of June 30, 1999

New Bank Earnings Analysis

For purposes of comparison, this analysis reviews the reported earnings of commercial banks established within the preceding three years of each report date, but only after two complete calendar years of operation. This analysis includes more than 1,500 institutions. New banks' earnings performance in the Memphis Region generally mirrors national trends but is not displayed because of the limited number of observations in certain years.

lished banks, based on a review of bank failures from 1980 to 1992, a period encompassing three recessions. From 1980 to 1992, 17.7 percent of banks chartered during or immediately preceding the period[6] failed, *more than double the failure rate for established banks.* The failure rate for established banks during the same time was 7.7 percent. In other words, more recently established institutions represented 21 percent of total bank failures during the period while constituting only 10 percent of banks.

The higher failure rates may be attributable to various factors. Many new banks hold concentrations of higher risk assets, such as C&I loans. This was particularly true during the 1980s. Also, anecdotal evidence suggests that new institutions' loan portfolios often include a disproportionately high number of unseasoned borrowers that have not experienced economic downturns. Another factor contributing to the higher failure rate is new banks' lower earnings performance. New banks' profitability remains below that of established banks for several years, and, as a result, lower earnings levels provide a more limited cushion to absorb credit losses.

Memphis Region Staff

[6] This analysis incorporated banks established between January 1, 1977, and December 31, 1989, three years prior to the beginning and ending dates of the period reviewed.

New Bank Facts

A review of the 74 new banks established in the Region since June 30, 1996, reveals the following:

- ***Most new banks are commercial lenders.*** Thirty-eight, or 51.4 percent of all new banks, are in the Commercial Lender Bank Group (institutions with 25 percent or more of total assets in C&I loans or commercial real estate loans).
- ***Some new banks quickly establish branch networks.*** Thirteen new banks have established at least one branch in addition to a headquarters location, with five new banks having two or more branches. As branch offices often represent excess capacity for new banks, profitability in such institutions may be depressed in the first years of operation. However, branches may help maturing new banks attract low-cost deposits.
- ***Some new banks are part of multibank holding companies.*** Eleven new banks, roughly 15 percent of the new banks in the Region, are associated with multibank holding companies. This operating structure may provide some stability during the formative years and serve as a cushion as these institutions mature.
- ***New banks do not appear to be embracing new technology.*** Only 8 of 74 new banks have Internet websites and only six have transactional Internet sites. New banks may be reluctant to offer Internet banking services because of start-up and maintenance costs and the fact that they often have limited staff resources.

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