Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FIRST QUARTER 2000

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In Focus This Quarter

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

By Arlinda Sothoron, Alan Deaton

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

By Paul C. Bishop

Regional Perspectives

◆ ***Region's Economic and Banking Conditions***—**The Region's economy is healthy, although employment growth is beginning to slow. Major economic drivers, including Wall Street, new high-tech industries, and commercial real estate, were highly profitable in 1999. Insured institutions reported generally sound financial conditions in the third quarter of 1999, although profitability measures reflected competitive pressures on bank margins. Asset quality measures improved in most loan segments. However, commercial and industrial loans showed slight weakening, primarily at the Region's larger banks.** *See page 18.*

◆ ***Noninterest Income Has Grown in Importance***—**As banks have attempted to diversify income sources, enhance profitability, and mitigate pressures on net interest margins, noninterest income has become a more significant contributor to bank earnings. Noninterest income now represents half of operating income at the Region's banks. Higher noninterest income reflects increased fees from traditional banking services such as ATM use and credit cards. In addition, banks have expanded into new activities, including trading, investment advisory, and insurance sales, which may be more susceptible to changes in financial market conditions than traditional bank services.** *See page 22.*

◆ ***The Region Is Again Losing Manufacturing Jobs***—**Despite the Region's robust economy, the manufacturing sector is continuing to lose jobs. These losses are attributed, in part, to higher energy prices, which hinder expansion by existing manufacturing companies and make the New York Region a less attractive site for new manufacturing.** *See page 24.*

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Recent Trends Raise Concerns about the Future of Business Credit Quality

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

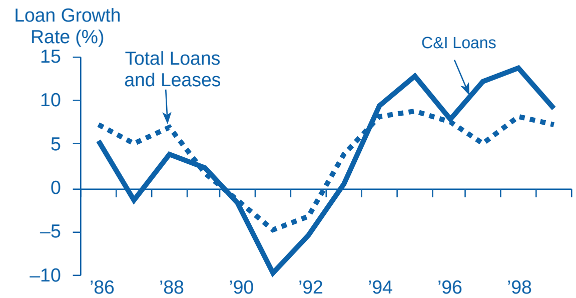
Commercial and industrial (C&I) lending is one of the largest and fastest-growing segments of lending at insured institutions. As of the third quarter of 1999, C&I loans comprised 24 percent of total loans and leases held by FDIC-insured institutions, up from 21 percent at the end of 1995. C&I loan portfolios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

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

C&I Loan Growth Has Accelerated

C&I loans held by FDIC-insured banks and thrifts grew by almost 9 percent during the 12 months ending in September 1999, down somewhat from a 13.4 percent rate of growth in 1998 (see Chart 1). By contrast, total

CHART 1



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

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

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

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

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

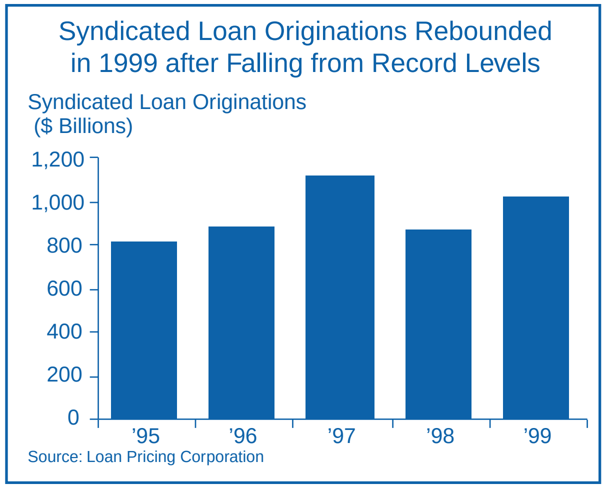
Is This Rapid Loan Growth a Cause for Concern?

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

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

Recent economic conditions have been particularly conducive to rapid growth in domestic C&I lending. Business investment has expanded at double-digit annual rates as firms have invested in new technologies to raise productivity and keep costs down. These productivity gains have been instrumental in allowing the

CHART 2



economy to grow at a relatively rapid pace with low inflation. Strong growth in real wages has helped boost the consumer confidence index to an all-time high of 144 in January 2000. Robust consumer demand for goods and services has kept business profits growing, further spurring business borrowing to finance inventories, new construction, and fixed assets such as computer networks. Amid all of these favorable trends, C&I loan charge-off rates have remained at record lows of less than 0.5 percent since 1994. Recently, however, despite a continuation of generally favorable conditions in the economy and the financial markets, signs of credit quality deterioration have begun to appear in C&I loan portfolios.

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

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

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

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

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

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

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

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

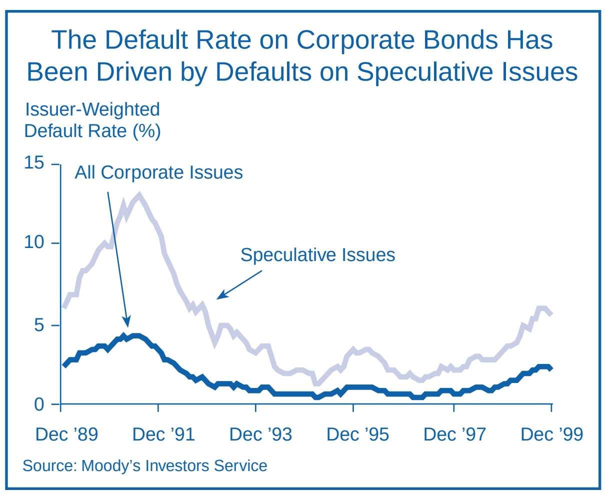
While the level of adversely classified syndicated loans remains low, 14 percent of the loans adversely classified during the 1999 review were loans made to new borrowers since the 1998 SNC review. In reference to this finding, ***Office of the Comptroller of the Currency (OCC)*** First Senior Deputy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

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

Corporate Bond Defaults Soared in 1999

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

CHART 3



[6] The annual interagency process reviews commercial loans over $20 million that are shared by three or more participants.
[7] Federal Reserve Board Press Release. November 10, 1999.
[8] "OCC's Williams Warns of Credit Risk in the Banking System; Calls for Bankers to Scrutinize Loan Portfolios More Closely." OCC Press Release. October 5, 1999.
[9] "Leveraged Loans: The Plot Thickens." Banc of America Securities Syndicated Finance Research. November 15, 1999. This loan amendment analysis was completed using only publicly available information from Loan Pricing Corporation and Banc of America Securities LLC.

[10] "Corporate Bond Default Rates Highest Since 1991." Moody's Investors Service. October 13, 1999.
[11] "Moody's Default Rate Pendulum." Moody's October 1999 Commentary. Moody's Investors Service. October 18, 1999.

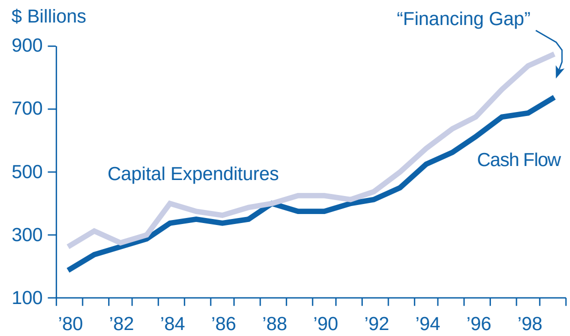
Why Are C&I Loan Losses Increasing Amid Strong Economic Growth?

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

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

Corporations are increasingly reliant on debt markets. Increasing levels of debt on corporate balance sheets have helped to foster C&I loan growth. The growth in corporate debt is partially a result of actions taken by firms to improve operating efficiency, including increasing merger and acquisition (M&A) activity and rising spending on fixed investments. Capital expenditures on fixed investments by businesses have increased at a steady rate since the 1990–91 recession, as evidenced by Chart 4. Cash flow has also been increasing, but at a slower rate, resulting in a growing "financing gap" that reached an annualized level of

CHART 4



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

$142 billion in the third quarter of 1999. Where cash flow has not been available to finance investment, firms have turned primarily to debt financing as opposed to equity financing. Net new corporate equity issues by nonfarm nonfinancial corporations have been negative in each year since 1993, while net new corporate bond issuance has increased from $75 billion in 1993 to $219 billion in 1998.

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

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

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

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

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

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

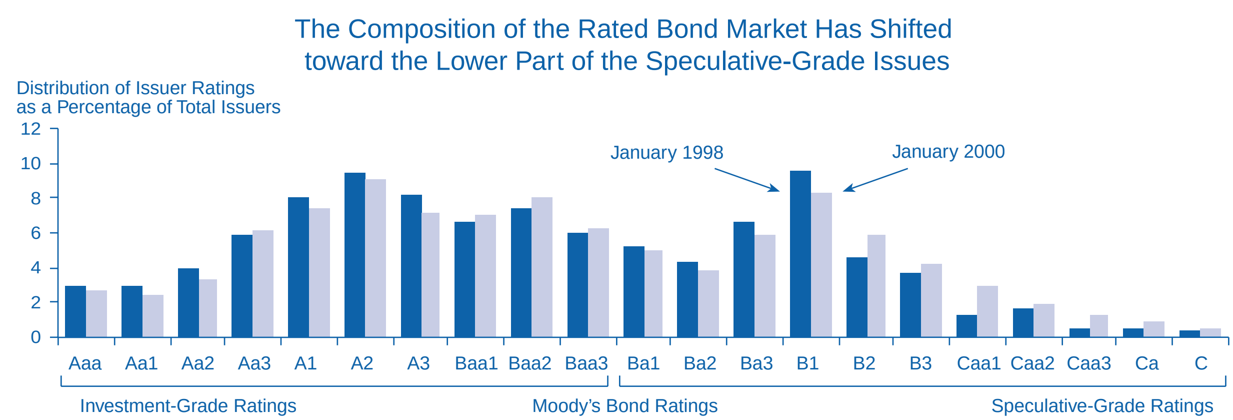
Financial markets have evidenced greater risk appetite. While the ratio of speculative-grade bond issues to total corporate bond issues has remained fairly stable at approximately 40 percent during the past decade, the composition of borrowings has shifted substantially. ***Moody's*** reports a shift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

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

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

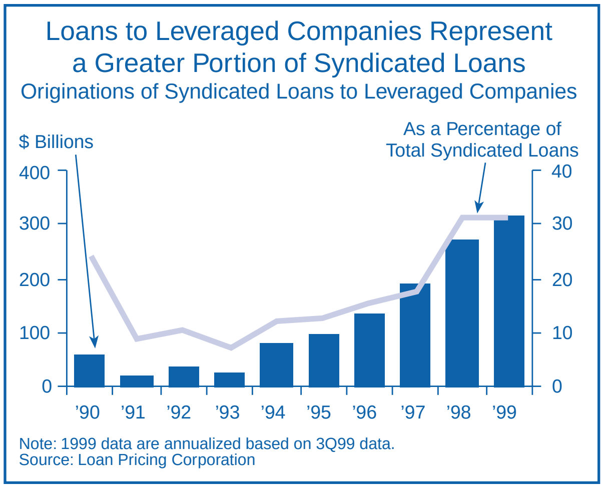
[15] *LPC Gold Sheets.* January 10, 2000.
[16] Moody's January 2000 Commentary. January 18, 2000.
[17] "Refunding Risk for Speculative Grade Borrowers." Moody's Special Comment. Moody's Investors Service. December 15, 1999.
[18] "Default Rate Pendulum." October 18, 1999.
[19] Moody's January 2000 Commentary.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

CHART 5



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

CHART 6



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

Where Is Business Credit Quality Heading?

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

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

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

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

[22] Houlihan Lokey's *Mergerstat.* www.mergerstat.com.
[23] "The Biggest Secret of Wall Street." May 14, 1999.

[24] "Global Financial System Stress: The Weak, the Vulnerable, and Those Limping Toward Recovery." Standard & Poor's. December 17, 1999.
[25] KMV's® proprietary calculation for EDF™ is based on (1) the current market value of the firm, (2) the structure of the firm's current obligations, and (3) the vulnerability of the firm to large changes in market value. Multiplying industry originations by median industry EDF™ scores provides an estimate of expected default volumes. This figure provides a more meaningful measure of aggregate lending risk exposure than pure origination volumes alone and can be used to rank industry exposures.

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

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

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

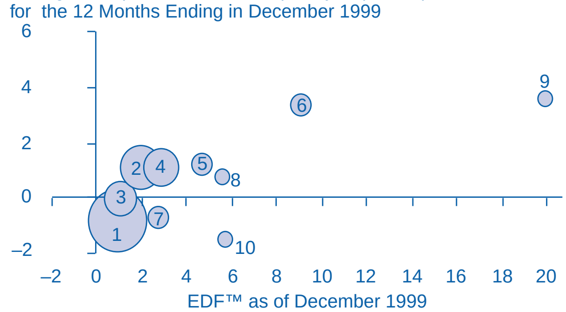
Potential growth in new markets presents both opportunities and challenges. The Internet and European syndicated loan markets represent both future potential growth areas and possible sources of credit risk for C&I lenders. The Internet has introduced large new markets to the loan and bond markets and has increased market efficiency. The "Internet economy" grew 68 percent from the first quarter of 1998 to the first quarter of 1999, with annual revenue expected to exceed $500 billion in 1999.[27] Internet technology has improved the efficiency of the syndicated loan markets, with recent changes including the development of public price reporting, credit ratings, and Internet sites for online trading.[28] Increased levels of credit risk could result from the volatility of Internet stock prices and the competitive disadvantage faced by firms that do not have an Internet presence but must compete against firms that do.

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

CHART 7

Lending to Some Industries May Involve Higher Risk Exposures

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



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

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

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

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

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

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

Underwriting Remains the Key to Assessing C&I Credit Quality

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

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

Summary

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

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

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

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

Local Industries in the Global Economy

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

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

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

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

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

International Trade Is of Growing Importance

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

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

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

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

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

TABLE 1

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

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

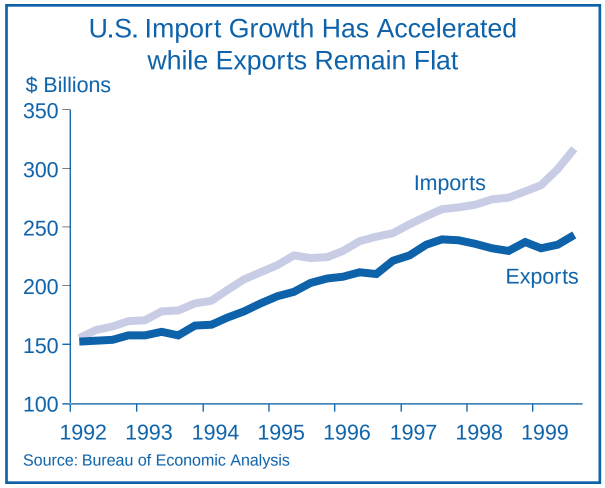
During the past two and a half years, for example, the international economy has been buffeted by a series of crises that resulted in steep exchange rate depreciations for a number of countries and a marked slowdown in economic growth in many emerging markets. Although the U.S. economy remained surprisingly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

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

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

The slowdown in U.S. export activity and the acceleration of import growth have resulted in an increasing trade imbalance (see Chart 1). The U.S. trade deficit, which reached a record $26.5 billion in November, has raised concerns among analysts about the vulnerability of the dollar. Faster growth abroad or a slowdown in U.S. growth could convince foreign investors to increase purchases of assets outside the United States, resulting in a sell-off of the dollar. Depending on the severity and speed of a sell-off, heightened financial market volatility and rising U.S. import prices could result. Although potentially many forces are at work in

CHART 1



such a scenario, rising inflation or a falling dollar may ultimately result in higher interest rates and slower U.S. growth. The extent to which U.S. trade would be affected by such a scenario is difficult to assess, since changes in the prices of either imports or exports would result in both positive and negative effects on firms' costs, revenue, and profitability.[2]

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

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

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

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

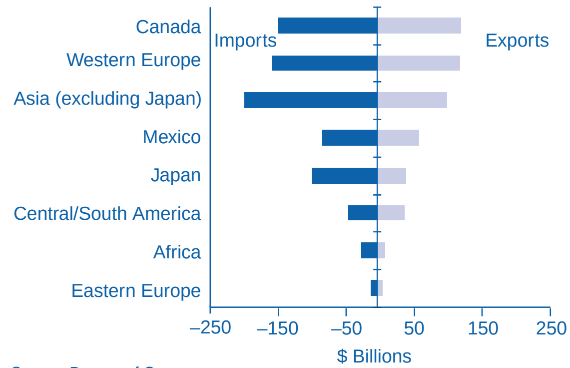
reduce prices of their U.S.-bound goods to compete more effectively with U.S. producers.[3]

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

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

CHART 2

Canada Is the Largest U.S. Trading Partner
(1Q99 through 3Q99, ranked by exports)



Source: Bureau of Census

The Importance of Trade Varies among Industries

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

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

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

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

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

Table 2

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

Highly Exposed Industries
Moderately Exposed Industries
Less Exposed Industries

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

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

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

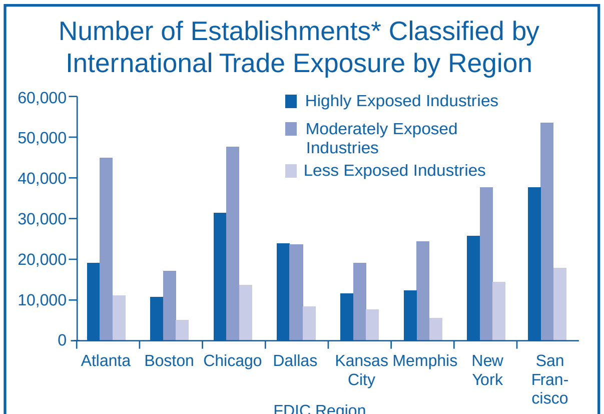
The industries in each column are categorized by the share of U.S. consumption expenditures in a particular industry that are satisfied by imports. Again, the Low and High categories each include 7 industries, and the Medium category includes the remaining 12 industries.[6] On the basis of this analysis,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

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

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

Chart 3 illustrates the distribution of establishments in each of the three categories by Region.[8] Among the group of industries analyzed, most are in the Moderately Exposed Industries category. Of the FDIC Regions, Atlanta, Chicago, and San Francisco have the greatest number of establishments in this category. The Chicago and San Francisco Regions lead in the number of establishments in the Highly Exposed Industries group, followed by the New York and Dallas Regions.[9] Less Exposed Industries account for a relatively small number of establishments. As suggested above, however, most service-sector, construction, and government enterprises, while not part of this analysis, could be classified as Less Exposed.[10]

Chart 3



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

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

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

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

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

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

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

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

Summary

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

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Senior Financial Economist

Regional Perspectives

- **Although the Region's economy remains healthy, employment growth has become sluggish, suggesting the possibility of less vigorous economic gains in the near future.**

- **Despite competitive pressures, the Region's banks reported generally sound financial conditions as higher noninterest income offset erosion in the average net interest margin. Credit quality measures improved for most loan segments, except commercial and industrial loans, which showed slight deterioration at larger banks.**

- **Noninterest income is expected to increase as banks look for ways to augment earnings and improve performance measures. As noninterest income becomes a more significant contributor to bank profitability, analysis of the quality and stability of these income sources becomes more critical.**

- **The Region's manufacturing sector, previously benefiting from the general economic expansion, is once again losing jobs. Analysts have cited higher energy costs as a major factor that discourages manufacturing relocations and expansions in the Region.**

Region's Economic and Banking Conditions

Region's Economy Is Healthy, although Employment Growth Is Beginning to Slow

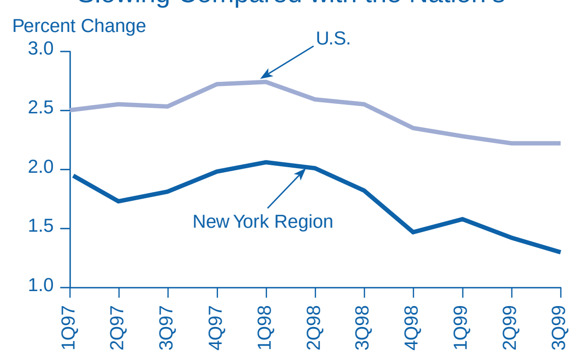
The New York Region's economy remains prosperous, with new jobs being created, incomes growing, and, according to surveys of consumer confidence, consumers upbeat about future economic prospects. The major economic drivers of the Region, which include Wall Street, new high-tech industries, and commercial real estate, were highly profitable in 1999. In many respects, the Region has recovered fully from the recession of the early 1990s, which was particularly harmful to the local economy with large numbers of layoffs. In contrast, these days, labor shortages are more common than layoffs. Economists' expectations for continued economic growth into the near future are high.

Although the Region's economy is healthy, employment growth has slowed. The Region added 286,000 jobs between the third quarters of 1998 and 1999, a 1.3 percent growth rate. While the increase represents respectable growth based on historical trends, it is less than the 2.2 percent growth rate attained by the nation over the same period and the 1.8 percent rate achieved by the Region between the third quarters of 1997 and 1998. Over the past several quarters, the rate of job growth has been gradually declining, and the gap between employment gains in the Region versus the nation has been widening (see Chart 1). Analysts traditionally associate the Region's slower job growth with several factors, including more expensive labor, higher energy costs, less space to build new office buildings or factories, and higher taxes. Limited population growth and, more recently, labor shortages also have been cited as impediments to job growth in the Region.

Employment gains have been leveling off in almost all of the Region's states and the **Commonwealth of Puerto Rico. Delaware,** the perennial job-growth leader in the Region, remained strong at 2.9 percent annual growth between the third quarters of 1998 and 1999. In

CHART 1

Region's Employment Growth Rate Is Slowing Compared with the Nation's



Note: Growth rates are quarterly year-over-year percent changes.
Source: Bureau of Labor Statistics.

Maryland, New Jersey, and **New York,** however, job gains slowed, ranging between 1.6 and 1.75 percent, down from 2 percent or more in each state.[1] The largest drop in the Region was in **Pennsylvania,** where employment growth slipped to below 0.5 percent between the third quarters of 1998 and 1999 from almost 1.75 percent a year earlier. Losses in manufacturing employment, particularly in industries related to steel production, apparel, textiles, transportation, electronic equipment, and industrial machinery, contributed to the slower employment growth. In particular, Pennsylvania's steel producers have been hurt by weak prices stemming from economic slowdowns that began in Asia in 1998. Subsequent economic recessions in Asia, Brazil, and Russia depressed demand for steel exports, resulting in lower prices and profits. Despite some economic turnaround in Asia and Brazil, it is too soon to assess whether the Region's steel manufacturers will benefit from any short-term recovery in steel prices.

Pennsylvania's overall employment slowdown has been particularly noticeable in the **Harrisburg** area, which between 1994 and 1998 was one of the fastest-growing locations for new jobs in the state. In 1999, however, job growth abated, primarily because of losses in the manufacturing and government sectors and limited growth in business services jobs. Consolidation and layoffs at Tyco International, a large manufacturer of electronic equipment in the Harrisburg area, are responsible for many of the job losses. Although it has begun to rise, Harrisburg's unemployment rate still remains below the state average of 4.4 percent and the national average of 4.2 percent in third quarter 1999.

A loss in the number of manufacturing jobs also has been noted in Puerto Rico. The gradual phaseout of federal tax incentives has discouraged investment and hurt the manufacturing sector over the past three years. Manufacturing employment declined by 5.2 percent between the third quarters of 1998 and 1999, which tops the previous-year decline of 3.6 percent. This decline has contributed to flat overall employment growth through the first three quarters of 1999. Despite reduced job growth, the Puerto Rican economy is expected to expand because of increases in other sectors such as tourism and construction. Declines in manufacturing-sector jobs also have been occurring in New Jersey and New York, where losses in textiles, chemicals, and apparel, as well as steel and primary metal production, have been reported.

[1] Annual employment growth is measured on a current quarter over prior year's quarter.

Employment growth in the Region's finance, insurance, and real estate (FIRE) industries as well as the service sector—industries that over time have become more vital to the Region's economic well-being—also has slowed. Higher interest rates and consolidations may be reasons that FIRE-sector companies are paring down hiring plans. At the same time, employment in some companies that provide service support to the FIRE sector may be slowing as well. Reported labor shortages in computer-related and high-tech industries also may be limiting job growth. Press reports suggest that labor force constraints are crimping companies' hiring plans, particularly in the rapidly growing **Baltimore-Washington, D.C.,** high-tech sector.

Region's Established Banks Report Healthy Conditions, but Competitive Pressures Remain

Following the strong economy, the New York Region's banks reported generally healthy financial conditions in the third quarter of 1999, although profitability measures reflected competitive pressures on bank margins. The average return on assets (ROA) for the Region's banks (excluding banks that have been in operation less than three years) slightly improved, to 1.15 percent in the third quarter of 1999 from 1.13 percent reported one year ago. While competition from banks and other financial service providers hindered interest income growth, increased noninterest income offset the effect of narrowing net interest margins (NIMs) on bank earnings. In the third quarter of 1999, the average NIM at the Region's established banks[2] declined to 3.94 percent from 4.04 percent one year ago. The decline occurred in spite of the widening spread between short- and long-term treasuries,[3] a trend that can be beneficial to banks. Noninterest income, however, increased from 1.64 percent of average earning assets in third quarter 1998 to 2.57 percent in third quarter 1999. Despite preparations for the year 2000, the Region's banks controlled expense growth, as the average efficiency ratio,[4] the ratio of an institution's operating or overhead expenses to operating income, remained at approximately 64 percent.

[2] Established banks are defined as banks that were in existence prior to September 30, 1996. New banks are discussed separately because of the increasing number of new banks in the Region and because new banks have different performance characteristics than established banks.

[3] Treasury spread is measured as the yield on the ten-year Treasury bill minus the yield on the six-month Treasury bill.

[4] The efficiency ratio is defined as noninterest expense divided by the sum of net interest income and noninterest income.

Asset quality measures improved in most loan categories. Past-due loans as a percentage of total loans in the Region declined slightly, from 2.5 percent to 2.4 percent, between the third quarters of 1998 and 1999. Delinquency rates were down for the credit card, commercial real estate, and consumer loan portfolios. However, the commercial and industrial (C&I) past-due ratio increased slightly over the past two years. Reported aggregate charge-off rates on the Region's loans have tracked, on a lagged basis, improvements in the Region's delinquency ratios. Aided by a declining rate of personal bankruptcy filings in the nation and a vibrant economy, the charge-off rate on the Region's credit card loans decreased to 5.16 percent in the third quarter of 1999, down from 5.90 percent reported in third quarter 1998. The charge-off rate on the Region's other major loan categories also improved from a year ago. Charge-offs on the Region's C&I loans, however, increased from 0.46 percent in the third quarter of 1998 to 0.75 percent in the third quarter of 1999.

While asset quality measures depict improved credit quality, the ratio of reserve coverage to noncurrent loans reported by the Region's banks has declined gradually and was below the average for the nation. Reserves to total noncurrent loans reached 133 percent as of September 30, 1999, compared with 146 percent one year ago and 180 percent for commercial banks nationwide.[5] Lower reserve coverage ratios could result in higher provisions by the Region's banks should loan quality deteriorate significantly because of either underwriting deficiencies or a slowing economy.

Aided by increased noninterest income, the Region's established community banks[6] reported a higher average ROA of 1.08 percent in the third quarter of 1999 compared with 1.01 percent one year ago. Community banks did not escape the effects of increasing competition for loans, as interest income as a percentage of average earning assets declined from the same period a year ago and is at its lowest point in five years. Higher noninterest income, which increased to 5.55 percent of average earning assets in the third quarter of 1999 compared with 2.19 percent in the same period one year ago, bolstered community banks' earnings.

[5] *FDIC Quarterly Banking Profile,* third quarter 1999.

[6] Established community banks are defined as banks with less than $100 million in assets that were in existence prior to September 30, 1996.

Community banks reported slightly higher operating expenses as measured by the average efficiency ratio, which rose from 71.3 percent to 73.2 percent between the third quarters of 1998 and 1999. In other words, established community banks spent approximately 73 cents to earn one dollar of income in the third quarter of 1999, compared with an average of just over 64 cents for all established banks in the Region. Community banks typically have higher (less favorable) efficiency ratios because they cannot achieve economies of scale (i.e., spread costs over a large revenue base) to the same extent as larger banks. (See ***"Bank Performance Remains Strong, but Earnings Variability Is Increasing," Regional Outlook,*** Third Quarter 1999.)

New Bank Formation Continues in the Region

The increasing number of new banks,[7] primarily in New Jersey and Pennsylvania, is driving down the average ROA for new banks in the Region. As of September 30, 1999, there were 67 new banks in the Region, compared with 37 one year earlier. New banks represented 7.5 percent of the Region's banks, the highest percentage in the 1990s. During the third quarter of 1999, the average ROA for the Region's new banks was negative 2.76 percent, compared with negative 1.47 percent one year ago. The higher percentage of banks in operation less than one year has skewed the average ROA reported by the Region's new banks. As of September 30, 1999, approximately 58 percent of the Region's new banks had been in operation less than one year, the largest share in the decade. However, the average ROA for banks that were between one and three years old was better (less negative) than that of their newer counterparts.

New banks typically report lower earnings in the initial years as bank management grows its clientele and develops businesses. To compensate for the impact of losses during the first few years of a bank's existence, new banks are required to have higher capital levels than their established counterparts. Although the Region's new banks reported substantially lower average ROAs than established banks, the group's capital ratio averaged 30.2 percent over the past two years, almost three times the average capital ratio of the Region's established banks. While most of the Region's new banks are located in strong local economies, they also face increasing competition for loans and deposits.

[7] New banks are defined as banks formed since September 30, 1996.

(For additional information on new bank formation in the New York Region, see ***"New Bank Activity Occurs in Clusters"*** in ***Regional Outlook,*** Fourth Quarter 1999.)

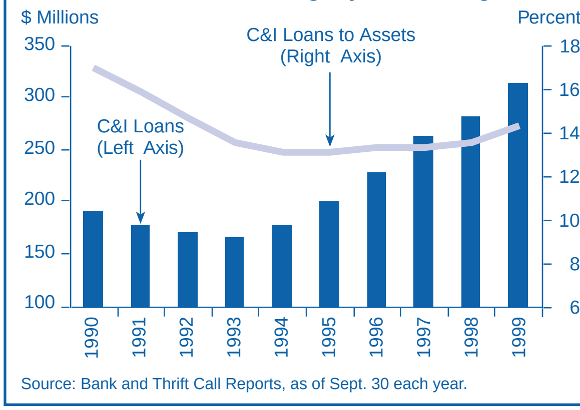
C&I Loans at Larger Banks Inch Up, but Credit Quality Shows Slight Weakening

While the dollar amount of C&I loans outstanding at the Region's banks increased almost 76 percent over the past five years, C&I loans increased only slightly as a percentage of total assets (see Chart 2). Among banks with assets greater than $1 billion, C&I loans increased from 14 percent of assets in the third quarter of 1998 to 15 percent in the third quarter of 1999.[8] Large banks are more active in certain segments of the C&I market, such as syndicated and leveraged lending, which have increased substantially in the past year. Increased syndicated lending activity may be contributing to C&I loan growth in the Region, as several of the Region's money center banks accounted for almost half of the syndicated lending volume in 1999.[9] Large banks also have been more active in the securitization of commercial loans. As competition for commercial loans has driven down spreads, some larger banks have packaged and sold C&I loans to improve profitability margins. Loans that are securitized are generally recorded as sold but are not reported on the balance sheet.

Recent underwriting surveys conducted by the ***Federal Reserve Board*** and the ***Federal Deposit Insurance Corporation*** have identified changes over the past two years in C&I underwriting. A November 1997 Federal Reserve Board ***Senior Loan Officer Opinion Survey*** noted that intense competition forced many banks to ease terms and standards on C&I loans during that year; however, more recent surveys, in August and November 1999, stated that during the first half of 1999, banks had subsequently tightened C&I underwriting standards.

Credit quality measures for the Region's C&I loans reflect the trends noted in the recent underwriting surveys. Following several years of improvement in credit quality measures, there are some recent signs of deterioration in the quality of the Region's C&I loans, primarily in large banks. The average past-due ratio on C&I loans reported by the Region's large banks increased slightly, from 1.8 percent to 2.1 percent between the third quarters of 1998 and 1999 (see Chart 3, next page). This deterioration may reflect the credit quality of the loans booked during the past two years, when banks were reportedly more aggressive in underwriting commercial loans. The C&I past-due ratios reported by the Region's community banks (those with assets less than $100 million) and midsize banks (those with assets between $100 million and $1 billion), however, were stable or improved, reflecting healthy economic conditions throughout many parts of the Region. The C&I charge-off ratio among the Region's large and midsize banks tracked the C&I past-due ratio: after several years of decline, charge-offs ticked up in the past two years. However, the ratios remain at relatively low levels. The Region's community banks showed improvement in the C&I charge-off rate (see Chart 4, next page).

Chart 2



Source: Bank and Thrift Call Reports, as of Sept. 30 each year.

Although some experts expect the economic expansion to continue, any slowdown in the nation's or Region's economy could contribute to deterioration of C&I loan performance. In fact, the results of the Federal Reserve Board's August 1999 Senior Loan Officer Opinion Survey on Bank Lending Practices showed that *one-third of respondents believed that their C&I portfolios have become more sensitive to periods of economic weakness.* Specific concerns include borrowers' increased financial leverage and narrower profit margins. Furthermore, the increase in lower-quality syndicated loans, such as leveraged loans, which now account for almost 45 percent of total syndicated

[8] Securitized C&I loans that have been packaged and sold by institutions are not included in this amount.
[9] Moyer, Liz, and B. Chase. "A Dominated Syndicated Loan Market," *American Banker,* January 4, 2000.

CHART 3

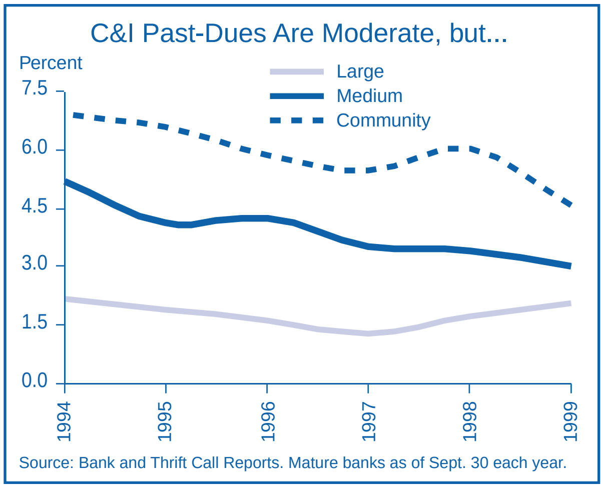
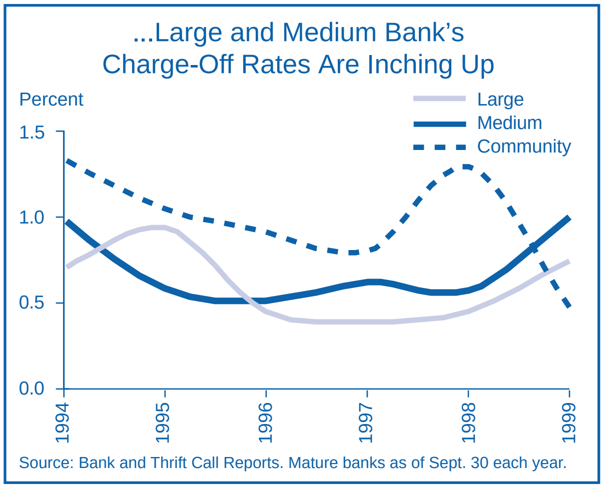


CHART 4



lending volume,[10] could have adverse effects on C&I credit quality measures. For more information on trends in commercial and industrial loans, see the "In Focus" article in this issue.

Noninterest Income Grows in Importance

Traditionally, insured institutions have relied on interest income from loans and securities to generate the bulk of their operating income; fees and service charges were usually supplemental. In the past five years, however, increased competition for loans and deposits between banks and other financial providers, including investment banks, brokerage companies, and insurance firms, has pressured bank interest margins and market share. In response, banks have attempted to diversify income sources, enhance profitability measures, and mitigate pressures on NIMs by generating more noninterest income.

The growth of noninterest income[11] results from increased fees from traditional banking services as well as expansion by banks into new services. Banks are generating more income from traditional banking activities, such as charges on deposit accounts and credit cards and fees for mortgage servicing and loan commitments, which generally are more insulated from changes in economic conditions or financial market instability. For example, automated teller machines (ATMs) have been a source of fee income for insured institutions for years; however, banks have initiated new charges for ATM use, including fees for noncustomer use and charges for the use of another institution's ATM (referred to as a "foreign fee"). According to ***CNNfn,***[12] a recent ***Public Interest Research Group*** survey found that the number of banks imposing ATM fees climbed 31 percent in 1998, with 93 percent of all banks now surcharging non-account-holders. Higher noninterest income also has resulted from increased bank involvement in activities that are more susceptible to changes in financial markets such as trading activities, investment advisory services, and the sale of life insurance products.

Increased reliance on noninterest income has occurred nationwide as noninterest income climbed from 29 percent of operating income[13] to 36 percent over the five years ending September 30, 1999.[14] In the Region, noninterest income has increased from 39 percent to 50 percent of operating income over the same period, as the growth of noninterest income has outpaced that of interest income.[15] The larger proportion of noninterest income to operating income reported by the Region's

[10] "Spotting for the Market," *The Investment Dealer's Digest,* December 6, 1999.

[11] Noninterest income, as defined by the ***Consolidated Reports of Condition and Income*** (Call Reports), includes trading income, fiduciary income, service charges on deposit accounts, other fee income, and all other noninterest income. Gains on the sale of investment securities are accounted for separately and not included in this discussion of noninterest income.

[12] Jacoby, Nicole. "Keeping Bank Costs in Check," *CNNfn,* May 3, 1999.

[13] Operating income is defined as net interest income plus noninterest income.

[14] Excluding banks in the Region.

[15] On a merger-adjusted basis.

banks reflects in part the broad scope and national presence of the Region's larger banks and credit card specialists.[16]

Because of size, market reach, and the types of products offered, the Region's larger banks (those with assets over $10 billion) have historically stood at the forefront of revenue diversification and generation of noninterest income. The larger banks, excluding credit card banks, accounted for approximately 70 percent of total noninterest income as well as two-thirds of all fees and income from trust activities, trading revenue, and mutual fund and annuity sales generated in the Region during the third quarter of 1999. Noninterest income constituted approximately 55 percent of the operating income for the Region's larger banks in the third quarter of 1999, up from 43 percent five years ago.

Increased syndicated lending has contributed to greater levels of fee income reported by large banks. According to ***Paine Webber Equity Research,***[17] syndicated lending generates more fees than any other type of underwriting activity. The report estimates that syndicated lending generates almost $6 billion in fees to banks annually, ranking it as the highest fee-generating business in investment banking. The report also states that syndicated lending is one of the fastest-growing markets for banks, increasing an estimated 15 percent per year. Periods of economic instability or reduced merger activity, however, could lessen demand for syndicated loans and pressure fees earned by banks in this market segment.

Trading revenue also is an important source of noninterest income to the Region's larger banks, ranking second behind fee income. As of September 30, 1999, trading revenue contributed 19 percent of total noninterest income to banks with assets over $10 billion. Noninterest income from trading includes income from interest rate, foreign exchange, equity, and commodity contracts. As is the case with syndicated lending, revenue from bank trading activities can be vulnerable to fluctuations in global financial markets.

The contribution of noninterest income is more significant in the Region's credit card specialists than in its larger banks. In the third quarter of 1999, 72 percent of operating income for the Region's nine credit card specialists came from noninterest income, compared with 55 percent during the same period five years ago. Credit card banks historically have generated a greater amount of fees and service charges than traditional bank lenders. As credit card lenders have saturated consumers with solicitations, credit card specialists have competed for market share by offering low-rate cards and other incentives such as mileage rewards and rebate programs. To offset the effect of lower yields earned on these "teaser" rate offers, many lenders increased service fees. According to industry reports, late and over-limit fees have increased the most in the past few years, with late fees currently averaging $24.02, up from $11.97 five years ago, and the average over-limit fees increasing to $23.44 from $12.57 in the same period.[18] Many major issuers also reduced their late payment grace period from 14 to 0 days, resulting in borrowers being subject to late fees sooner. Some credit card issuers have even instituted charges for closing an account and for general customer service.

The expansion into subprime lending is another factor contributing to the growth of noninterest income. Some credit card banks, along with other insured and nonbank lenders, are making loans to subprime borrowers more accessible than in prior years. Subprime loans, which are offered to borrowers who are considered to have weaker credit histories, typically generate more fees than loans to borrowers who have better credit quality characteristics. Subprime loans typically incur more late charges, insufficient fund charges, and escrow charges than nonsubprime loans. Recent entrants in subprime lending have benefited from a strong economy; however, revenue from subprime loans, including interest and noninterest income, may prove to be less significant during weaker economic environments.

Growth in Noninterest Income Is Not Limited to Larger Banks

Increased reliance on noninterest income is not limited to the Region's credit card specialists and larger banks. The Region's midsize banks (those with assets between $100 million and $1 billion) have reported a higher proportion of noninterest income to operating income in recent years. Noninterest income increased from 17 percent of operating income in third quarter 1994 to 28 per-

[16] Credit card specialists are defined as banks that have 50 percent of assets in loans and 50 percent of loans as credit card loans.
[17] Madan, Ruchi. "The Biggest Secret of Wall Street," Paine Webber Equity Research, May 14, 1999.
[18] Jacoby, Nicole. "Picking a Credit Card," *CNNfn,* July 21, 1999.

cent in third quarter 1999.[19] This segment of the Region's banks reported "other noninterest income"[20] as their main source of noninterest income.

While some types of "other" noninterest income are generated by ongoing operations, such as data processing services and rental income, others are derived from a merger or restructuring of an institution's balance sheet or operations. Barring a continuous stream of mergers or restructuring, the amount of income generated from this source is limited.

Gains from the sale of securitized assets are another example of "other" noninterest income that is sensitive to changes in financial markets. During the past year, several financial providers, primarily subprime lenders, reported substantial losses resulting from decreases in the value of gains recorded on securitizations because of changes in market conditions, primarily interest rates. As a result of these losses, some subprime lenders that relied almost exclusively on gains from securitizations for earnings have been forced to merge or cease operations.

The Region's community banks (those with assets less than $100 million) also have increased reliance on noninterest income, from just under 15 percent of operating income during the third quarter of 1994 to almost 32 percent during third quarter 1999.[21] Fee income represented the largest share of community banks' noninterest income. According to the ***American Bankers Association*** (ABA), a 1999 ***Community Bank Competitiveness Survey*** found that mortgage and trust fees were a significant source of fee income (22 and 17 percent, respectively) for community banks.[22] Like their larger brethren, community banks are earning more fees from traditional banking activities and developing new fee-based businesses. For example, sales of nondeposit investment products such as mutual funds and annuities have augmented community banks' earnings. According to a recent report in the ***ABA Banking Journal,*** community banks that sell nondeposit investment products are more successful than regional or money center banks at realizing profits from these products and penetrating their deposit base. Community banks' income from the sale of nondeposit products could decline if confidence in the stock market erodes or other financial intermediaries expand their presence into local communities.

[19] Excluding credit card specialists.

[20] The Call Report definition of "other noninterest income" includes data processing fees, net gain on sale of assets such as buildings and branches, and rental income.

[21] Excluding credit card specialists.

[22] "The Income Picture: Shifts and Surprises," *ABA Banking Journal,* February 1999.

Implications for Insured Institutions

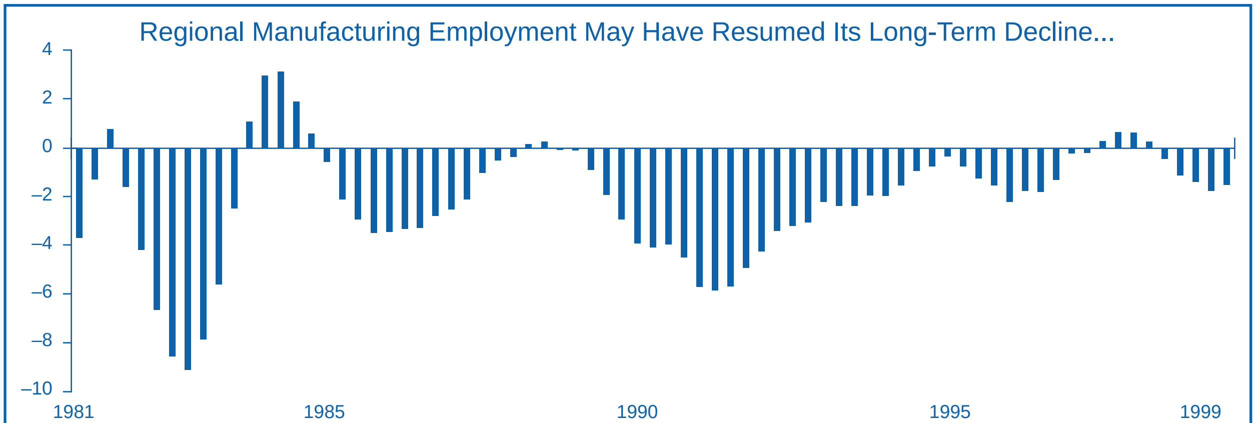
The benefits to insured institutions of earning higher levels of noninterest income are numerous. Noninterest income has helped strengthen banks' earnings while mitigating the effect of narrowing interest margins on profitability. Higher fee income, in part, reflects the successful expansion by banks into new markets and products, which strengthens the banks' market share while diversifying income. Furthermore, noninterest income enhances an institution's return on assets and equity, because service-based income does not require capital reserves. In addition, noninterest income generally is not subject to credit quality concerns, as is interest income on loans and securities.

Insured institutions' emphasis on noninterest income is expected to continue as banks look for ways to augment earnings and improve performance measures; however, increased competition from other financial services providers and fluctuations in the financial markets may hinder future growth. Some types of noninterest income may be more susceptible to changes in market conditions than more traditional bank products. Increased competition among banks and nonbank financial providers also could influence banks' ability to generate noninterest income. The enactment of the Gramm-Leach-Bliley Act, which expands permissible bank activities such as investment banking and insurance activities and permits mergers between insured institutions and other financial providers, may intensify competition for banking products and services. As noninterest income becomes a more significant contributor to bank profitability, the analysis by banks of the quality and stability of these income sources becomes more critical.

The Region's Higher Costs Have Hurt the Manufacturing Sector

The Region's manufacturing sector has been contracting for decades (see Chart 5). After World War II, manufacturing industries gradually began to exit the Region for lower labor-cost areas of the South and overseas. Throughout the 1970s and 1980s, declines in the

CHART 5



Note: Represents year-over-year percentage change.
Source: Bureau of Labor Statistics

Region's manufacturing sector, including the fabricated metal, machinery, furniture, textiles, and transportation equipment industries, were particularly severe. In the 1990s, job declines in the Region reflected downsizings and major restructurings in defense-related firms, pharmaceuticals companies, and a number of prominent manufacturers, including Xerox, IBM, and Kodak, whose losses contributed to the Region's severe recession. These restructurings, however, increased productivity of the Region's manufacturing sector by 30 percent between 1990 and 1997, improving these firms' competitive position in the global market (see Chart 6). In the late 1990s, employment levels began to rise. Crises in Asia, Brazil, and Russia, however, reduced worldwide demand for manufactured goods from the United States and the Region, resulting in a decline in manufacturing employment beginning in third quarter 1999 through year-end.

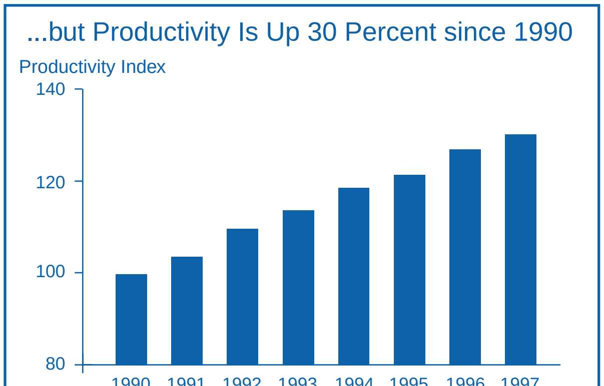
Region's Large Cities Pay High Electricity Rates

Higher electricity rates as well as higher labor costs have been particularly burdensome to businesses in the Region. A recent study by the ***New York City Comptroller's Office*** found that electricity costs in many of the Region's cities are among the highest in the United States.[23] **New York City**'s residential electrical rates ranked the highest of any major U.S. city, even after factoring in state and local taxes. Moreover, **Philadelphia** was ranked second and **Pittsburgh** and Washington, D.C., were in the top ten. On the commercial side, the picture was no better. Every major city[24] in the Region ranks among the U.S. cities paying the highest dollar per kilowatt-hour. Higher rates can be attributed to the local utilities' cost of doing business. These utilities face limited access to less expensive hydroelectric power or the inability to burn cheap coal because of local air quality restrictions. The

[23] New York City Office of the Comptroller. *Economic Notes: The High Price of New York City Power,* September 1999.

[24] Major cities include Baltimore, New York City, Pittsburgh, Philadelphia, and Washington, D.C.

CHART 6



Note: Productivity is measured by dividing gross state product by the number of employees. Data from 1997 are the most recent available and exclude Puerto Rico.
Source: Bureau of Labor Statistics, National Income and Product Accounts.

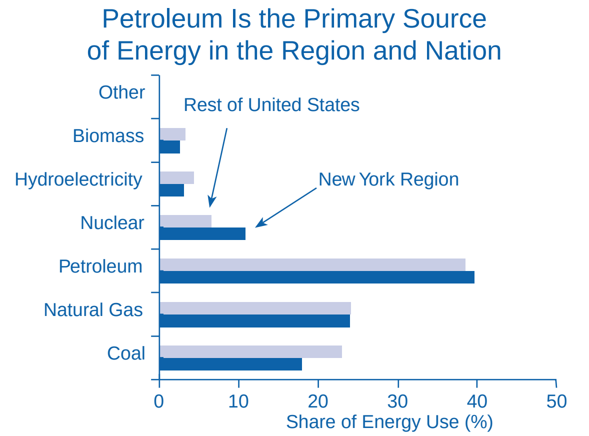
Comptroller's report also cites high local and state utility taxes as well as high administrative costs as contributing to the costs of energy production.

Some States Are More Vulnerable to Oil Price Hikes

The Region's energy costs have been driven even higher with the increase in oil prices since last year. In December 1998, the cost of benchmark West Texas intermediate oil stood at $11.28 per barrel. Agreements by the **Organization of Petroleum Exporting Countries,** however, had driven the price to $26.08 per barrel by December 1999, an increase of over 130 percent. Despite the increase, oil has become less important to the economy than it was in the 1970s, as the economy moves toward services and away from manufacturing. A recent article in the ***Wall Street Journal*** said that many of the nation's companies have learned to protect themselves from oil-price swings by diversifying fuel sources and developing new energy-saving technologies,[25] thus also helping to shield the nation's and Region's economies from higher prices.

Petroleum, nevertheless, represents the largest single energy source in both the Region and the nation, accounting for approximately 40 percent of all energy use (see Chart 7). In Delaware, Maryland, and New Jersey, petroleum dependency is higher, representing

CHART 7



Source: U.S. Department of Energy

over 55 percent of all energy use in Delaware and New Jersey and over 43 percent of all energy use in Maryland. Delaware and New Jersey are very dependent on petrochemical products for their chemicals industries, and increases in oil prices could hinder future economic growth. Increases in oil prices, like additional taxes, increase production costs. Delaware, Maryland, and New Jersey businesses could suffer a competitive disadvantage if oil prices remain high.

Kathy Kalser, Regional Manager
Norman Gertner, Regional Economist
Alexander Gilchrist, Economic Analyst

Special thanks to Mark Otero, Intern
George Small, Examiner

[25] Liesman, Steve, and Jacob Schlesinger. "Blunted Spike: The Price of Oil Has Doubled This Year; So Where's the Recession?," *The Wall Street Journal,* December 15, 1999.

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