◇ Regional Outlook ◇

FEDERAL DEPOSIT INSURANCE CORPORATION FIRST QUARTER 2001

FDIC
NEW YORK
REGION

DIVISION OF
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Regional Perspectives

◆ ***The Region's Economic Growth Slowed as 2000 Came to a Close***—**After a record nine years of economic expansion, the nation's and Region's economies slowed at the end of last year. Slower job and income growth suggests that the pace of the Region's expansion will moderate during the first half of 2001.** *See page 4.*

◆ ***Banking Conditions Are Becoming More Challenging***—**The Region's insured institutions reported slightly lower profitability through the nine months ending September 30, 2000, than a year ago, as higher funding costs and competitive pressures constrained net interest margins. Credit quality of commercial and industrial loans at the Region's large banks showed signs of continued weakening.** *See page 6.*

◆ ***Community Banks' Margins Decline despite Strong Loan Growth and a Shift into Traditionally Higher-Risk Loan Categories***—**Benefiting from the record long economic expansion, the Region's community banks have reported strong growth in commercial loan types over the past several years. Despite the increased credit risk profile, net interest margins have declined, reflecting increased competitive pressures and a relatively flat Treasury yield curve.** *See page 7.*

◆ ***New Bank Formation Has Increased in the Region***—**Several factors, including strong economic conditions, have contributed to new bank formation in the Region. Several of the Region's metropolitan statistical areas that are home to a greater percentage of new banks are more dependent on some troubled industry sectors. The Region's new banks also have an increasing credit risk profile, evidenced by growing commercial real estate loan portfolios and increased use of noncore funding.** *See page 9.*

By the New York Region Staff

In Focus This Quarter

◆ ***Credit Problems for U.S. Businesses Continue to Rise***—**Commercial loan quality indicators of insured banks have steadily worsened since 1998. Factors contributing to this deterioration include rising financial leverage in the corporate sector as well as weaknesses within certain domestic industries. Many market observers also have attributed the increase in problem commercial loans to a heightened appetite for risk and relaxed underwriting standards from 1996 to 1999. The apparent softening in economic conditions in recent months reduces prospects that business loan quality will improve any time soon. In the meantime, lenders, analysts, and supervisors continue to pay close attention to U.S. business lending conditions.** *See page 14.*

◆ ***Outlook for Three Industries Facing Uncertainty***—**Industries as diverse as telecommunications, health care, and textiles have been experiencing problems, despite the economic expansion that began nine years ago. Although the sources of their difficulties are quite different, these industries share some common concerns and challenges. Fierce competition characterizes their operating environment. Armed with a better grasp of the origins of stress in these industries, we will have a better basis for understanding the lending risks associated with a changing policy and economic environment in the years to come.** *See page 22.*

By the Division of Insurance Staff

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Letter from the Executive Editor

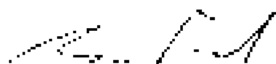
To the Reader:

The goal of the ***Regional Outlook*** is to provide useful risk-related information to bankers, banking agency staff, and other interested readers. To do this more effectively, the second quarter 2001 edition will have a new look. We will publish a single national edition that will provide an overview of economic and banking risks and discussions of these risks as they relate to insured institutions in each FDIC Region. We will tell the national story and, at the same time, alert the reader to specific trends and developments at the regional level.

After considering our experience with this new format, we may adopt it permanently for the second and fourth quarters of each year. The first and third quarter editions will continue to feature in-depth coverage of the economy and banking industry in each Region. Trying new formats will help us find the right balance between regional coverage of specific topics and analysis of economic and banking issues that cut across regional lines.

After you have read the next edition of the ***Regional Outlook,*** we would like to hear from you. Does this new approach provide a more effective vehicle for reporting on banking and economic trends? What other suggestions do you have for improving our presentation of risk-related information? Call us with your comments at (877) 275-3342 or (800) 925-4618 (TDD) or e-mail them to lnejezchleb@fdic.gov.

Sincerely,



George E. French
Executive Editor

Regional Perspectives

- **The Region's economic growth rate slowed toward the end of 2000. Slower job growth in the manufacturing and financial services sectors has contributed to a less robust economic outlook.**

- **Insured institutions reported slightly lower profitability through the nine months ending September 30, 2000, than a year ago, primarily because of higher funding costs, which pressured net interest margins. Commercial and industrial loan quality weakened at the Region's large banks.**

- **To counter margin pressure, the Region's community banks grew their loans and shifted into traditionally higher-risk loan categories as the Region's economy showed signs of slowing.**

- **Similar to the 1980s experience, new bank formation increased during the recent economic expansion; however, compared with their 1980s peers, today's new banks report greater concentrations of commercial real estate loans, suggesting an elevated credit risk profile.**

Region's Economic and Banking Conditions

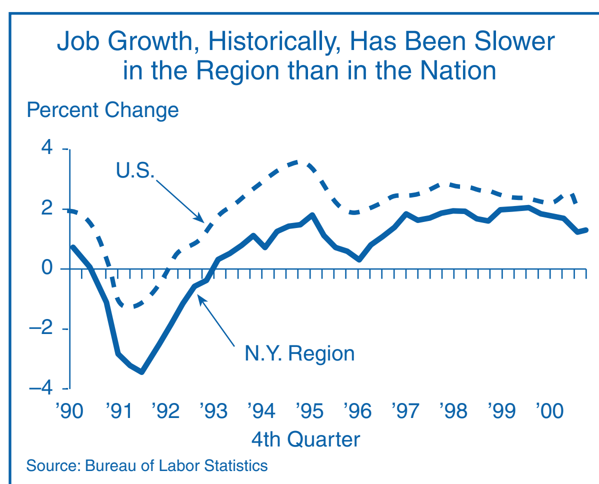
Economic Growth across the Nation and in the Region Slowed in the Second Half of 2000

After a record nine years of economic expansion, growth in the nation's economy slowed as 2000 came to a close. The gross domestic product, the nation's broadest barometer of economic activity, rose 2.2 percent annually during third quarter 2000, the slowest quarterly growth rate in four years. Furthermore, in December 2000, the survey of consumer confidence declined to the lowest level in two years, indicating that consumers are growing more wary about the economy.[1] A confluence of factors, including rising energy prices, lower corporate profits, and the lagged effects of tighter monetary policy by the Federal Reserve Board, has raised the prospect of slower economic growth in the nation. Over the past nine years, productivity gains helped boost U.S. corporate profits. However, intensifying global competition, a strong dollar, and less robust productivity growth began to squeeze many companies' profit margins in the latter half of 2000. Moreover, spreads between corporate debt and U.S. Treasury securities significantly widened at the end of the year, signaling heightened credit concerns among investors. Furthermore, reflecting less robust economic conditions, an increasing number of U.S. firms scaled back earnings forecasts for fourth quarter 2000.

Reflecting the national trend, economic growth among the Region's states also moderated during 2000. In fact, ***Economy.com*** forecasts a significant reduction in the rate of economic growth for the Region.[2] Slower job and income growth contributed to the expectation that the economy will slow. The Region's job growth has declined, in part because of tight labor markets, which have been further constrained by limited population growth in many of the Region's states. In fourth quarter 2000, the Region added 295,000 new jobs, representing a gain of 1.3 percent compared with about a 1.6 percent increase for the nation (see Chart 1).

Lower rates of employment growth primarily reflected slower job growth in several of the Region's major

CHART 1



Source: Bureau of Labor Statistics

[1] The Conference Board, a not-for-profit business membership and research organization, produces the survey of consumer confidence.

[2] State gross product forecasts as of January 2001.

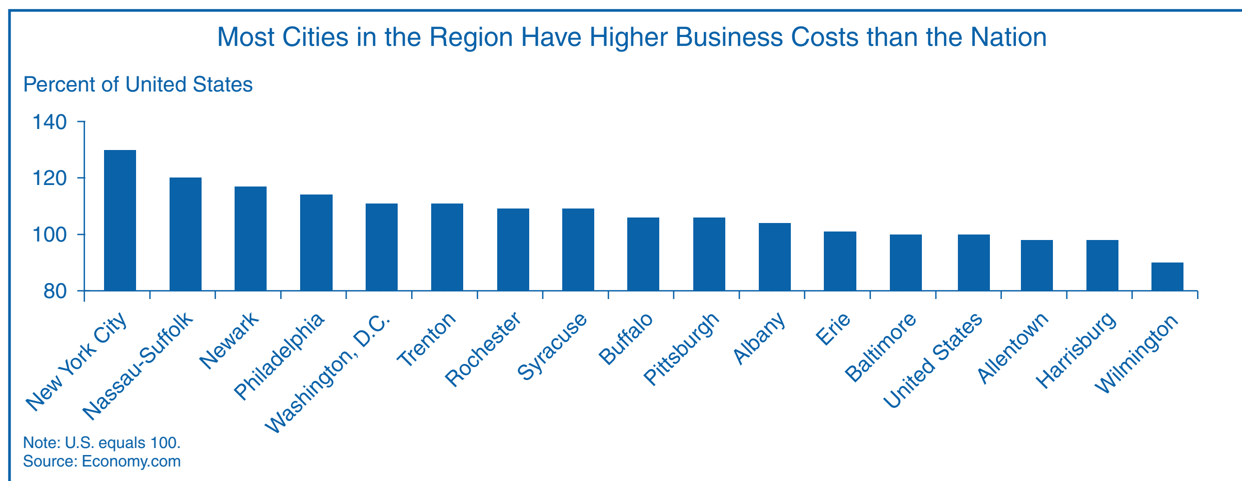
industries, including the finance, insurance, real estate, services, and manufacturing sectors. Declining equity valuations, particularly on the NASDAQ; decreased initial public offering activity; and reduced issuance of corporate debt have curtailed the hiring plans of many of the Region's investment banking and financial service providers. In fact, several investment firms have announced layoffs. Employment growth in the Region's service sector, although healthy, also has slowed. During the first three quarters of 2000, employment growth in this sector ranged between 2 percent and 2.5 percent, below the 3 to 4 percent rate of the past five years. In addition, the Region's manufacturing employment has declined over the past several decades, as many manufacturers have left for lower-cost venues.

The Region's housing sector also may be feeling the effects of a slowing economy and the higher mortgage rates that prevailed throughout much of 2000. The volume of home sales declined in some of the Region's largest metropolitan statistical areas (MSAs) during 2000.[3] Prices for single-family homes, however, continued to rise in third quarter 2000, primarily in the suburbs of **New York City, Baltimore,** and **Washington, D.C.,** as demand outstripped supply. Nevertheless, a weakening stock market and growing consumer uncertainty could slow housing activity in the Region.

Region's Economy Remains Healthy, but Areas of Weakness Are Emerging

Despite signs of more modest growth, economic conditions were relatively healthy in 2000. The Region has experienced strong productivity, high levels of household income, and generally favorable commercial real estate conditions. However, the Region's economy may be more vulnerable to certain risks than other parts of the nation, particularly weakness in the financial markets. The securities industry accounted for over 40 percent of **New York** state's increase in gross state product and over 20 percent of the Region's economic growth between 1990 and 1998. Moreover, because financial, legal, and business services generally are linked to stock and bond market activity, a slowdown on Wall Street could affect the Region's service sector adversely. For example, 41 percent of **Delaware's** economy is related to financial service activities. Higher business costs, prevalent in many of the Region's larger cities, also could make the Region more susceptible to economic weakness. Areas in the Region experiencing increased labor costs, higher real estate prices, and greater reliance on petroleum products could be more vulnerable than other areas to the downside of a business cycle, as companies curtail higher-cost operations (see Chart 2).

CHART 2



[3] Data provided by Economy.com as of January 2001.

Banking Conditions Are Becoming More Challenging

The New York Region's insured institutions reported slightly lower profitability for the nine months ending September 30, 2000, than for the same period a year ago, reflecting an increasingly competitive banking environment and changes in the level and shape of the Treasury yield curve. The Region's banks have benefited from the nation's long economic expansion, experiencing strong loan demand and favorable credit quality. However, competition for loans, deposits, and other bank products and services is becoming increasingly aggressive, with a wide variety of nonbank financial companies offering traditional banking services. Attracting low-cost core deposits has been a particular challenge for many of the Region's insured institutions, reflecting the increased popularity of noninsured deposit alternatives, including mutual funds. Because loan demand has outpaced core deposit growth, the Region's banks have increased reliance on noncore funding, which has contributed to a tightening of bank net interest margins (NIMs) and has heightened liquidity risk at some institutions. A relatively flat Treasury yield curve that prevailed throughout much of 2000 also contributed to lower NIMs.

Large Banks' Profitability Is Pressured by Lower Margins and Weaker Credit Quality

The New York Region's large insured institutions[4] reported moderately lower profitability for the nine-month period ending September 30, 2000, compared with the same period a year ago (see Table 1). The median return on assets declined primarily because of a decrease in the NIM as funding costs increased more than the yield earned on assets. For the fifth consecutive quarter the average cost of funds increased for the Region's large banks, reflecting higher wholesale market interest rates. Noninterest income increased from 47 percent of operating income[5] during the first nine months of 1999 to 53 percent during the same period in 2000. This percentage declined, however, during the second and third quarters of 2000, reflecting weakness in the capital markets.

Table 1

Tightening NIMs Pressure the Profitability of the Region's Insured Institutions

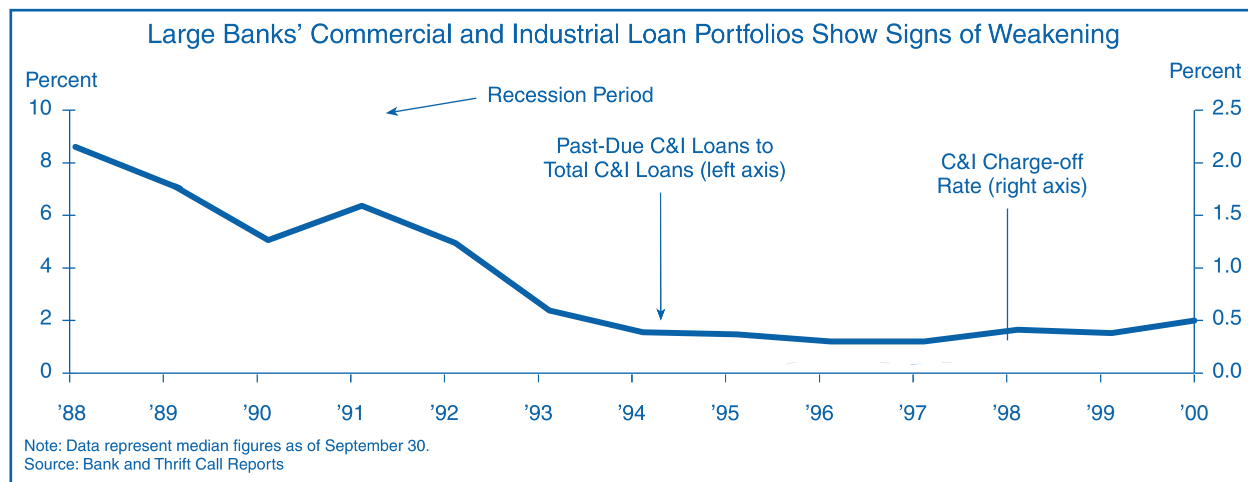
	Assets Greater than $25 Billion			Assets between $1 Billion and $25 Billion			Assets Less than $1 Billion		
	Sep '00	Sep '99	Sep '98	Sep '00	Sep '99	Sep '98	Sep '00	Sep '99	Sep '98
Return on Assets (ROA)	1.03	1.13	1.11	1.06	1.15	1.14	0.93	0.95	0.97
Net Interest Margin (NIM)	3.23	3.56	3.84	3.55	3.58	3.84	3.93	3.94	4.04
Efficiency Ratio	60.03	56.70	56.91	54.52	53.59	56.52	63.41	64.39	63.10
Noninterest Income/ Operating Income	53.32	47.36	45.93	18.36	17.56	16.42	11.27	11.16	10.59
Past-Due Ratio—Total Loans	1.66	1.89	1.69	1.39	1.43	1.80	1.56	1.76	2.17
Past-Due Ratio—C&I Loans	2.01	1.47	1.59	1.51	1.39	1.96	0.96	1.19	1.27
Core Deposits/Assets	35.95	36.61	38.78	59.56	59.41	59.02	72.79	74.44	76.08
Loans/Assets	59.35	60.42	59.05	62.37	60.12	59.69	63.88	61.58	61.16
Reserves/Loans	1.37	1.52	1.91	1.10	1.14	1.22	1.02	1.03	1.10
Tier 1 Leverage Ratio	6.78	6.60	6.11	7.53	7.54	7.82	9.64	9.66	9.89
Tier 1 Risk-Based Capital Ratio	8.66	8.37	8.01	11.52	11.88	12.74	16.42	16.67	17.44

Notes: Median data excluding institutions in operation less than three years and credit card banks.
Operating income = net interest income plus noninterest income
Past-due ratio = loans past due 30 days or more plus nonaccrual loans divided by gross loans
Source: Bank and Thrift Call Reports for the nine-month period ending September 30

[4] Institutions with total assets greater than $25 billion, excluding credit card banks. The banking analysis uses median figures unless otherwise noted.
[5] Operating income is defined as the sum of net interest income and noninterest income.

Overall reported asset quality at the Region's large institutions improved compared with a year ago, evidenced by lower past-due and charge-off-to-total-loans ratios; however, commercial and industrial (C&I) credit quality continued to show signs of weakening. While well below levels reported a decade ago, the median past-due C&I loan ratio increased for the Region's large banks, reaching a seven-year high of 2.01 percent as of September 30, 2000 (see Chart 3). The increase in syndicated loans adversely classified under the ***Shared National Credit*** program,[6] higher corporate bond defaults, relatively wider corporate debt spreads to Treasuries, and an increased proportion of rating downgrades to upgrades on corporate bonds suggest continued weakening of commercial credit quality. According to ***Fitch/IBCA,*** defaults on high-yield bonds likely will remain at above-average levels throughout 2001.[7] Slowing economic and corporate profit growth, higher interest rates, and less disciplined underwriting standards during the mid- to late 1990s likely contributed to the weakening of C&I loan quality at large banks.[8]

CHART 3



[6] Joint release by the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. October 10, 2000. Bank Regulators' Data Show Continued Increase in Adversely Classified Syndicated Bank Loans.

[7] Fitch/IBCA. December 2000. *High Yield Default Rates Continue to Climb to a 9-yr Peak.*

[8] The Federal Reserve Board's *Senior Loan Officer Opinion Surveys on Bank Lending Practices* from 1996 to 1998 indicated easing of C&I lending standards nationwide.

Community Banks' Margins Decline despite Strong Loan Growth and a Shift into Traditionally Higher-Risk Loan Categories

The Region's community banks[9] reported slightly lower profitability during the first nine months of 2000 compared with a year ago as improved asset yields, which reflected higher market interest rates and strong loan growth, were more than offset by increased funding costs (see Table 1). Benefiting from strong economic conditions, loans increased in the aggregate by 10 percent during the past 12 months, slightly more than the 9 percent growth rate reported a year ago.[10] Commercial loan[11] levels grew most rapidly, increasing 17 percent, more than double the 7 percent growth rate of residential loans.

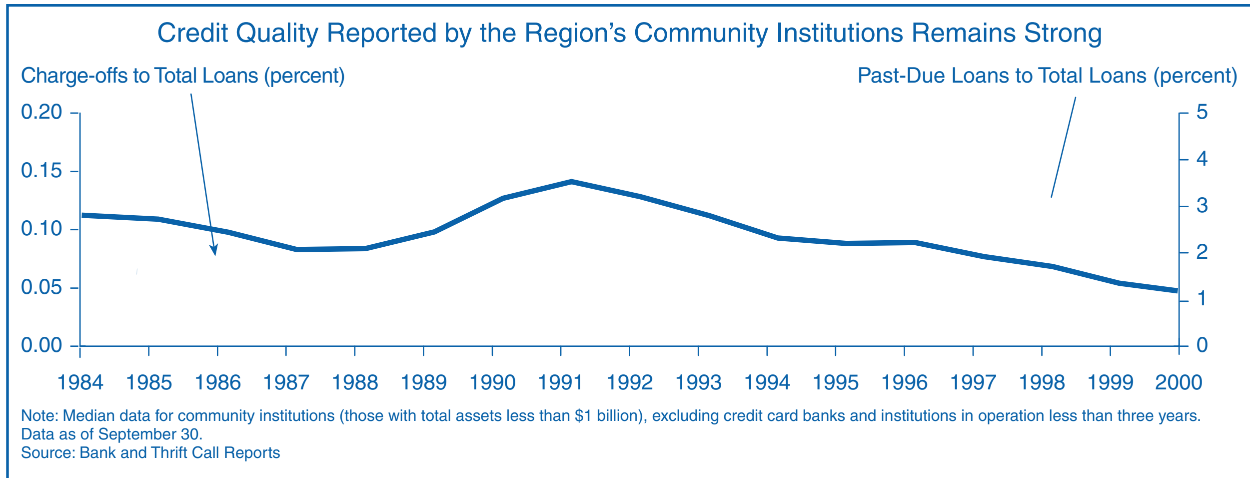
Reported asset quality among the Region's community banks was favorable, evidenced by a median past-due loan ratio that was lower than a year ago and well below levels reported before the recession of the early 1990s (see Chart 4, next page). After declining for several years, the dollar amount of delinquent loans reported by the Region's community banks leveled off in the first nine months of 2000, suggesting that improvements in

[9] Institutions with total assets less than $1 billion, excluding institutions in operation less than three years and credit card banks.

[10] The growth rates reported are for the 12-month periods ending September 30, 2000, and September 30, 1999, and are adjusted for mergers.

[11] Defined as the total of commercial and industrial, commercial real estate, and construction and development loans.

CHART 4



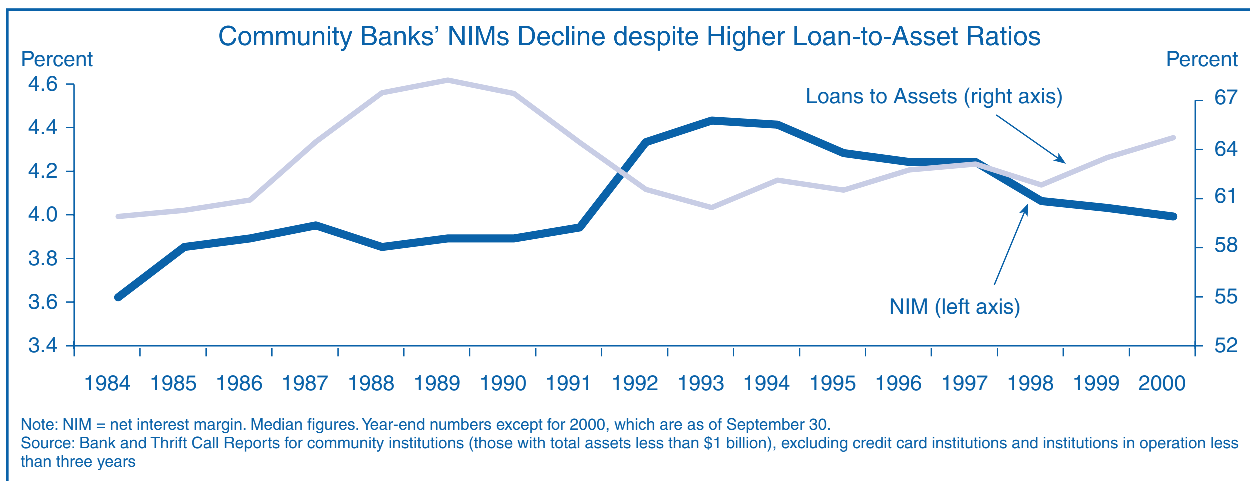
Note: Median data for community institutions (those with total assets less than $1 billion), excluding credit card banks and institutions in operation less than three years. Data as of September 30.
Source: Bank and Thrift Call Reports

credit quality may be waning. Residential loans, which remain community banks' largest loan category, continue to show a low past-due ratio; however, a national trend warrants attention. According to a study by ***Mortgage Information Corporation,*** the delinquency ratio for mortgage loans originated nationwide in 2000 exceeded that for loans originated in 1999 and 1998, and was double the level for 1993 and 1994 vintages.[12]

Despite the current economic expansion and higher loan-to-asset (LTA) ratios, the median NIM reported by the Region's community banks has trended down since the mid-1990s (see Chart 5). Unlike large banks, which have more diversified revenues, the Region's community banks are heavily dependent on the NIM or "spread" income. As a result, loan growth and asset yields are key to community banks' profitability.

Strong loan growth during an expanding economy is consistent with the experience of the Region's community banks during the 1980s business expansion. During the last cycle, these banks increased LTA ratios by growing residential and commercial loan portfolios at the expense of consumer loans. During the 1990s economic expansion, community banks also have emphasized commercial loans, which traditionally are higher yielding and higher risk, and have significantly reduced consumer loan concentrations. As of September 30, 2000, commercial loans accounted for 33 percent of community banks' loan portfolios, compared with 26 percent four years ago.

CHART 5



Note: NIM = net interest margin. Median figures. Year-end numbers except for 2000, which are as of September 30.
Source: Bank and Thrift Call Reports for community institutions (those with total assets less than $1 billion), excluding credit card institutions and institutions in operation less than three years

[12] The Mortgage Information Corporation. Summer/Fall 2000. *The Market Pulse.* The delinquency ratio is for conventional, prime-quality mortgages. The measure used is 60 days or more past due.

Growth in commercial lending has been widespread among the Region's community banks, with 65 percent of banks reporting a higher concentration in commercial loans than four years ago.[13] While the credit risk profile of the Region's community banks may be increasing, median capitalization and reserve-to-loan ratios are higher than a decade ago, providing a greater degree of protection against potential credit quality weaknesses.

Increased Competition Has Pressured Community Banks' Margins

Increased competition for bank products and services has contributed to community bank margin compression. The growth of nonbank financial service providers, increased credit union membership and services, and expanded market share of mortgage companies have heightened competition for community banks. Membership in credit unions increased nationally from 68.2 million in 1996 to 76.7 million in 2000,[14] and many credit unions now compete with banks for residential mortgages and business loans. Competition from mortgage companies also has grown. Mortgage companies' share of annual residential mortgage originations increased from 35 percent in 1990 to 56 percent in 1997.[15] Furthermore, increased new bank formation in the Region provides additional competition for the Region's established community banks (see Box).

[13] Data are adjusted for mergers.

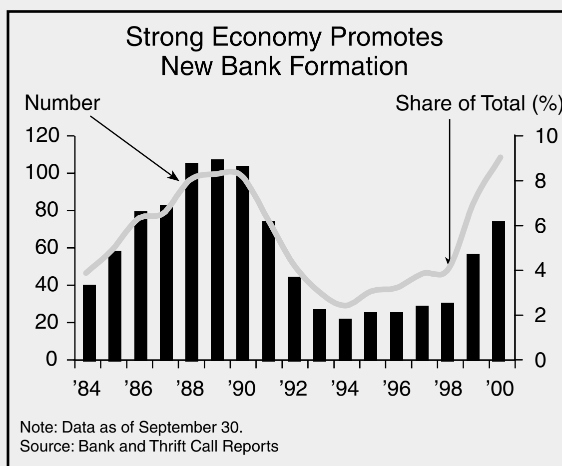
[14] National Credit Union Administration. 2000. *Mid-Year Statistics for Federally Insured Credit Unions.*

[15] Mortgage Bankers Association of America. Most recent data available were from 1997.

New Bank Formation Has Increased in the Region

The strong economy has contributed to increased new bank[16] formation in the Region, both in number and proportion. As of September 30, 2000, the percentage of new banks in the Region slightly exceeded the level achieved at the height of the 1980s business cycle (see Chart 6). While the Region's proportion of new banks to total banks is roughly equivalent to the national average (8 percent for the Region[17] compared with 7 percent for the nation), some of the Region's MSAs have a more significant concentration of new banks (see Map 1, next page).

CHART 6



Several factors have contributed to the level of new bank formation in the Region, including strong economic growth[18] and relatively high wealth concentration.[19] Merger activity also may be a contributing factor. As smaller community banks are acquired by larger, and in many instances out-of-state, banks, a niche exists for new local banks to provide personal service and capitalize on management ties to the local community. The Region's MSAs, with a larger proportion of new banks than the nation, also experienced a greater degree of bank consolidation over the past five years than the rest of the Region.[20]

Deposit market share data for the Region also suggest that bank consolidation may be a contributing factor to new bank formation. Deposits have become more

[16] For the purposes of this article, new banks are defined as insured institutions that have been chartered for three years or less.

[17] When including only "true" de novos—that is, those without a large parent company—the proportion drops to roughly 6 percent of total banks.

[18] Moore, Robert R., and Edward C. Skelton. First quarter 1998. Federal Reserve Bank of Dallas. "New Banks: Why Enter When Others Exit?" *Financial Industry Issues.*

[19] Correlation between new bank formation and growth in capital gains in the New York Region is strongly positive.

[20] The average rate of contraction between 1995 and 2000 in the ten highly concentrated MSAs cited above is 26 percent, while the rate for the Region as a whole is only 15 percent. The rate of consolidation was 60 percent in Nassau-Suffolk, 40 percent in Washington, D.C., and 33 percent in Newark.

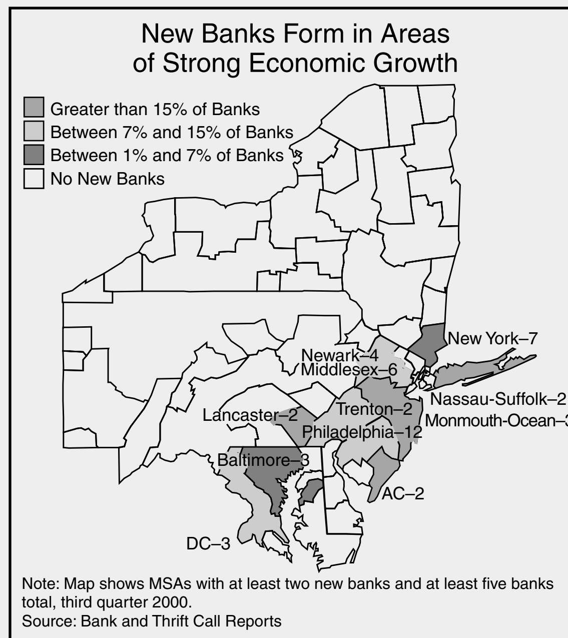
concentrated among fewer institutions during the past five years,[21] particularly in those MSAs with a greater percentage of new banks than the national average. In most of these MSAs, large, out-of-state banks have increased deposit market share by acquiring local institutions, creating an opportunity for new, neighborhood-oriented institutions. Although deposit market share has become more concentrated in these MSAs, the level of deposit concentration varies. The Region's major metropolitan areas, including New York City, **Philadelphia,** and Washington, D.C., which are home to larger banks, reported a higher level of deposit concentration than the smaller MSAs of **Nassau-Suffolk, Middlesex-Somerset-Hunterdon (Middlesex),** and **Newark.**

The Risk Profile of New Banks Has Increased

Like the Region's established community banks, new banks face an increasingly challenging banking environment. Pressure to meet profitability forecasts, in light of strong competition for loans and deposits, may be reflected in the loan profiles of the Region's new banks. Although the LTA ratio reported by the Region's new banks was 55 percent as of September 30, 2000, slightly lower than the 60 percent achieved by new banks at the peak of the 1980s expansion, loan composition at the current crop of new banks suggests an increased credit risk profile compared with a decade ago. As of September 30, 2000, commercial real estate (CRE) loans constituted the largest share of new banks' loans (33 percent), more than the Region's established community banks and more than new banks a decade ago. The increased proportion of CRE loans at today's new banks suggests that these entrants are targeting higher-yielding but potentially higher-risk loans in order to bolster profitability.

Like the Region's established community banks, new banks are facing increased competition for core deposits and, as a result, are relying more on noncore funding. During the past five years, the ratio of noncore funding to assets reported by the Region's new banks doubled from 10 percent to 20 percent. Wholesale funding, including brokered certificates of deposit and large time deposits, may facilitate new banks' access to liquidity, but can be more expensive than traditional core deposits. Furthermore, types of wholesale funding may be more sensitive to changes in market interest rates and investors' perceptions of credit quality conditions than core funding, conditions that could challenge banks' liquidity management.

Map 1



Note: Map shows MSAs with at least two new banks and at least five banks total, third quarter 2000.
Source: Bank and Thrift Call Reports

Several of the Region's MSAs with a higher percentage of new banks also have significant exposure to troubled industry sectors, including manufacturing and high tech. For example, almost a quarter of the workforce in the **Lancaster,** Pennsylvania, MSA is employed in the manufacturing sector, which has experienced declining employment for years. The Middlesex, New Jersey, MSA economy has an increased exposure to the telecom and high-tech sectors, which are experiencing industry consolidation, lower profitability, and reduced access to financing. The Middlesex MSA also has significant exposure to the financial services industry and therefore is susceptible to weakness in the capital markets. The **Atlantic-Cape May,** New Jersey, MSA depends on tourism and gaming, two of the more cyclical industries. Philadelphia and Newark have significant exposure to the health care and pharmaceuticals industries, both of which have been consolidating.

[21] FDIC Summary of Deposit Data. June 30, 1999. The deposit concentration metric is the Herfindahl-Hirschman Index (HHI). A higher HHI number indicates a greater concentration of deposit market share in the area or a less competitive—more monopolistic—market structure.

Characteristics of Banks between Four and Seven Years Old May Suggest Heightened Risk Profile

A study by the ***Chicago Federal Reserve Bank***[22] suggests that the probability of a bank's failure is greatest during the period four to seven years after it begins operation. During the first three years of operation, a bank is typically required to hold higher capital ratios to offset operating losses that are usually incurred while it establishes an earnings base. Following the third year of operation, capital requirements are typically eased as an institution's business matures. An insured institution, however, may experience heightened levels of credit risk after the third year, as newly minted loans season and become more vulnerable to credit problems. According to the study, the probability of failure typically declines dramatically following a bank's seventh year of operation as earnings stabilize and the bank's businesses are more established.

Like new banks, banks in the Region that have been in operation between four and seven years[23] hold a significant share of CRE loans, 34 percent of the loan portfolio as of September 30, 2000, compared with 24 percent for this group of institutions in third quarter 1989. Although commercial real estate conditions were generally favorable throughout the Region through the first nine months of 2000, local economic conditions vary, and these variations have implications for commercial real estate conditions. Weaknesses in credit quality may emerge if assumptions used in the underwriting of recent CRE loans are based on a continuation of the robust economic growth rates achieved over the past two years.

Competition also could affect the financial condition of the Region's unseasoned banks. For example, increased competition among banks in a local area could pressure loan underwriting and pricing terms, resulting in tighter margins. However, leverage capital ratios for the Region's four- to seven-year-old banks were slightly higher than those of established community banks as of September 30, 2000, and exceeded levels maintained by community banks and the four- to seven-year-old group at the height of the last economic expansion. Nevertheless, four- to seven-year-old institutions that experience difficulty meeting original profitability targets, whether because of increased competition or less favorable economic conditions, may be tempted to alter original business plans and engage in potentially higher-risk business lines or extend into less familiar markets, increasing risk profiles.

[22] DeYoung, Robert. Third quarter 1999. Federal Reserve Bank of Chicago. "Birth, Growth, and Life or Death of Newly Chartered Banks." *Economic Perspectives.*

[23] As of September 30, 2000, the Region was home to 20 banks that were between four and seven years old.

The proliferation of mutual funds and other alternatives to bank deposits also has hindered community banks' ability to grow retail core deposits, adding pressure to NIMs. Investments in mutual funds nationwide totaled less than one-third of bank deposits throughout the early 1990s but now exceed the total deposits held by insured institutions.[24] Although core deposits remain community banks' largest funding source, the median ratio of core deposits to assets for the New York Region's community banks has declined steadily since 1992, from 84 percent to 73 percent, consistent with national trends (see Chart 7, next page). Furthermore, the mix of core deposits has shifted from lower-cost savings and money market deposit accounts (MMDAs) to typically higher-cost time deposits. Savings accounts and MMDAs have declined from 39 percent of core deposits in 1992 to 31 percent in 2000, while time deposits have increased from 35 percent to 40 percent during the same period. Furthermore, because of increased competition for core deposits, banks have turned to noncore funding sources such as brokered deposits and Federal Home Loan Bank borrowings, which typically are more costly than retail core deposits.

Community Banks' Margins Also Are Challenged by the Flat Yield Curve

Changes in the shape of the yield curve also have affected community banks' NIMs. Community banks tend to offer deposit rates based on shorter-term interest rates, while pricing loans on the basis of longer-term rates. Therefore, a flattening yield curve, characterized by a decline in the spread between short- and long-term U.S. Treasury rates, can pressure NIMs. As indicated in

[24] Federal Reserve Board (Haver Analytics). Third quarter 2000. Bank and Thrift Call Reports.

CHART 7

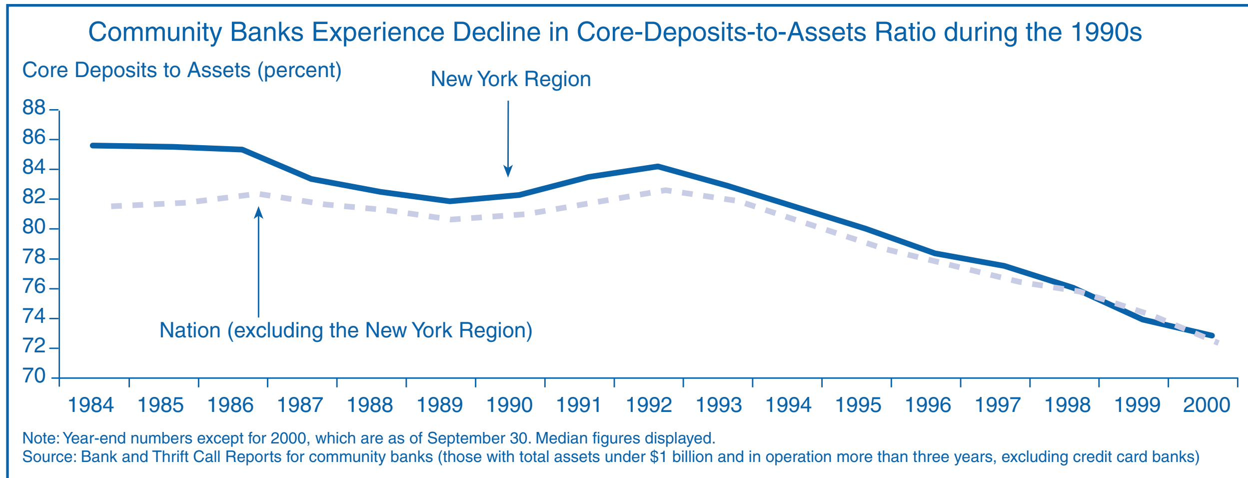
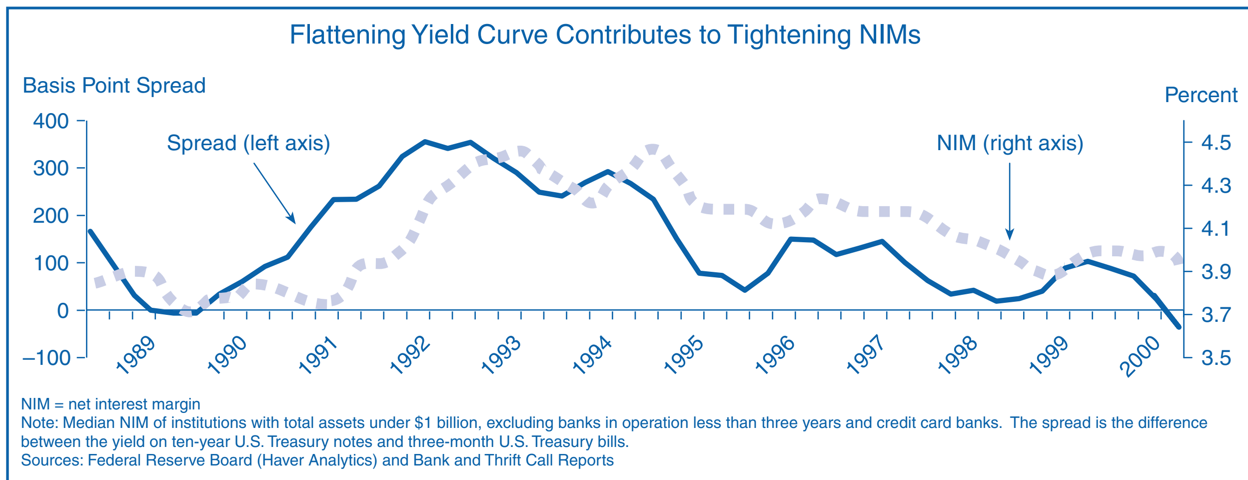


Chart 8, the flattening of the yield curve in the second half of the 1990s accompanied declining NIMs for the Region's community banks.[25] Furthermore, as long-term rates declined in 1997 and 1998, consumers and commercial borrowers preferred longer-term loans. Similar to the extension of residential mortgage portfolios as the result of the mortgage refinancing wave of 1998, the maturity structure of nonresidential mortgage loan portfolios has lengthened during the current period of economic expansion (see Chart 9).[26] Extension in maturity could expose community banks to greater interest rate risk because of community banks' typically short-term funding structure. In addition, longer-term loans could heighten credit risk because banks' funds are committed for a longer period, allowing more time for credit weaknesses to develop.

Today's Community Banks Face Cyclical and Competitive Challenges

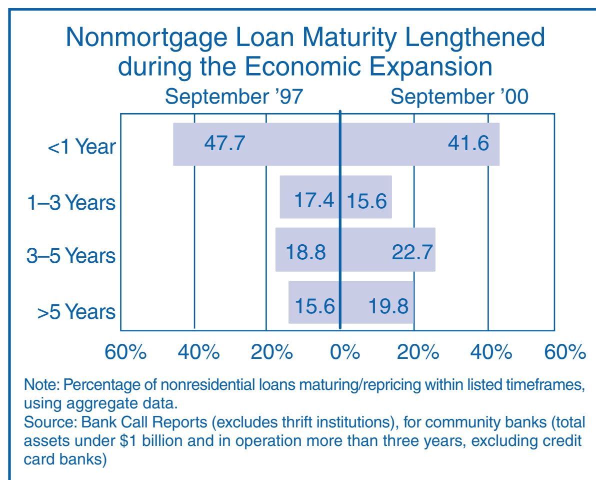
The Region's community banks have benefited from the nation's economic prosperity, as did their peers during the 1980s. Much as banks did during the 1980s, today's crop of community banks has increased loan portfolios to meet the growing financing needs of consumers and businesses. Recent loan growth has been focused on commercial lending, a typically higher-yielding, higher-

CHART 8



[25] Steepness of the yield curve is measured by the difference in yield on ten-year and three-month U.S. Treasury securities. An increase in the spread indicates a steepening of the yield curve; a decrease in the spread indicates a flattening yield curve.
[26] Nonresidential mortgage repricing data include commercial, consumer installment, and all other nonmortgage loans.

Chart 9



risk lending segment. Community banks now face the prospect of slower national and regional economic growth. Favorable credit quality has aided community banks’ profitability in the face of declining NIMs; however, should the economy slow further, credit quality may deteriorate. While capital and reserve ratios are generally higher than a decade ago, the Region’s community banks are exhibiting an increasing credit risk profile as the economy enters a period of slower growth.

Moreover, despite strong loan growth reported by the Region’s community banks, margins have been strained from increased competition and a flat yield curve. Although the shape of the Treasury yield typically varies over time, increased competition in the banking industry is likely here to stay. As a result, NIMs may continue to narrow despite favorable changes in the shape of yield curve and a shift into traditionally higher-yielding, higher-risk loan categories.

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Credit Problems for U.S. Businesses Continue to Increase

- **Commercial credit quality trends have been slipping since 1998, despite generally favorable U.S. business conditions.**

- **The recent economic slowdown, coupled with tighter credit conditions, points to continued deterioration in business credit quality over the coming months.**

- **Trends in bond defaults, syndicated lending, corporate profitability, and expected default levels reveal a number of industry sectors that pose a heightened degree of risk to lenders.**

Introduction

Continuing increases in problem commercial loans have focused the spotlight on business lending conditions. On September 30, 2000, commercial banks reported the highest relative level of noncurrent[1] commercial loans—at 1.52 percent of total commercial loans—since third quarter 1994. In fact, commercial banks have been reporting steadily higher rates of noncurrent domestic commercial loans since the second quarter of 1999. The first quarter 2000 edition of ***Regional Outlook*** identified several factors contributing to the decline in business credit quality despite the strong economic indicators then in place. These factors, which are still relevant today, include the rise in financial leverage for domestic corporations, greater investment risk appetite and looser underwriting standards from 1996 to 1999, and increasing financial stress within various industry sectors. More recently, an apparent slowdown in economic growth increases prospects for further deterioration in business credit conditions.

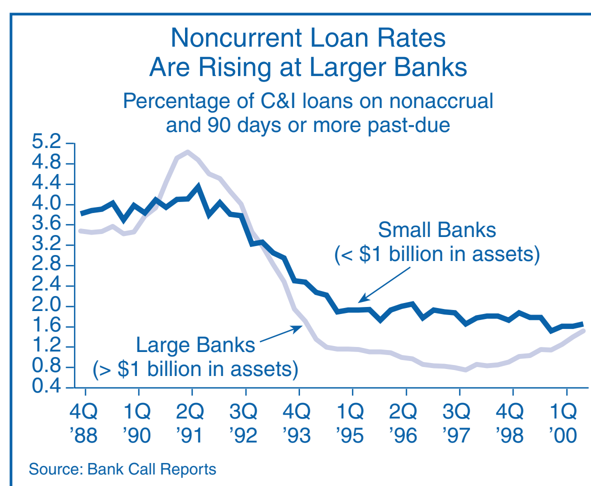
Large Banks Experience a Reversal in Commercial Credit Quality Trends

Through much of the 1990s, a sustained period of economic growth produced improving commercial loan credit quality indicators for insured commercial banks. This trend reversed itself in 1998, when banks began experiencing a steady rise in nonperforming and delinquent commercial loans. While the initial catalyst for this reversal was related mainly to events abroad,[2] a slowing domestic economy has since taken center stage as the underlying driving force behind worsening commercial credit quality trends.

As of September 30, 2000, noncurrent commercial and industrial (C&I) loans held by commercial banks stood at $15.6 billion, a 46 percent increase over the previous year. Roughly 97 percent of this increase is attributable to the rise in nonaccrual and delinquent credit to U.S. domiciled borrowers. Net C&I loan loss rates are also rising. Through the first three quarters of 2000, annualized C&I loan loss rates reached 0.64 percent, up from 0.58 percent in 1999. The last time banks saw C&I loss rates this high was in 1993 (0.74 percent).

Larger banks, which have the greatest exposures to large- and middle-market corporate credits, have been hardest hit by the turnaround in business credit conditions. As shown in Chart 1, banks with over $1 billion in assets have experienced most of the recent deterioration in C&I noncurrent loan rates. Since the fourth quarter of 1997, the noncurrent C&I loan rate of large

Chart 1



Source: Bank Call Reports

[1] Nonaccrual loans plus loans 90 days or more delinquent.

[2] Significant events that contributed to higher levels of problem foreign loans in 1998 include the collapse of Asian currency exchange rates and default by the Russian government on its sovereign debts. Some domestic industries that were highly dependent on exports (steel, for example) were also adversely affected by these events.

banks has increased from 0.74 percent to 1.50 percent. Over the same period, noncurrent C&I loan rates at small banks were unchanged at 1.64 percent. While the increase in noncurrent loan rates at larger banks is significant, these higher rates remain well below those that preceded the 1990 to 1991 recession, when noncurrent loan rates at large banks were in the 3.40 percent to 3.60 percent range.

Much of the recent deterioration in banks' business credit quality is attributable to the seasoning of credits underwritten during a period of relaxed lending standards. Each of the three bank supervisory agencies has recognized and warned about the potential impact of loosened loan underwriting standards in the event of a slowdown in the economy. For example, just over a year ago, the Office of the Comptroller of the Currency (OCC) issued a warning to banks about the "...cumulative effect of the past four years of easing standards..." for commercial loans.[3] The shift toward more liberal credit standards from 1996 to 1999 was fueled by various factors, including a robust economy, intense competition to originate syndicated credits, and an increased appetite for risk. During this period, a number of banks moved aggressively into non-investment-grade lending to combat narrowing interest margins and declining investment-grade yields. According to a recent ***Standard & Poor's*** commentary, several banks have acknowledged the role of 1997 and 1998 vintage credits in producing higher levels of problem loans.[4]

Business Loan Performance Is Not Likely to Improve Any Time Soon

Prospects for any near-term reversal in deteriorating commercial loan trends are dimming as signs of slower economic growth and tighter credit conditions emerge. Economic indicators suggest an aging economic expansion that is losing momentum. In third quarter 2000, the U.S. economy recorded its 39th consecutive quarter of growth. However, real gross domestic product growth for the third quarter was only 2.2 percent, well below the previous quarter's growth of 5.6 percent and below the 4.9 percent average quarterly growth rate during the past eight quarters. Corporate earnings also appear to be slowing. Annualized corporate profit growth in the third quarter slowed to 5.1 percent, down from a 15.6 percent annualized growth rate in second quarter 2000 and a 10.4 percent average growth rate over the past eight quarters.[5] Corporate earnings are widely anticipated to slow even further based on the number of companies that have warned of profits falling below expectations in the fourth quarter.[6]

Prospects for slower economic growth prompted the Federal Reserve to lower its target for the federal funds rate (the rate charged on overnight lending) by 1/2 percentage point to 6 percent on January 3, 2000. This cut follows a 175-basis-point increase in the targeted federal funds rate since the end of June 1999. Although higher interest rates have undoubtedly raised borrowing costs for U.S. corporations, business borrowing rates—even before the Federal Reserve cut interest rates in January 2001—are well below those prevalent during much of the 1980s (see Chart 2, next page). Moreover, changes in rates have been far less volatile in the latter part of the 1990s than they were during the 1980s and early 1990s.

Tolerance for risk on the part of investors and lenders is waning. In a November 2000 survey of underwriting practices, the ***Federal Reserve Board*** noted that 44 percent of U.S. banks tightened credit terms for large- and middle-market borrowers in the past three months, the highest incidence of tightening since fourth quarter 1990. This tightening of credit terms is primarily in response to economic concerns, industry-specific problems, and a lower tolerance for risk. Banks appear to be especially apprehensive about taking on additional credit risk related to merger and acquisition financing deals, new borrowing prospects, and specific industry segments such as health care, movie theaters, and communications.[7]

Tighter credit terms by banks will have the greatest impact on high-risk companies, which have fewer financing options in an environment of slumping bond and stock prices. Moreover, there appears to be a significant increase in the volume of maturing debt that could be forced into default if capital market or bank

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[3] Office of the Comptroller of the Currency Press Release. October 5, 1999.

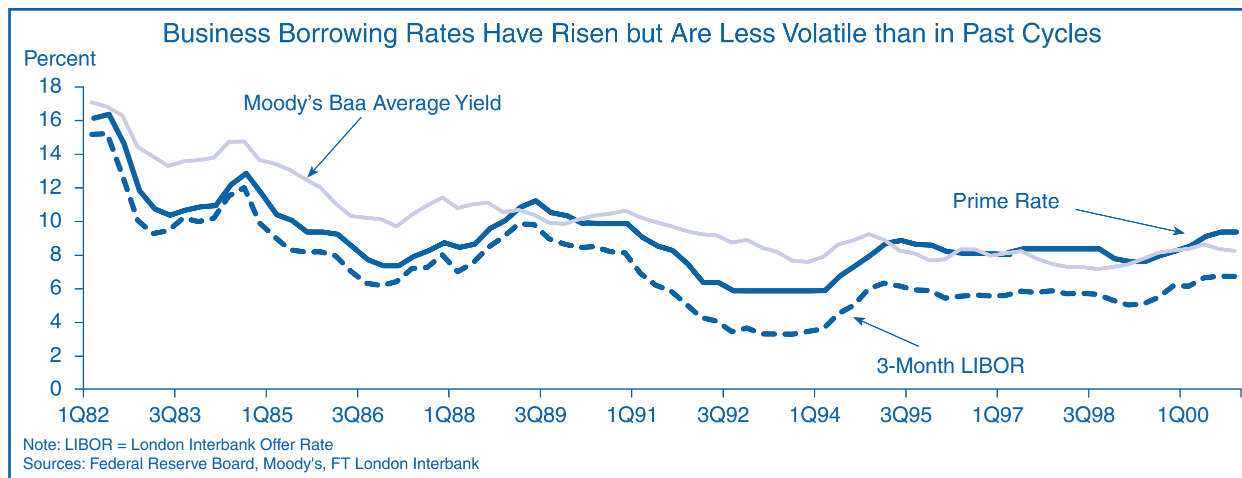
[4] July 20, 2000. "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." Standard & Poor's Commentary.

[5] These figures are taken from the U.S. Department of Commerce's statistics on corporate profits with inventory valuation adjustments.

[6] According to First Call/Thomson Financial, 505 companies released warnings that fourth quarter 2000 earnings would fall below expectations, up 96 percent from the 257 companies with negative profit warnings for fourth quarter 1999.

[7] See the Federal Reserve Board's *November 2000 Senior Loan Officer Opinion Survey on Bank Lending Practices.*

Chart 2



Note: LIBOR = London Interbank Offer Rate
Sources: Federal Reserve Board, Moody's, FT London Interbank

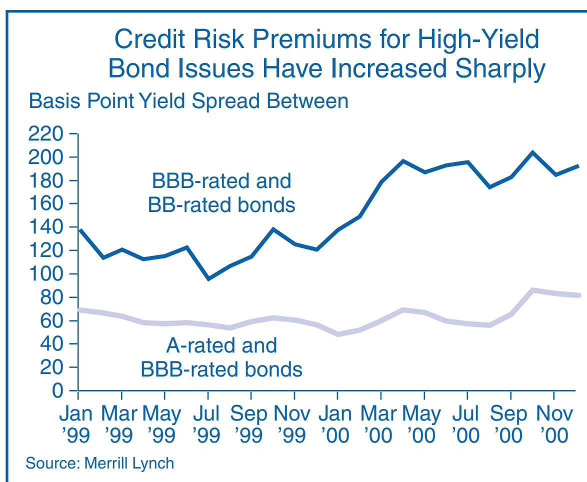
funding is not available. According to ***Moody's,*** some $108 billion of rated speculative-grade corporate debt held by banks matures over the next three years, a 40 percent increase over year-earlier levels.

Higher-risk companies also have a lower capacity to absorb the cost of higher interest rates. Yet many companies with debt maturing in the near term will likely be forced to pay higher risk premiums than in the past. For example, *Moody's* notes that in November 2000, speculative-grade bond yield spreads over seven-year Treasuries reached their widest level since February 1991, at 771 basis points.[8] Chart 3 illustrates further how credit spreads between just-investment-grade bond issues and near-investment-grade bond issues have widened considerably compared with spreads between lower-investment-grade bond issues since the beginning of 2000. Some of the most significant increases in credit spreads have been observed in the high-yield telecommunications sector, where credit spreads over seven-year Treasuries widened by 688 basis points in 2000.[9]

The effects of tighter credit conditions and a reduced appetite for risk are beginning to emerge in loan origination volumes. According to ***Loan Pricing Corporation,*** originations of highly leveraged loans[10] through the first three quarters of 2000 fell to $117 billion from $140 billion for the same period in 1999.

Corporate bond trends provide further evidence of financial stress in the domestic market and suggest more near-term deterioration in problem business loans. Corporate bond default rates have climbed significantly since 1997 (see Chart 4). Through November 2000, trailing 12-month default rates on speculative-grade corporate bonds reached 6.8 percent, up from 3.5 percent at the end of 1998. Higher default rates have been accompanied by an accelerated pace of negative ratings revisions, which, according to *Moody's,* reached a rate of 3.2 speculative-grade downgrades for every speculative-grade upgrade through the first 11 months of 2000.[11] More signifi-

Chart 3



Source: Merrill Lynch

[8] December 2000. Moody's Leveraged Finance Commentary.

[9] Merrill Lynch Global Bond composites. Issues facing the telecommunications industry are explored further in the article entitled "Three Industries Navigating in a Competitively Charged Environment" in this issue of the *Regional Outlook.*

[10] Loan Pricing Corporation defines highly leveraged loan transactions as those carrying interest rates of 250 basis points or more over the London Interbank Offer Rate (LIBOR).

[11] See *Moody's Credit Perspectives,* December 4, 2000.

cant, *Moody's* projects that speculative-grade corporate bond defaults will continue to move higher to 9.1 percent over the coming year. Given a fairly strong correlation between speculative bond default rates and banks' noncurrent loan rates, these projections suggest a continuing rise in the relative level of problem commercial loans.[12]

Loan Default Risk Is Rising in a Number of Industry Sectors

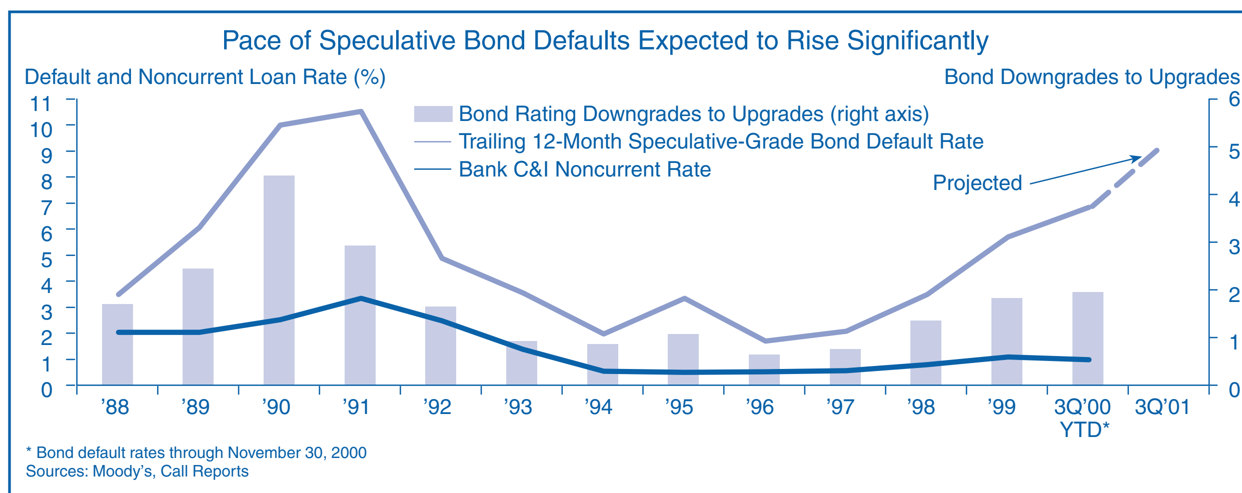
Evidence from Corporate Bond Defaults

Corporate bond defaults provide clues as to which industries may experience a higher rate of defaults. Chart 4 shows the historical trend in speculative-grade bond defaults since 1988. The initial upward spike in default rates in 1998 was largely the result of events abroad, when 74, or 59 percent, of 126 defaulted issues were attributed to foreign-domiciled issues.[13] In 1999, the distribution of defaults shifted decidedly toward domestic issues, with U.S. firms accounting for 99, or 67 percent, of 147 defaults. Of the U.S.-domiciled defaults in 1999, 64 percent were related to industrial sectors, with concentrations in price-sensitive commodity and trade-dependent sectors such as oil and gas, shipping, and steel. Other domestic sectors that experienced a noteworthy rise in defaulted issues in 1999 were telecommunications and health care. Year-to-date 2000 defaults continue to be dominated by U.S. firms.[14] According to *Moody's,* year-to-date defaulted bond issues have been concentrated in health care; telecommunications; and textiles, leather, and apparel.[15]

Evidence from Syndicated Loan Trends

Past growth in syndicated loans may be another indicator of default risk. Many lenders appeared to increase their appetite for risk from 1996 through 1999, judging by the growth in leveraged loan and highly leveraged loan volumes during this period (see Chart 5, next page).[16] Because rapid loan growth can be an indicator of aggressive risk taking, it is important to review some significant borrowing industries that experienced rapid credit growth from 1996 to 2000. It is also worthwhile to review industries where higher-risk (high-yield) borrowing accounted for a substantial proportion of syndicated loan transactions.

Chart 4



* Bond default rates through November 30, 2000
Sources: Moody's, Call Reports

[12] There is a strong correlation between historical speculative-grade corporate bond defaults and noncurrent loan rates. The correlation coefficient between these two variables for the period 1984 to the present is 0.67.

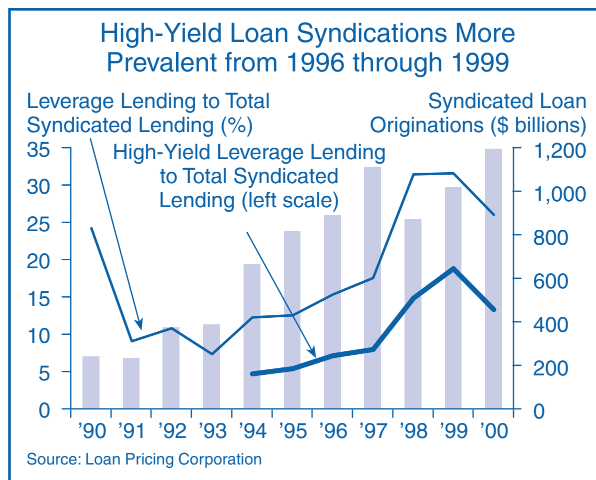
[13] Indonesia alone accounted for 32 defaulted issues in 1998, and sovereign issuers accounted for 36 percent of defaulted debt volume. *Historical Default Rates of Corporate Bond Issuers, 1998.* Moody's Investor Service.

[14] *Historical Default Rates of Corporate Bond Issuers, 1999.* Moody's Investor Service.

[15] *Moody's Credit Perspectives,* December 11, 2000. Issues facing the health care and textile industries are explored further in the article entitled "Three Industries Navigating in a Competitively Charged Environment" in this issue of the *Regional Outlook.*

[16] Loan Pricing Corporation defines leveraged transactions as those that carry interest rate spreads of 150 basis points or more over LIBOR and highly leveraged transactions as those that carry spreads of 250 basis points or more over LIBOR. Because these definitions are spread-driven, the rise in the proportion of higher-yield issuance is attributable in part to a general increase in credit spreads. This was the case particularly during the 1998 period, when credit spreads rose significantly.

CHART 5



Source: Loan Pricing Corporation

Table 1 lists selected industries[17] that accounted for a significant proportion of syndicated loan volumes from 1996 to 2000, according to ***Thomson Financial Securities Data.*** Industries that experienced some of the most rapid growth rates in syndicated loan volumes during that time include utilities, telecommunications, and real estate investment trusts (REITs). Industries that recorded a particularly significant proportion of high-yield transactions during that period include real estate and construction, REITs, health care, and entertainment/lodging/leisure.

Evidence from Corporate Profit Trends

Industry sector earnings trends may also be an indicator of industry default risk, because higher defaults are more likely in sectors with weak earnings. As noted above, profit growth rates of domestic firms appear to be decelerating following two years of strong earnings growth overall. Rapid growth in previous quarters appears to have been driven in large part by high-tech and related sectors, such as electronic equipment and communications. These sectors have to a large extent overshadowed noteworthy declines in profit growth in other sectors, such as metals, chemical production, medical services, property casualty insurance, apparel and textiles, manufactured housing, agriculture, transportation, and wholesale trade (see Table 2).

Evidence from Credit Risk Models

Credit default models have proliferated in recent years because of advances in technology, data availability, and financial theory. One such model is ***KMV LLC's*** Cred-

TABLE 1

Historical U.S. Syndicated Loan Trends Help Identify Possible Sources of Industry Credit Risks

Industry	Share of 1996 to 2000 Issuance (%)	1996 to 2000 Avg. Annual Issuance Growth (%)	2000 Issuance Growth (%)	HY as a % 1996 to 2000 Issuance
Wholesale and Retail Trade	7.8	–2	–12	34
Electric, Gas and Sanitary Utilities	6.5	34	15	19
Telecommunications	5.4	28	54	29
Nondepository Investment Companies	5.2	19	24	33
Oil and Gas	4.1	23	83	18
Securities Brokers/Dealers	3.7	15	13	4
Entertainment/Leisure/Lodging	3.3	5	31	42
Real Estate Investment Trust	2.7	27	25	49
Health Care	2.6	–4	–41	44
Real Estate and Construction	2.5	25	46	50

Note: HY (high-yield) issuance includes deals priced at 125 basis points or more over LIBOR.
Source: Thomson Financial Securities Data

[17] This list is taken from a group of 50 sectors defined using Standard Industrial Codes (SICs). Only industries that accounted for more than 2 percent of 1996 to 2000 origination volumes were considered for inclusion.

it Monitor®. This model, which uses publicly available information to estimate the likelihood of default for individual firms, is widely used by lenders to monitor and evaluate obligor risk and credit risk trends. While it is not the only model available, the KMV model can be applied consistently and easily to the analysis of industry sector credit risk across a broad range of industry groupings.

In brief, the KMV model uses options-pricing theory to derive market-based expected default probabilities or an expected default frequency (EDF™).[18] The model relies mainly on three pieces of information: (1) a firm's asset market value; (2) the volatility of a firm's asset market values; and (3) the firm's capital structure or financial leverage. Although EDF™ scores are company-specific, median industry expected default probabilities can be constructed and compared across industries and across time to discern relative rankings of industry risk and industry risk trends. These median EDF™ scores also can be mapped to other default measurement scales, such as external rating agency ratings, based on individual EDF™ scores of firms with rated debt.

Since the second quarter of 1998, median EDF™ scores have risen significantly across a wide range of U.S. nonfinancial industry sectors (see Chart 6, next page). The service and trade sector includes the greatest proportion of firms with high default risk. The median probability of default for the manufacturing sector firms is lower, but it is rising and roughly equaled that of Standard & Poor's BB-grade (sub-investment-grade) obligors as of December 2000.

Table 2

Various Industries Have Exhibited Negative Profitability Trends

	Annual Growth in Net Income		
Industry	1998 to 1999 (%)	1996 to 1999 Average (%)	1994 to 1999 Average (%)
Steel	–1,237.9	–428.6	–187.4
Copper	–80.7	–65.5	13.2
Internet	–43.2	–42.7	–35.5
Tires and Rubber	–81.9	–28.6	–12.7
Aluminum	–13.2	–13.9	156.4
Chemicals	–38.1	–3.9	18.4
Medical Services and Information Systems	–48.2	–2.5	44.8
Property Casualty Insurance	–3.9	–2.0	3.8
Recreational Goods and Services	.5	2.5	17.1
Apparel and Textiles	2.5	10.4	3.3
Manufactured Housing and Recreational Vehicles	–9.8	11.7	27.3
Agriculture	–1.3	12.3	4.6
Wholesale Trade	–8.8	13.7	13.7
Cement and Aggregates	1.2	21.6	60.5
Oilfield Services and Production	–373.7	39.9	19.3
Airlines and Freight	–13.2	1,085.5	666.5
All Corporate Profits (with Inventory Valuation and Capital Consumption Adj.)	5.0	4.4	13.6

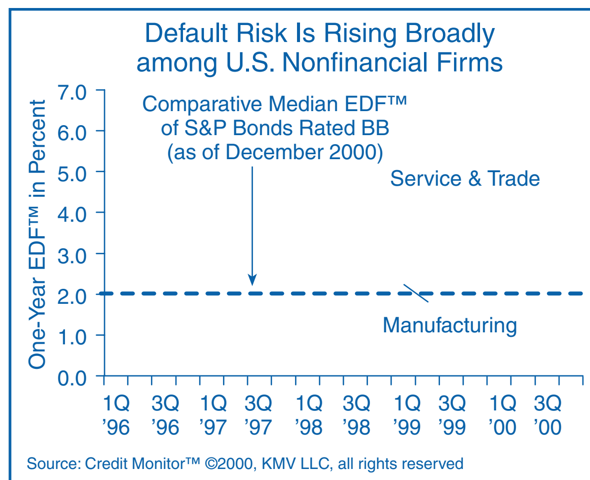
Sources: Economy.com Precis Reports; U.S. Department of Commerce, Survey of Business Conditions

[18] Typically expressed as the probability of default over the coming year.

Although no one factor can explain the rise in expected default measures for U.S. nonfinancial firms, rising financial leverage is clearly a major determinant. U.S. corporate debt burdens continue to rise in conjunction with the longest-running economic expansion in U.S. history. The debt-to-net-worth ratio (book value) of nonfarm, nonfinancial businesses rose to 83 percent in the second quarter of 2000, up from 72 percent at year-end 1996. Although these figures remain below the relative debt levels experienced in the late 1980s and early 1990s,[19] U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability. Higher asset value volatility[20] has also played a role in rising EDF™ scores, which, as in any options-based credit risk model, leads to a greater likelihood of default.

Chart 7 shows eight of the highest-risk industries in terms of changes in median EDF™ scores over the past two years. These industries were drawn from a list of 50 financial and nonfinancial sectors segregated by Standard Industrial Codes (SICs). For each of these 50 sectors, median EDF™ scores were determined for December 2000 and compared with median EDF™ scores for the same sector in December 1998. Consistent with general industry observations, entertainment and leisure, health care, and telecommunications are among the sectors where default risk has risen most significantly over the past two years.

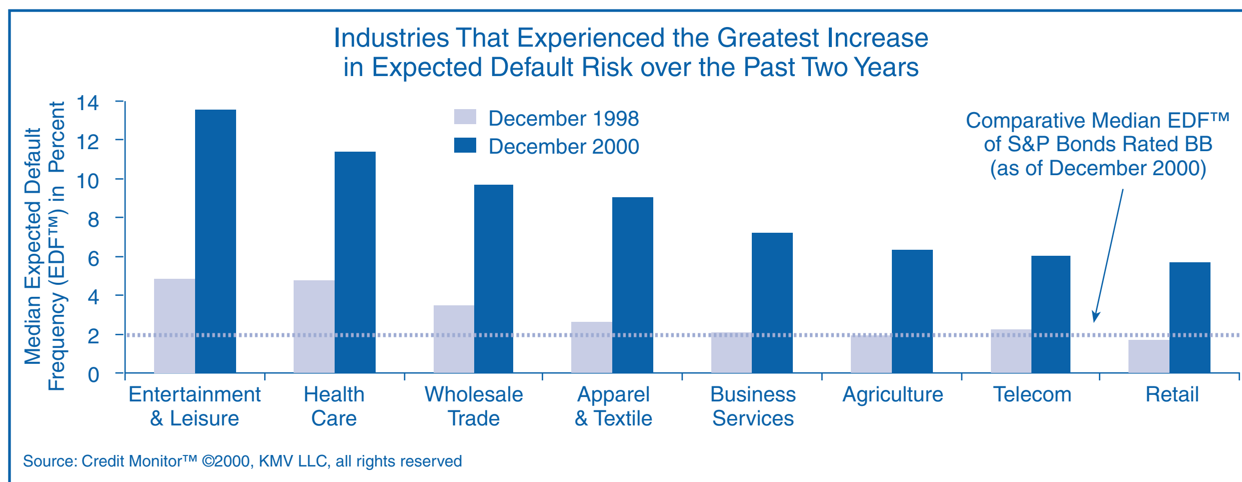
CHART 6



While Chart 7 illustrates sectors undergoing financial stress, it does not provide information on the relative importance of these sectors to lenders. ***Thomson Financial Securities Data*** provides information on the volumes of syndicated loan originations by banks and nonbanks. Matching industry-expected default trends with syndicated loan origination trends by industry is one way to determine the relative importance of higher-risk industry credit exposures.[21]

Chart 8 shows median EDF™ and syndicated loan origination pairs for selected industries during the past three

CHART 7



[19] The debt-to-net worth ratio for U.S. nonfarm, nonfinancial businesses averaged slightly under 87 percent from 1988 to 1992.
[20] Implicit in changes in stock prices.
[21] Syndicated loan originations are an imperfect measure of actual loan exposures in the financial industry. For example, it is not possible to determine the level of outstanding exposures simply by summing up origination levels from year to year, because payments on long-term debt are not considered. Moreover, a substantial volume of debt represents revolving lines of credit where credit exposures roll over on a periodic basis. Nevertheless, trends in originations do contain some information on the relative level of industry exposures, because they show which industries are borrowing more or less during any given year.

years. Of the industries shown, the telecommunications industry appears to present the greatest degree of risk, given a nearly $50 billion increase in loan volumes from 1998 to 2000, coupled with a 170 percent increase in median expected default levels over the same period. In contrast, loans to securities brokers and dealers can be considered relatively less risky—despite a $17 billion rise in originations from 1998 to 2000—because of a fairly modest rise in median expected defaults. It is also interesting to contrast the health care and entertainment and leisure sectors. Firms in both sectors have experienced a dramatic rise in expected defaults. However, since 1998, Thomson Financial Securities Data shows a significant curtailment in lending to health care companies, while entertainment and leisure originations have held steady over the same period. Because banks appear to be reducing credit exposures to health care firms, banks should eventually see a decline in the level of defaulting debt related to this sector.

Chart 8 illustrates how U.S. syndicated loan issuance and expected default measures can be linked to produce a better sense of risk-weighted industry exposure volumes held by lenders. On the basis of this type of analysis, producing a list of industry sectors that appear to pose the greatest degree of syndicated loan default risk is relatively straightforward. Perhaps not surprisingly, industries such as telecommunications, wholesale and retail trade, entertainment and leisure, health care, and apparel and textiles rank high in terms of risk-weighted industry credit exposures using this analysis.[22]

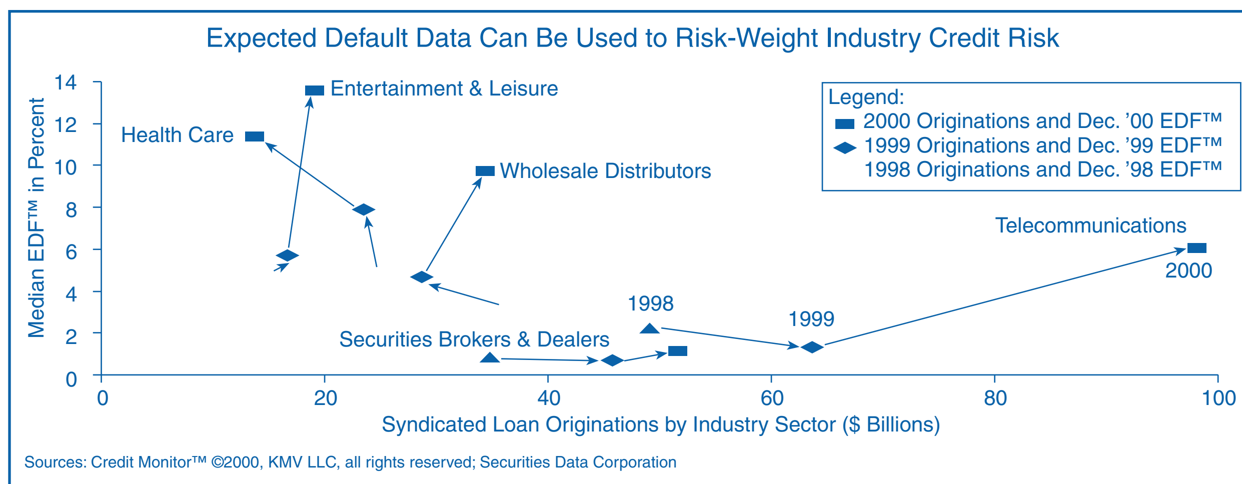
Conclusion

Many U.S. banks are experiencing deterioration in business loan quality measures. The adverse effects of higher interest rates, a tightening of credit terms, slowing profit growth, and industry sector weaknesses are the primary contributing factors to this deterioration. Several indicators—including a projected increase in corporate bond default rates, rising expected default trends in certain industry sectors, and evidence of lax underwriting practices in previous periods—suggest that banks could experience substantial further deterioration in business loan quality in the near term.

Although worsening business loan quality is a concern, these negative trends must be put into perspective. In relative terms, current indicators of business loan problems do not approach the experience of banks during the last economic downturn of the early 1990s. Moreover, continued strong earnings and capital provide a significant buffer for banks to weather the effects of higher levels of nonperforming business loans and business loan losses. Nevertheless, the prospect of a slowdown in the economy raises concerns about the possible severity of commercial loan problems, a situation that will undoubtedly be watched closely by both banks and bank supervisors in the coming months.

Steven Burton, Senior Banking Analyst

CHART 8



[22] Fifty sectors, grouped by SIC codes, were considered.

Three Industries Navigating in a Competitively Charged Environment

The rising tide of a booming economy in the United States has lifted the boats of a broad spectrum of industries over the past nine years. Some industries, however, have fallen on hard times despite continued economic expansion. These industries represent a broad cross-section of the economy. Problems in these industries were precipitated by diverse factors, reflecting the differences among sectors in industries ranging from old economy (such as textiles) to services (such as health care) to those on the horizon (such as telecommunications).

These industries will navigate in turbulent waters over the next few years. All three face an uncertain economic outlook, changing public policies that can influence their operating environment, and fierce competition.

The importance of these industries to the U.S. economy varies based on employment. The telecommunications industry accounts for about 1.4 million jobs, or 0.85 percent of total U.S. employment.[1] Health care, on the other hand, contributes over 11 million jobs, or 7 percent of total employment. Textile industry employment has been falling steadily for many years and is now under 550,000, accounting for less than 0.40 percent of total U.S. employment.

As diverse as these industries are, a common denominator exists. Intense competition characterizes their operating environment, leaving little room for strategic missteps. Indeed, there have been reports that these industries have been significant contributors to the recent rise in problem bank loans.

With a better grasp of the origins of stress in these industries comes a basis for understanding the lending risks associated with a changing policy and economic environment in the years to come. The following discussion describes trends and developments contributing to stress in these industries and looks at the near- and long-term outlook. Our discussion also looks at the implications for the insured institutions lending to the telecommunications, health care, and textiles industries.

Telecommunications

The telecommunications sector consists of several industry subsectors, including telecommunications services, cable television, and telecommunications equipment, all of which are facing significant challenges.

Telecommunications Services

Rapid growth in the telecommunications services industry has been fueled by strong domestic consumer demand. However, the pace of consumption of telecommunications services has slowed in recent months. This sector has experienced booming growth in revenues from computer network access since 1998, while local and long distance revenues have grown at a much more moderate pace (see Chart 1).

Rapid change and intense competition characterize the industry environment. Long distance businesses, in particular, have experienced fierce competition, resulting in severe pricing pressures. Competitors include both established and new wireline long distance providers, as well as wireless services. Local telephone companies, however, have fared well in recent years, as residences and small businesses have added phone lines to accommodate the growing demand for Internet access. However, as high-speed DSL and cable Internet access become more readily available, the demand for additional telephone lines may diminish, cutting into a lucrative source of revenue for local phone companies.

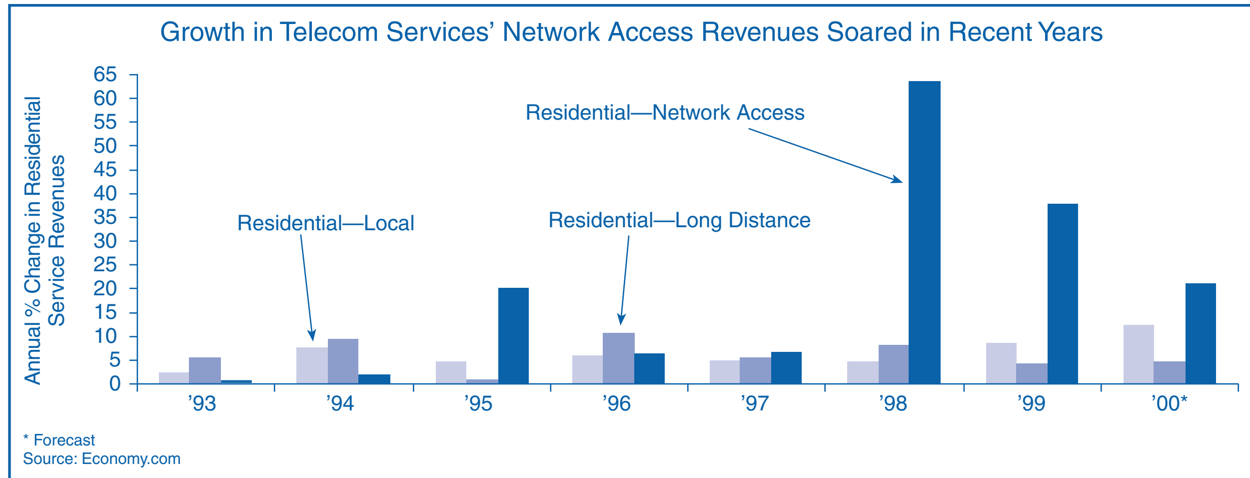
Capital spending by telecommunications services companies has soared in recent years, although it was expected to level off in 2000 in response to higher interest rates and reduced earnings growth. Nevertheless, high levels of telecommunications equipment investment are expected to continue for the foreseeable future, as telecom service firms require additional equipment upgrades to accommodate increased network traffic and wireless applications (see Chart 2).

Cable TV

Cable TV is another important component of the telecommunications services industry. According to ***Economy.com,*** "among the current technologies available, cable is viewed as the leading option for delivering

[1] Source: Economy.com. Includes employment in telecommunications services, telecommunications equipment manufacturing, and cable television.

CHART 1



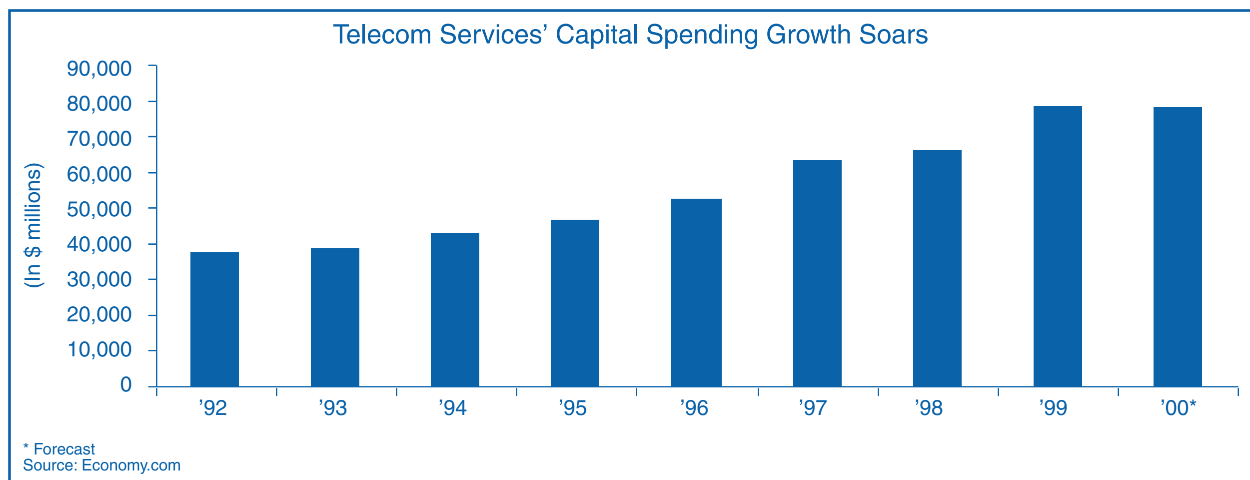
video, telephony, entertainment, and computing services to households and businesses."[2] Cable TV sales revenue has grown more than 19 percent a year since 1995. In spite of this stellar revenue growth, most cable companies are not earning a profit because of the high levels of capital investment required.

Telecommunications Equipment

The telecommunications equipment industry is growing rapidly, as telecom service providers rush to upgrade infrastructure to enhance their offerings of high-speed broadband services. Telecommunications service providers are not only upgrading fiber optic and cable line networks; they are rapidly upgrading antiquated circuit-switched networks to more efficient packet-switch networks. However, the growth in revenues and profits was expected to moderate in 2000 because of higher interest rates and slower growth in the domestic economy (see Chart 3, next page).

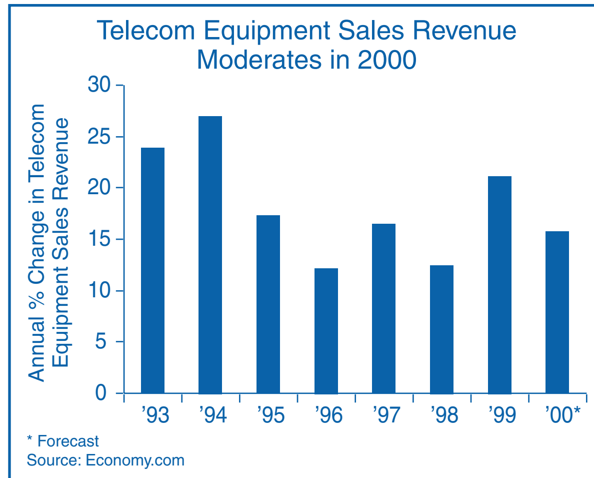
The wireless phone industry also has experienced problems since late 2000. The major mobile phone companies have missed earnings projections, casting doubt on the growth potential of the industry. Much is riding on the development of third-generation (3G) wireless technology, which is expected to allow wireless access to the Internet, transmission of video and other images, and videoconferencing—all from a handheld mobile phone. Although huge amounts of money are being invested to develop 3G technology, it is unclear what applications will generate the demand to make the investments profitable.

CHART 2



[2] September 2000. Economy.com, Precis: Industry: Cable TV.

CHART 3



Outlook

The telecommunications industry has been badly battered in both equity and bond markets in the past several months. A spate of bad news has resulted in sharply lower stock prices and higher costs in debt markets. As a result, the availability of financing for some higher-risk firms is now questionable. Investors are concerned about the prospect of slowing wireless subscriber growth, continuing capital expenditures, intense competition, and the rapid rise in telecom debt[3] (see Chart 4).

The long-term outlook for the telecommunications services industry is positive. The emergence of high-margin technologies and continued growth in wireless subscriber rates should enhance profitability in the future. Consumers and businesses are also expected to spend an increasing share of their incomes on telecom services. Nevertheless, strong competition, huge investments in equipment upgrades, and rapidly changing technology will force firms to be nimble and innovative.

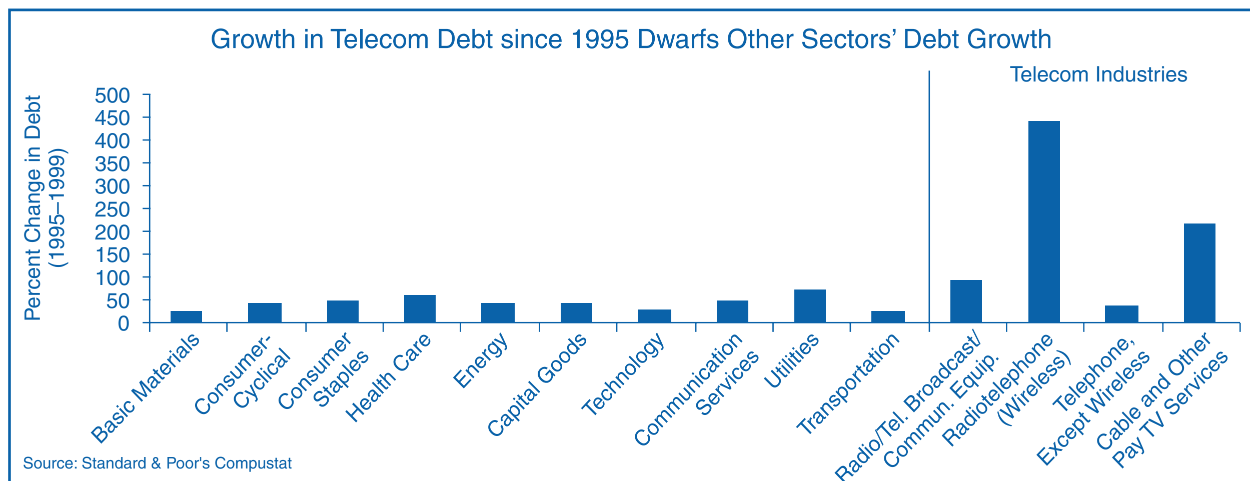
The long-term outlook for the telecommunications equipment industry is positive, as the demand for data, Internet, and wireless services continues to grow strongly. Nevertheless, individual firms in the industry face a highly competitive environment and rapidly changing technology.

Cable TV's long-term outlook is also positive because of growing advertising sales and technological developments that should allow cable firms to offer a broader array of services. Still, the competitive environment is fierce. In addition to competing with a host of "traditional" telecommunications firms, cable firms must contend with satellite TV providers, which are partnering with major firms to offer sophisticated communications and entertainment services.

Implications for Banks

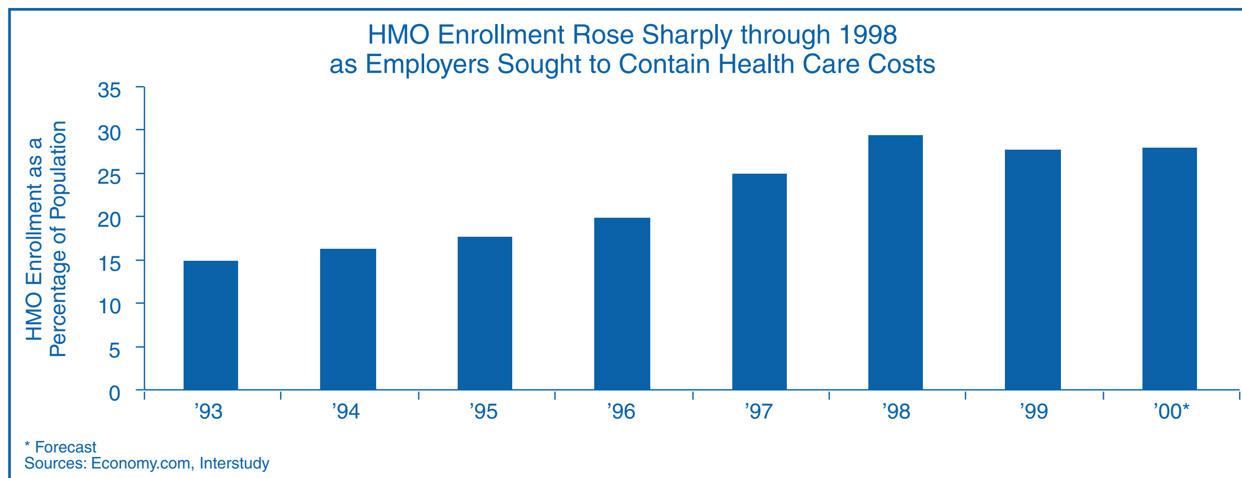
The most important characteristics of the telecom industry with respect to lending risks are its highly competitive environment and its pace of technological change. These characteristics suggest that the medium-to long-term outlook for a particular credit may not be well represented by current conditions. The success of telecom firms will be based on management's ability to adapt to change and compete with a fluid set of competitors.

CHART 4



[3] Solomon, Deborah, and Nicole Harris. October 18, 2000. "Talks on Merger By AT&T Wireless Face Investor Static." *Wall Street Journal.*

CHART 5



With both equity and bond markets turning against the telecommunications industry, cash-hungry telecom firms may have difficulty obtaining financing. This could pose a serious risk for banks with a significant exposure to telecom start-ups without a major partner or an investor sponsor.

The high capital requirements and financial leverage of many telecommunications firms complicate these lending risks. Some of these firms are borrowing heavily to put into place an infrastructure to accommodate a demand for services that is yet to come on-stream, meaning that the payback on this investment may not occur for a number of years.

Health Care

Industry trends such as declining hospital occupancy rates and rising outpatient visits to hospitals, intense competition, and the unexpected results of new Medicare policy combined to put the health care industry in difficult financial straits during the past few years. However, subsequent industry consolidation and streamlining and revised Medicare rules have helped to stabilize prospects for many health care providers.

Recent Trends and Developments

The health care industry has been suffering since the implementation of the Balanced Budget Act of 1997 (BBA), which cut Medicare payments much more than expected. However, two subsequent bills were passed to "give back" a portion of the Medicare payment cuts implemented in the BBA. The Balanced Budget Refinement Act of 1999 should restore some $16 billion of the cuts to health care facilities over five years.[4] Also, the recently passed Benefits Improvement and Protection Act of 2000 (BIPA) will restore about $35 billion in benefits to the industry over the next five years. BIPA will provide the greatest benefit to hospitals, managed care plans, nursing homes, and home health agencies.

The health care industry's financial situation has stabilized somewhat in the past year because of widespread consolidation of hospitals and other health care providers. This has helped the industry reach greater levels of efficiency as well as improved bargaining power in negotiations with managed care organizations.

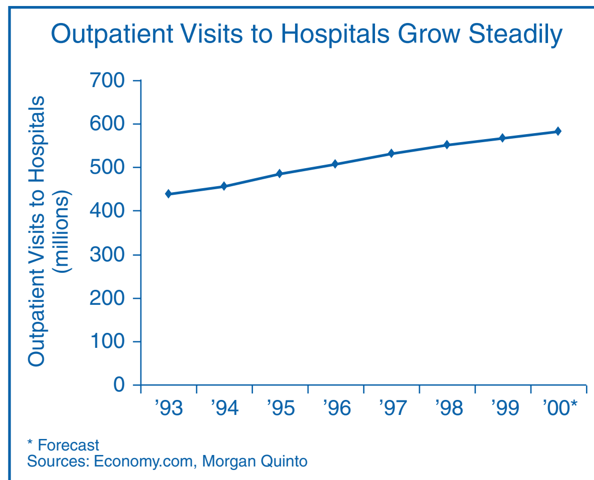
Notwithstanding these favorable developments, other trends continue to pose serious challenges to many firms. Higher labor costs, continued HMO penetration, breakthrough pharmaceutical therapies resulting in reduced demand for services, and increased outpatient volumes have buffeted many health care facilities (see Chart 5 and Chart 6, next page).

Higher-Risk Sectors

A better understanding of risks and trends in health care can be gained by discussing its specific sectors. We have segregated these sectors based on the results of an option-pricing model of firm default risk. These models estimate the probability that the market value of a firm's assets will fall below a level that would trigger default. Firms that have low stock prices, volatile stock prices, or high debt levels will tend to be flagged as having high default risk by such models.

[4] June 15, 2000. *Healthcare: Facilities.* Standard & Poor's Industry Surveys.

CHART 6



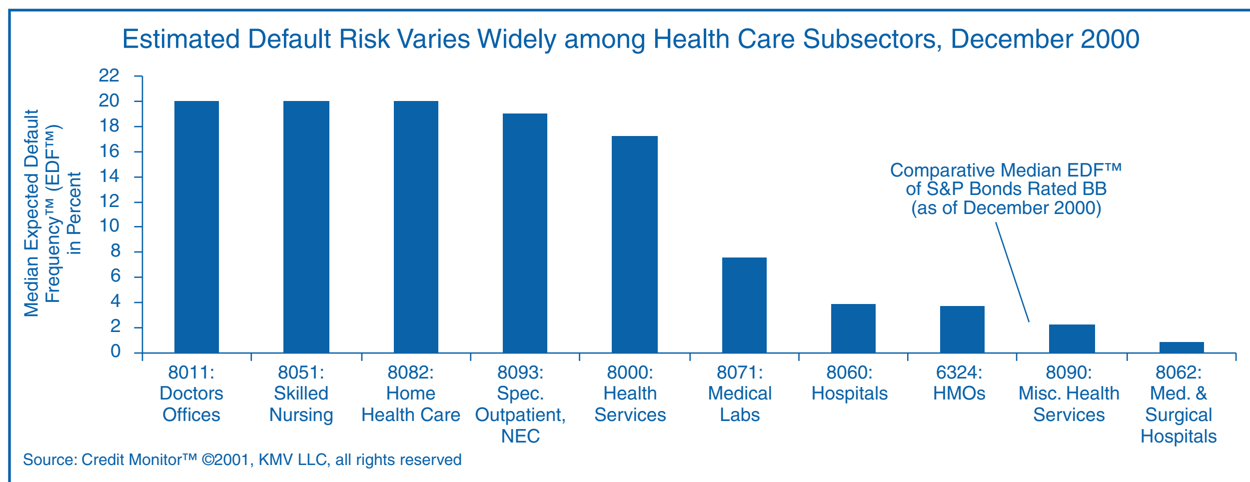
One such model that is readily available is Credit Monitor™, which was developed by KMV LLC.[5] We stratify health care sectors based on their median one-year default probability as estimated by expected default frequencies™ (EDFs™) generated by Credit Monitor™. Sectors identified in this article as higher-risk sectors, therefore, are those with a relatively high percentage of firms with low stock prices, volatile stock prices, or high debt levels. Readers are cautioned that the risk profile of a specific company may be very different from the sector risk profiles described here.

Health care industry subsectors have been grouped into three categories: higher risk, moderate risk, and lower risk, which refer to the degree of default risk relative to other subsectors in the industry. The estimated default risk across these subsectors varies substantially. The highest-risk health care sectors include Offices of Medical Doctors; Skilled Nursing Care Facilities; Home Health Care Services; Specialized Outpatient Facilities, NEC; and Health Services (see Chart 7).

Offices of Medical Doctors are largely physicians' practice management firms. These firms acquire a practice of physicians based on a multiple of the practice's discounted cash flow. The multiple can be several times the practice's asset value at the time of purchase. However, these firms have had difficulty achieving profitability because of legal restrictions on referrals among affiliated groups of physicians, as well as the reluctance of physicians to submit their medical practice to the criteria of cost control.[6] Total liabilities in this sector have grown rapidly over the past few years.

Skilled Nursing Care Facilities' earnings have been hurt badly by the BBA. However, they stand to benefit from the Medicare "giveback" provided by the recently enacted BIPA, which seeks to rectify the deeper-than-expected cuts in funding resulting from the BBA. Skilled nursing care facilities' performance has also been adversely affected by (1) declining occupancy

CHART 7



[5] Credit Monitor™'s Expected Default Frequency™ (EDF™) estimates the probability of default within one year. KMV LLC'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 vulnerabiltiy of the firm to large changes in market value measured in terms of asset volatility. EDFs™ are one of many potential measures of industry risk, and their use in this article should not be construed as an endorsement by the FDIC or Credit Monitor™.

[6] Gruehn, Charles. April 2000. *Healthcare Industry Manual.* Federal Reserve Bank of Atlanta.

rates caused at least partly by increased competition from lower-acuity facilities such as assisted living facilities; (2) rising labor and legal costs; and (3) surging debt service costs. Many of these firms are experiencing severe financial stress. The stressed facilities have registered negative net income for the past year or so, as well as burgeoning debt levels. The high debt levels are the result of acquisitions of ancillary support services that in many cases are not generating adequate cash flow because of the BBA.[7] Most of these firms have seen their interest coverage ratios decline sharply over the past few years.

Home Health Care Services focus primarily on respiratory therapy programs and intravenous and infusion services. The industry is undergoing financial stress as a result of the Health Care Financing Administration's implementation of a prospective payment system that reduced reimbursements on respiratory therapy and infusion therapy.

Specialty Outpatient Facilities, NEC are primarily engaged in outpatient care of a specialized nature, such as alcohol and drug treatment and birth control/family planning. They have permanent facilities and medical staff to provide diagnosis, treatment, or both for patients who are ambulatory and do not require inpatient care. Many of the firms in this sector have experienced a rising debt burden over the past few years, pushing default risk to higher levels.

Health Services firms are engaged primarily in furnishing medical, surgical, and other health services. Firms listed in this broad category rather than more specific categories include companies providing dental services, laser eye correction, and physical and occupational therapy. Many publicly traded firms in this category have experienced sharply rising liabilities over the past three to four years.

Moderate-Risk Sectors

Moderate-risk health care sectors include medical laboratories, hospitals, and HMOs.

Medical Laboratories provide professional analytic or diagnostic services to the medical profession or to the patient as prescribed by a physician. Companies with diverse financial performance and risk of default are included in this sector. A number of medical laboratories have registered deteriorating interest coverage ratios in the past year or two.

Hospitals, as defined for these purposes, are specialty hospitals. They are primarily engaged in providing diagnostic services, treatment, and other hospital services for specialized categories of patients. Only eight publicly traded firms are listed in this category. They are involved in providing specialized hospital care such as rehabilitation, diabetes treatment, and drug and substance abuse treatment.

Hospital and Medical Service Plans (HMOs) are primarily engaged in providing hospital, medical, and other health services to subscribers or members in accordance with prearranged agreements or service plans. Generally, these service plans provide benefits to subscribers or members in return for specified subscription charges. Also included in this industry are separate HMOs that provide medical insurance. After several years of intense competition among HMOs, which restricted premium-rate hikes when medical costs were rising sharply, HMOs began to pursue a more aggressive approach toward price increases. This new approach has improved the near- and intermediate-term outlook for this sector. Yet, the prospect of the passage of a Patients' Bill of Rights suggests that rising costs could be an issue for HMOs in the future. As an industry, HMOs are highly concentrated, with the top 10 HMOs accounting for nearly two-thirds of total HMO enrollment in the United States.[8]

Lower-Risk Sectors

The lowest-risk sectors in the health care industry include miscellaneous health and allied services, and general medical and surgical hospitals. Many of these firms have an estimated default risk that puts them in speculative credit risk categories in spite of the fact that they are considered lower risk compared with other health care sectors.

Miscellaneous Health and Allied Services firms are involved in providing kidney or renal dialysis services and outpatient care of a specialized nature, such as alcohol and drug treatment and birth control/family planning. Some firms are engaged in providing health and allied services such as blood banks, blood donor stations, childbirth preparation classes, medical photography and art, and oxygen tent services.

[7] Ibid.

[8] August 31, 2000. *Healthcare: Managed Care.* Standard & Poor's Industry Surveys.

General Medical and Surgical Hospitals provide general medical and surgical diagnostic and treatment services, other hospital services, and continuing nursing services. They have an organized medical staff, inpatient beds, and equipment and facilities to provide complete health care. According to a study conducted by HCIA-Sachs and Ernst & Young, "The BBA created the greatest financial instability that hospitals have experienced since the creation of Medicare in 1965. Yet the most severe reductions have just begun to impact hospitals, and will continue to do so through 2002. The recently enacted Balanced Budget Refinement Act provides little sustained relief to the industry, and significant financial problems are likely to remain."[9] The study also indicates that smaller hospitals (fewer than 100 beds) are in the "greatest financial jeopardy." The recent enactment of BIPA will help to stabilize the finances of hospitals over the next several years. However, other trends adversely affecting hospitals include as much as 40 percent estimated excess capacity, rising labor costs, a severe shortage of nurses, continued HMO penetration, breakthrough pharmaceutical therapies, and increased outpatient volumes (see Charts 5, 6, and 8).

Outlook

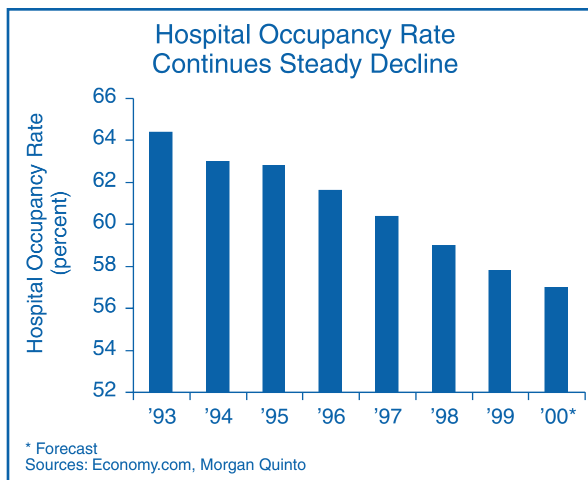
The outlook for the health care industry has improved substantially in the past year. Industry consolidation and legislation to give back some of the Medicare cuts implemented in the Balanced Budget Act of 1997 have gone a long way to stabilize health care providers' financial prospects, particularly those of hospitals and nursing homes.

The passage of a Patients' Bill of Rights in 2001 could also strengthen the hand of health care providers relative to HMOs. Such a bill could contain provisions that would weaken the position of managed care organizations to contain costs and negotiate with health service providers.

Longer term, the demographic trends are positive, with the population aging and life expectancy increasing. The result should be a growing demand for health care services in the future. On the negative side, however, the current trends toward greater use of outpatient procedures and drug therapies will dampen the demand for inpatient hospital services.

[9] HCIA-Sachs, LLC, and Ernst & Young, LLP. May 1, 2000. *The Financial State of Hospitals: Post-BBA and Post-BBRA*.

CHART 8



Implications for Banks

The opportunities for financing health care firms will continue to grow into the future. Recent experience has shown that the financial performance of many health care providers is profoundly influenced by changes in Medicare policy. As Medicare expenditures grow to occupy a greater and greater place in the federal budget, Medicare policy will be scrutinized to an unprecedented degree, magnifying the importance of understanding the policy risk associated with health care lending.

Powerful demographic trends should lead to the growth in demand for many health care services over the next 10 to 20 years. For example, demand for nursing homes and assisted living facilities will increase sharply as baby boomers reach old age. However, regional supply and demand for these services can get out of balance as providers add facilities to meet demand. Monitoring local demand and supply trends is an important part of assessing the credit risks in these loans.

Textiles

The textile industry has been plagued by excess capacity, fierce competition from cheaper imports, and sagging textile prices. The result was a sharp drop in industry profits in 1999 and continued weakness in 2000.

Recent Trends and Developments

The textile industry is a mature industry that by a number of measures has been declining. Intense competition from low-cost imports has taken its toll on domestic

textile businesses. Since 1995, textile imports have increased nearly 50 percent while exports have grown just under 10 percent. A strong dollar should help textile imports continue to outpace exports. As a result of industry consolidation and the movement of many operations offshore, textile employment has continued to fall steadily. Textile employment has dropped from 663,000 in 1995 to an estimated 544,000 in 2000.[10]

Closely linked to all these trends, labor productivity in the textile industry is low relative to the average for other manufacturing industries because of low output prices and a heavier reliance on labor in the production process.

The Department of Commerce reports that the industry's profit as a percentage of sales declined from 3.2 percent in 1998 to just 1.3 percent in 1999 (see Chart 9).[11] Also, drought in the South has had an adverse effect on textile manufacturing firms, as these firms use a large amount of water in bleaching and dyeing fabric.[12]

Because of improving global demand and plant closings in the United States, many analysts believe textile prices have now reached a low point. Indeed, data for 2000 show a slight increase and some firming of prices in the first three quarters of the year (see Chart 10, next page). Nevertheless, the profit picture seems to have weakened further in 2000 because of an increase in nonoperating expenses.

Publicly traded firms in the textile industry can be separated into six major categories: knitting mills, textile mill products, broadwoven fabric mills–cotton, broadwoven fabric mills–manmade fiber/silk, carpets/rugs, and miscellaneous fabricated textile products. The default risk characteristics of these sectors vary significantly as measured by the median EDF™.

Higher-Risk Sectors

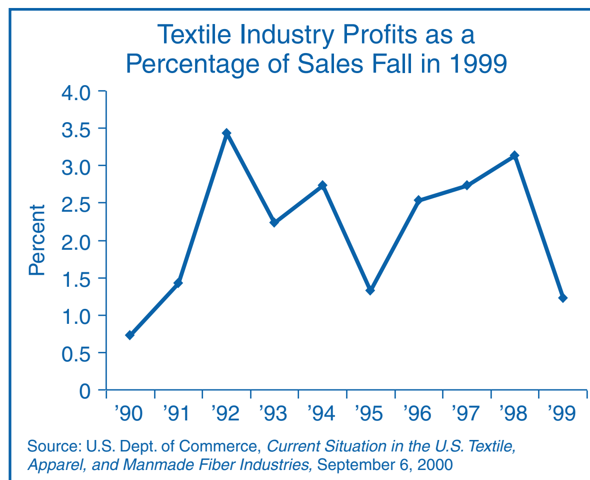
The higher-risk sectors include knitting mills, Broadwoven Fabric Mills–Cotton, and Textile Mill Products (see Chart 11, next page).

[10] Economy.com. November 2000. Apparel and Textiles, Precis Industry.

[11] Office of Textiles and Apparel, U.S. Dept. of Commerce. September 6, 2000. *Current Situation in the U.S. Textile, Apparel, and Manmade Fiber Industries*.

[12] Kilman, Scott, and Amy Merrick. July 25, 2000. "Drought in the South Crimps Economy in Region." *Wall Street Journal*.

CHART 9



Source: U.S. Dept. of Commerce, *Current Situation in the U.S. Textile, Apparel, and Manmade Fiber Industries,* September 6, 2000

Knitting Mills are engaged in knitting, dyeing, and finishing hosiery, stockings, outerwear, underwear, and other products from yarn or knitted fabrics. Two public firms in this industry accounted for 66 percent of the sector's 1999 sales. Three out of eight firms in this sector reported net losses and six out of eight reported declining sales in 1999. The trends are similar in 2000 based on incomplete available data.

Broadwoven Fabric Mills–Cotton are engaged primarily in weaving fabrics more than 12 inches in width, wholly or chiefly by weight of cotton. One dominant firm accounted for nearly 38 percent of the sales of all publicly traded firms in this sector in 1999. The performance of firms in this sector was mixed in 1999. Six out of nine of these firms recorded negative net income in 1999. Two companies reported a sizable increase in 1999 net income. Incomplete 2000 results suggest that six firms are in the black, leaving just three with negative net income.

Textile Mill Products is a broad category that includes establishments engaged in performing any of the following operations: (1) preparation of fiber and subsequent manufacturing of yarn, thread, braids, twine, and cordage; (2) manufacturing broadwoven fabrics, narrow woven fabrics, knit fabrics, and carpets and rugs from yarn; (3) dyeing and finishing fiber, yarn, fabrics, and knit apparel; (4) coating, waterproofing, or otherwise treating fabrics; (5) the integrated manufacture of knit apparel and other finished articles from yarn; and (6) the manufacture of felt goods, lace goods, nonwoven fabrics, and miscellaneous textiles. Two firms dominate this sector. Together, they accounted for over 60 percent of the sector's sales in 1999 (considering publicly traded

CHART 10

firms only). Net income for both firms was off sharply in 1999. Still, some companies registered net income gains in 1999, building on several years of growth in net earnings. Although the 2000 data are incomplete, most firms in this sector have reported weak earnings. Indeed, several firms have reported more quarters of negative than positive net income.

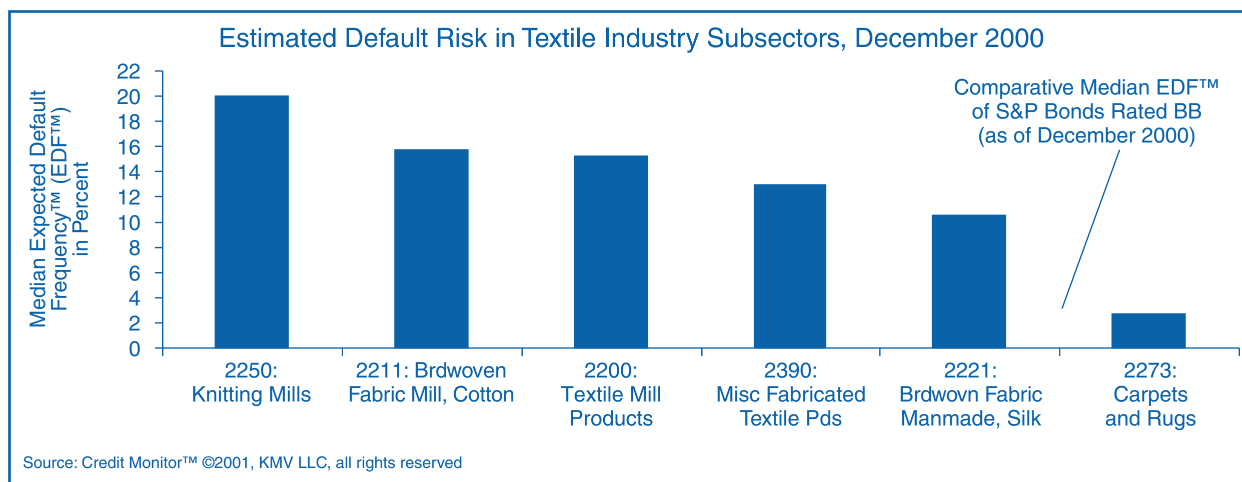
Moderate-Risk Sectors

The moderate default risk sectors include Miscellaneous Fabricated Textile Products and Broadwoven Fabric Mills–Manmade Fiber/Silk.

Miscellaneous Fabricated Textile Products includes businesses primarily involved in manufacturing curtains and draperies, house furnishings, textile bags, and canvas and related products; performing pleating, decorative and novelty stitching, and tucking for the trade; manufacturing automotive trimmings, apparel findings, and related products; Schiffli machine embroideries; and manufacturing fabricated textile products, not elsewhere classified. Net income for three out of the five publicly traded firms in this sector was negative in 1999. Two of those firms have experienced losses for at least two years' running. Most of these firms reported negative net income through the first two or three quarters of 2000. The three largest firms' total debt has grown considerably over the past few years. The increase is related primarily to financing acquisitions.

Broadwoven Fabric Mills–Manmade Fiber/Silk are engaged in weaving fabrics more than 12 inches in width using primarily silk and manmade fibers, including glass. Net income for each of the six publicly traded firms in this category was down in 1999—in most cases down sharply. Earnings for most of these firms

CHART 11



appear to have continued to deteriorate in 2000. Interest coverage ratios for several firms were down in 1999 and 2000 because of lower income, higher liabilities in some cases, and higher interest rates.

Lower-Risk Sector

Manufacturers of carpets and rugs represent the only lower-risk sector in the textile industry.

Carpets/Rugs businesses are involved in manufacturing woven, tufted, and other carpets and rugs. This sector, as a group, experienced strong income growth in 1999. Only one out of six publicly traded firms failed to make a profit in 1999, and several firms reported sizable profit increases. Available 2000 data suggest that each of these firms will have generated positive earnings. Two firms dominate the carpet and rug sector, accounting for about 65 percent of 1999 sales for the group. Carpet and rug manufacturing is capital and research intensive, which gives the U.S.-based firms a comparative advantage over overseas companies, which do not have the same level of access to capital markets and an educated workforce.

Outlook

Some positive factors could temper the adversity being experienced by the U.S. textile industry. Low fiber costs and an improved trade situation with Asia should strengthen the textile industry in the future. Labor productivity has been rising slowly, as firms continue to invest in labor-saving computer technology and equipment. The industry is pursuing various strategies to remain competitive, including consolidations and mergers and setting up operations in Mexico.[13] Nevertheless, the current slowdown in the U.S. economy and the increased risk of an actual recession has posed challenges for the textile industry.

Another concern for U.S. producers is trade liberalization and its effect on textile imports. The normalization of trade relations with China and the elimination of import quotas by 2005 according to the World Trade Organization (WTO) Agreement on Textiles and Clothing could lead to even greater imports.

Implications for Banks

Banks lending to textile firms face an array of risks emanating from the economic environment in which these firms operate. These risks include the ebb and flow of demand associated with the business cycle of the U.S. and world economies; the exchange rate of the U.S. dollar, which affects the competitiveness of domestically produced textile products; and the prices of both inputs and textile products. U.S. trade policy will also have a profound impact on the competitive environment in which domestic textile firms operate. Banks need to monitor these developments carefully.

Concentration risk can be a significant issue for some banks. Textile mill employment is highly concentrated geographically. About 72 percent of all textile mill jobs are located in five southeastern states (North Carolina, Georgia, South Carolina, Alabama, and Virginia). Almost 29 percent of these jobs are in North Carolina alone. Another 18 percent are in Georgia. Even within these states, textile employment can be regionally concentrated, introducing concentration risk to banks with significant exposures to local textile firms. This risk is measured in terms of not only the volume of textile loans in the portfolio but also the spillover effects that plant layoffs can have in the community.[14]

In an increasingly global market, credit risk in textiles will depend on decisions about production processes and intercompany linkages. For example, capital-intensive domestic producers may be in a better position to compete with offshore firms with greater access to cheap labor resources. Some textile firms may be able to enhance profitability and control risk by entering into partnerships with domestic and overseas organizations.

Stephen Gabriel, Financial Economist

[13] Reichard, Robert. January 2000. "New Year Offers Problems and Opportunities," *Textile World*.

[14] See "Regional Economy," *Atlanta Regional Outlook,* second quarter 1998.

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