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In Focus This Quarter

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

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

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

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

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

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

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

By the Analysis Branch Staff

Regional Perspectives

◆ ***Economic and Banking Conditions*—The Region's economy is healthy and growing steadily. Heavy reliance on financial services in the Region increases potential risk in the event of a stock market downturn. The Region's banks continue to post solid financial results; international banks performed well despite continued global turmoil.** *See page 16.*

◆ ***Savings Institutions Underperform Commercial Banks*—The flat yield curve has hurt savings institutions more than commercial banks, depressing interest margins and the bottom line. Also, the Region's savings institutions have higher delinquency rates than the rest of the nation.** *See page 19.*

◆ ***Consumer Behavior and Lending Trends*—Consumer debt levels and personal bankruptcies are at all-time highs. Although debt burdens have leveled off in the past year, these trends suggest some cause for concern. Credit card banks, which face consolidation, competition, and the increasing popularity of new consumer lending products, are especially vulnerable to changes in consumer borrowing behavior.** *See page 20.*

By the New York Region Staff

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Economic Conditions and Emerging Risks in Banking

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

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

Economic Developments

Conditions Have Improved Markedly since Late 1998

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

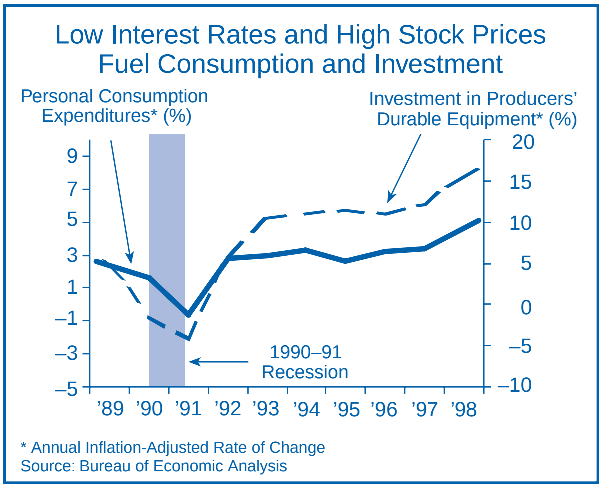
Consumer Spending and Business Investment Are Key to Economic Strength

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

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

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

CHART 1



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

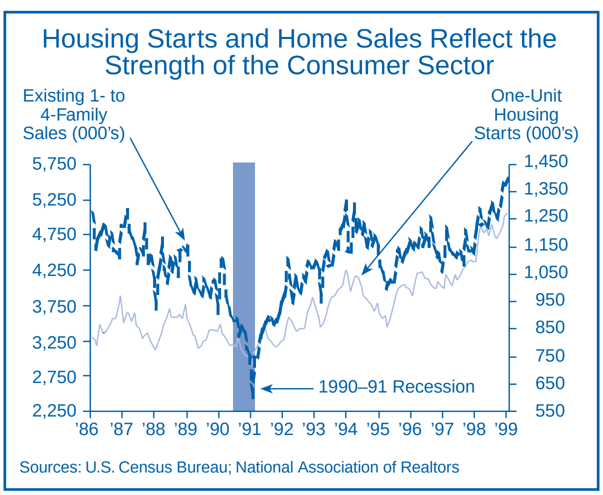
Although real disposable personal income grew by more than 3 percent during 1998, personal savings was essentially zero during the fourth quarter. This was the lowest rate of personal savings recorded in the United States since the Great Depression. The decline in personal savings has prompted much discussion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

Conditions Vary across Industry Sectors

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

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

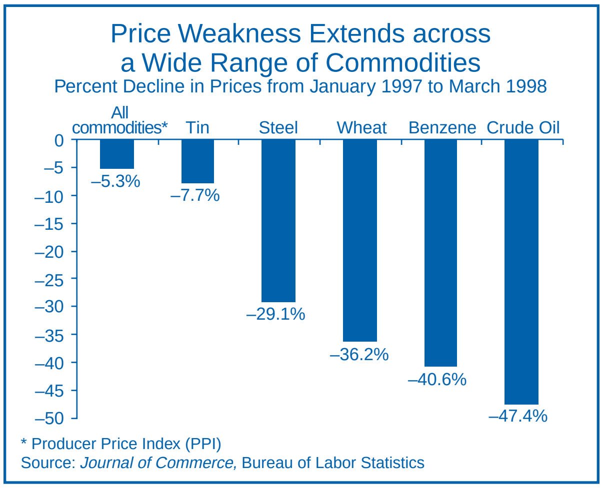
CHART 2



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

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

CHART 3



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

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

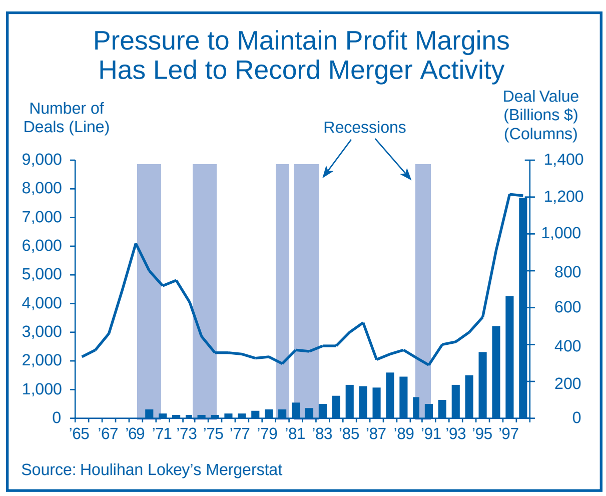
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record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

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

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

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

CHART 4



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

The Outlook for the Global Economy Remains Uncertain

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

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

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

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

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

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

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

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

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

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

Risks Remain despite a Positive U.S. Economic Outlook

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

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

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

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

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

Trends Affecting Banking Lines of Business

Overview

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

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

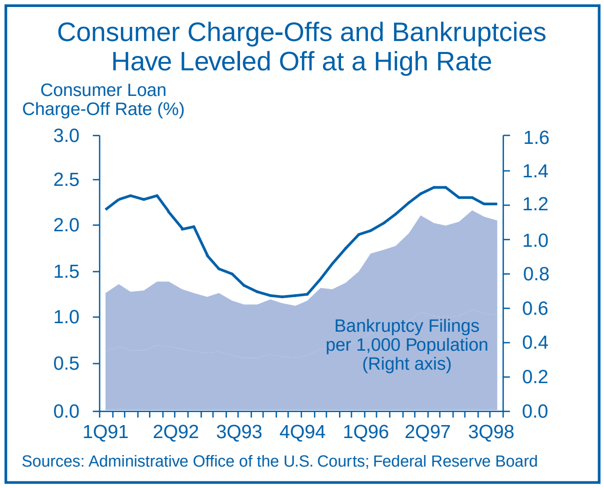
Consumer Lending

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

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

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

CHART 5



"reloading" of credit card debt would further strain the financial flexibility of consumers.

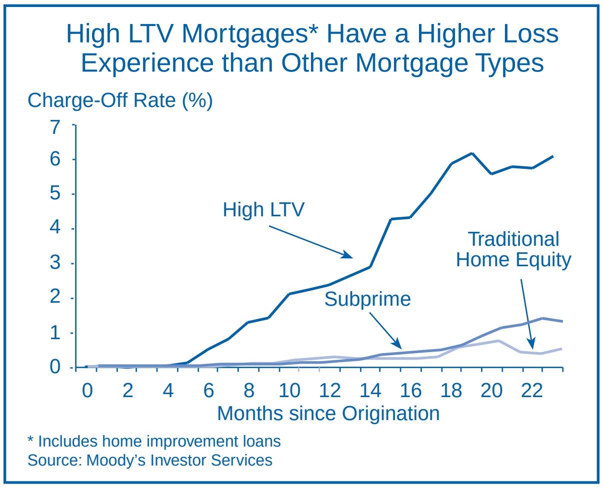
High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

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

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

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

CHART 6



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

Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

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

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

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

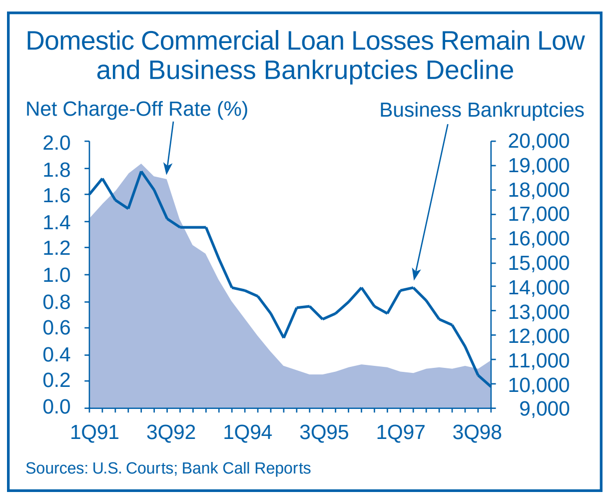
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

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

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

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

CHART 7



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

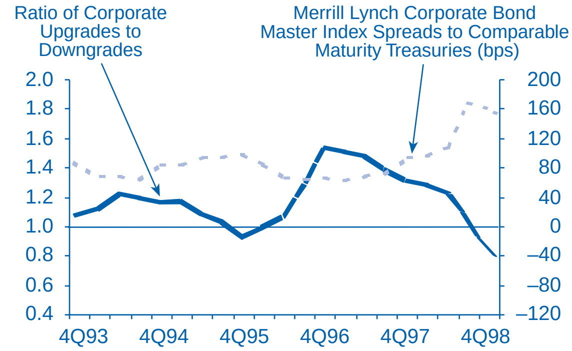
As Debt Markets Become More Cautious, Syndicated Lending Shifts toward Higher Risk Borrowers

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

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

CHART 8

Corporate Bond Ratings and Required Yields Reflect Greater Market Uncertainty



Sources: Moody's Investor Service; Merrill Lynch

Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

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

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

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

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

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

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

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

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

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

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

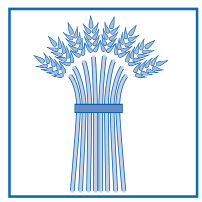
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger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

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

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

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



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

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

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

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

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

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

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

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

Interest Rate Changes Pose Asset/Liability Management Challenges

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

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

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

CHART 9

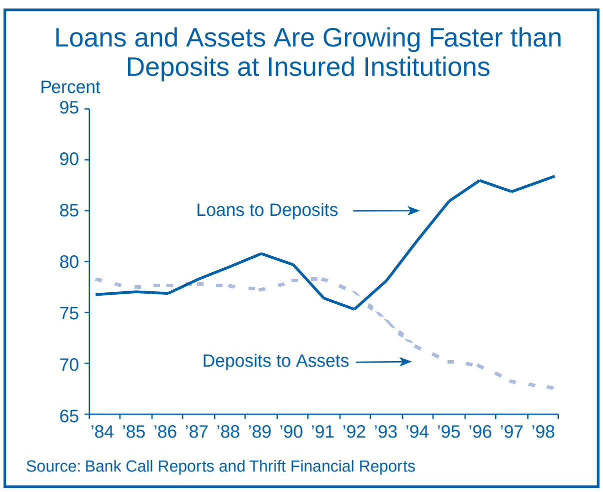
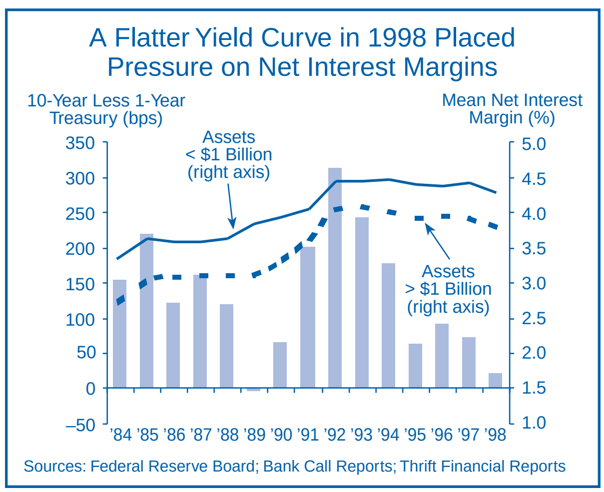


CHART 10



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

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

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

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

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

Bank Performance Remains Strong but Earnings Variability Is Increasing

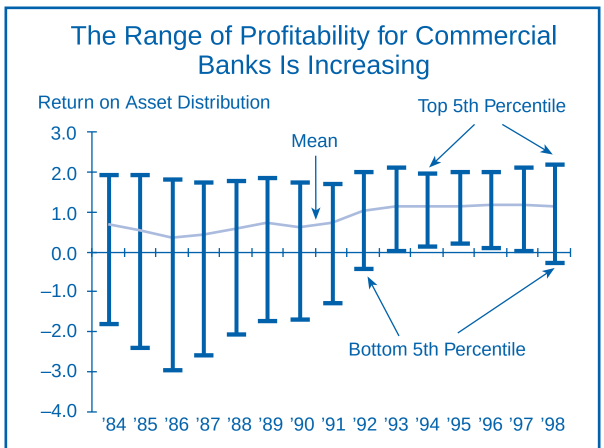
Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent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

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

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

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

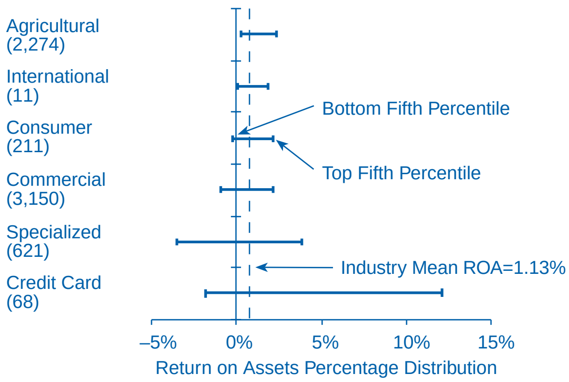
CHART 11



Source: Bank Call Reports

CHART 12

1998 Performance Varies by Business Specialization



Note: Group institution count is in parentheses.
Source: Bank Call Reports (Research Information System)

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

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

Summary

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

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

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

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

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

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

trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

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

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

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

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Regional Perspectives

- **The New York Region's economy is healthy and growing steadily, even though its economic growth still trails that of the nation.**

- **The Region's banks continue to record favorable financial results. International banks have rebounded despite turmoil in the global market.**

- **The flat yield curve has hurt savings institutions more than commercial banks. Also, the Region's savings institutions have a higher rate of delinquencies than that of the nation.**

- **Growing levels of consumer debt raise questions about credit quality. Credit card banks face consolidation, competition, and the increasing popularity of new consumer lending products, such as high loan-to-value home equity and subprime loans.**

Economic and Banking Conditions

The Region's Economy Is Getting Stronger

With the nation prospering in the longest peacetime expansion in U.S. history, the Region's economy is growing steadily. The combined gross state products for the Region[1] increased for the seventh consecutive year, climbing 2.9 percent in 1998. While this performance represents the highest increase since 1994, it is a full percentage point below the national figure (see Chart 1). Higher business costs, less available land for development, and weaker population growth all contribute to the slower growth of the Region compared with that of the nation. Nevertheless, the Region's economic expansion has generated higher incomes and new jobs for many of its residents. This in turn has stimulated consumption, particularly in housing and automobiles.

In large measure, the Region's expanding economic output stems from the increasing concentration of high-value-added industries, such as management consulting, legal services, media and publishing, engineering, and financial services. Companies in these sectors generally pay higher salaries than those in other industries and generate substantial amounts of revenue per employee. As a result, over the past decade workforce productivity rates[2] in the Region have been higher than in the nation and have been increasing at a faster rate (see Chart 2). Fueled by the stock market, the increased profitability of financial service industries in particular has contributed to the surge in productivity.

The Region Is Heavily Dependent on Financial Services

The financial services industry, which includes the banking, insurance, real estate, and securities sectors, is significantly more concentrated in the Region than in the nation. This industry accounted for 25 percent of the Region's total economic output (or gross state product) in 1998, compared with 19 percent for the nation. In **Delaware**, the financial sector accounted for 45 percent of the gross state product because of its large number of credit card banks. An economic diversity index developed by the FDIC[3] shows that Delaware is one of the least diverse states in the United States. **New York**, which has the largest number of security industry employees, generated 31 percent of its gross state product from the financial sector. Because a growing share

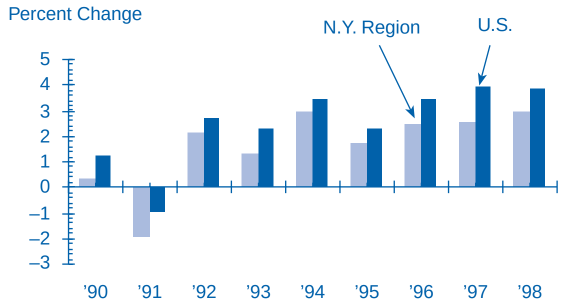
[1] Data supplied by ***Regional Financial Associates***.

[2] Workforce productivity is defined as output divided by the number of workers.

[3] ***The Index of Economic Diversity*** summarizes how closely the state's economy resembles the nation's. A lower index value, such as that of Delaware, indicates that a state has a higher concentration of economic activity than the United States in some industries.

CHART 1

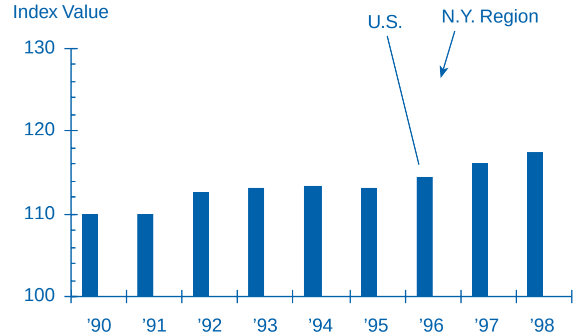
The Region's Gross Product Has Grown for Seven Consecutive Years, but Still Trails the Nation



Source: Regional Financial Associates, National Income and Product Accounts

CHART 2

Productivity Is Higher and Increasing Faster in the Region than in the Nation



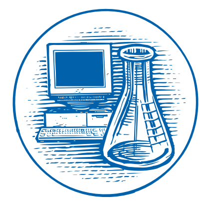
Index: 1980 = 100.
Source: Bureau of Labor Statistics and National Income and Product Accounts

of its wealth is generated by Wall Street, New York's economic diversity index has fallen in the past ten years. Except for **Pennsylvania**, all of the other states in the Region were higher than the national average in financial sector concentration. Reliance on the financial sector may increase further over the next few years, with continued strong growth in employment on Wall Street.

Because the relationship between economic growth and the stock market is stronger in the New York Region than elsewhere, a sustained disruption in the stock market could have particularly adverse consequences for the Region's economy. When the world's equity markets fell in unison during the third quarter of 1998, several international banks[4] and brokerage houses sustained heavy losses. Many of the losses resulted from exposure to emerging markets and derivative products. As of December 31, 1998, banks in the Region reported almost $25 trillion in notional amount of derivatives, or 80 percent of all derivative contracts held by insured institutions in the United States. Several institutions announced restructuring plans and layoffs. Moreover, prices for some high-end residential real estate in New York fell almost immediately as demand softened and financing for commercial real estate evaporated. Although the stock market quickly recovered and liquidity slowly returned to the financial markets after the Federal Reserve Board lowered interest rates, such immediate, if short-lived, consequences of a temporary market upheaval demonstrate the potential risks of overreliance on the financial services industry.

Global Economic Turmoil Spreads to Brazil and Adversely Affects the Region's Trade

The recessions in Asia, Brazil, and Russia are putting pressure on the economies of both the United States and the Region. After having risen for several years, the Region's exports to Brazil dropped more than 11 percent between 1997 and 1998.[5] During the same period, the Region's exports to Asia dropped more than 14 percent. Industries in the Region that are most vulnerable to declining exports include chemicals, industrial machines, and electrical components. The Region's exporters could face a further drop-off if the Brazilian economy continues to contract. Analysts are calling for a 3 to 4 percent decline in Brazil's gross domestic product in 1999.[6]



Moreover, the Region's manufacturers are being harmed by an influx of cheap imports from these troubled economies. With the price of imports from emerging markets around the world declining because of devalued currencies, some of the Region's manufacturers will be hard-pressed to remain competitive. The steel, chemical, and pharmaceutical industries are most susceptible. Cheaper imported steel from Brazil, for example, could worsen an already bad situation for steel producers in areas such as western Pennsylvania, which has been

[4] International banks are banks that have total assets greater than $10 billion and 25 percent of total assets in foreign assets.

[5] Data supplied by ***Regional Financial Associates.***

[6] *Blue Chip Economic Indicators,* April 1999.

feeling sharp competitive pressure from cheap Asian and Russian imports.[7]

The Region's Banks and Thrifts Continue to Report Healthy Financial Conditions

The Region's banks and thrifts reported generally healthy financial conditions in the fourth quarter of 1998. The Region's average return on assets (ROA) was 0.94 percent, compared with 0.97 percent at year-end 1997. The average net interest margin (NIM) declined to 4.0 percent in the fourth quarter, compared with 4.16 percent a year earlier. The average NIM declined significantly in savings institutions, which experienced a drop of 60 basis points from December 31, 1997 (3.54 percent to 2.94 percent). The average reported leverage capital ratio remained strong, rising 33 basis points over the year-end 1997 figure. Aggregate past-due ratios continued to decline, reflecting improvement in almost all loan categories, with the exception of commercial and industrial loans and loans to consumers, which both saw a modest rise in past-due levels. Credit card portfolios,[8] the sector with the highest past-due and charge-off rates, had aggregate charge-offs of 4.69 percent in 1998, the first time that figure fell below 5.0 percent in more than two years. However, aggregate past-due credit card loans continued to rise slightly, up to 5.11 percent from 4.99 percent in 1997. The rise in past-dues occurred in the most seriously delinquent loan category, 90 days or more past due, suggesting that charge-off levels are unlikely to fall significantly in the next few quarters.

The Region's International Banks Adjust to Emerging Markets

After reporting lower earnings in the third quarter, most of the Region's international banks rebounded in the fourth quarter despite continued weakness in emerging markets. These banks are more vulnerable to instability in foreign markets because of their significant cross-border exposure and trading activities. For example, as of September 30, 1998, exposure of all United States banks to Brazil totaled $18.6 billion; more than 71 percent of this exposure was in international banks, most of which are in the New York Region.[9] The exposure was three times greater than the exposure to Russia at the height of its crisis last August. While far less than the peak of $27 billion in the late 1980s, bank exposure to Brazil is still larger than to any country outside Western Europe and Canada. Banks had been cutting their emerging market exposure in reaction to global turmoil, and as a result, total U.S. exposure to Brazil declined by 32 percent over the past year and a half.

[7] The House of Representatives passed a bill in March that would limit U.S. imports to pre-1998 levels. The bill faces opposition both in the Senate and at the White House. Its final passage is uncertain.

[8] These figures are for all banks in the Region, not just credit card banks.

[9] ***Federal Financial Institutions Examination Council*** Country Exposure Lending Survey, January 13, 1999.

Savings Institutions Underperform Commercial Banks

The Region's 358 savings institutions (savings banks and savings and loan associations) are underperforming commercial banks. As of December 31, 1998, this group had an average ROA of 0.71 percent compared with 1.10 percent for commercial banks. The primary reasons for the difference are lower-than-average NIMs and a comparative lack of noninterest income. The Region's savings institutions reported an average NIM of 3.37 percent as of year-end 1998 compared with 4.40 percent for commercial banks, a difference of over 100 basis points. Savings institutions have a significantly larger portion of their assets in low-yielding residential real estate loans than commercial banks (41 percent versus 9 percent). With mortgage rates hovering at or below 7 percent throughout 1998, savings institutions faced margin pressures as their portfolios amassed large volumes of low-yielding, long-term, fixed-rate assets.

The flat yield curve environment of the past two years has prevented banks from lowering their short-term deposit rates sufficiently to maintain as favorable spreads. Savings institutions have been most affected; this group's average cost of funds, at 4.10 percent on December 31, 1998, was significantly higher than the 3.50 percent reported by commercial banks. Savings institutions' interest margins also may be more vulnerable to rising interest rates. In the past, savings institutions have relied heavily on adjustable rate mortgages (ARMs) to help manage interest rate risk and maintain spreads. With fixed rates so low, however, ARMs have been losing their popularity among borrowers. ARMs accounted for only 15 percent of mortgage originations in 1998, down from 22 percent in 1997 (and 39 percent in 1994, the peak in this decade).[10] In addition, many ARM borrowers have been refinancing into fixed-rate mortgages in the past two years, further dropping their prominence in loan portfolios. This situation is likely to exacerbate earnings pressure on savings institutions when the current low-interest-rate environment changes.

Because of the nature of their business, consumer-oriented savings institutions lack the cushion of having noninterest income as a significant revenue source. Savings banks in the Region have an average ratio of noninterest income to earning assets of 1.26 percent, compared with the commercial banks' average ratio of 2.59 percent. With fewer opportunities to raise revenue through fee income, savings banks' net income levels are squeezed more than those of commercial banks when interest margins tighten.

The Region's savings institutions also reported higher aggregate delinquency rates throughout the 1990s. For the Region's savings banks, the aggregate ratio of noncurrent loans to total loans was 2.1 percent as of December 31, 1998, compared with 0.75 percent for the rest of the nation (see Table 1). Although the reasons for this discrepancy are not precisely known, differences in usury and foreclosure laws could be partly responsible. Anecdotal evidence suggests, for example, that

[10] Federal Home Loan Mortgage Corporation.

Table 1

The Region's Savings Banks Have Higher Levels of Noncurrent Loans, but Not Charge-Offs

State	Noncurrent Loans/ Total Loans (%)	Ranking*	Charge-Offs/ Total Loans (%)	Ranking*
Delaware	2.04	4	0.27	7
Maryland	2.51	2	0.14	22
New Jersey	4.40	1	0.20	12
New York	1.11	10	0.17	18
Pennsylvania	0.78	26	0.19	14
Washington, D.C.	1.75	6	0.02	45
Region	2.10	1	0.17	4
Rest of Nation**	0.75	NA	0.19	NA

Data as of December 31, 1998. Puerto Rico has no savings banks.
* Rankings: 1 = highest or worst ratio out of the 50 states.
** These figures exclude the New York Region.
Source: Bank and Thrift Call Reports

foreclosure proceedings in **New Jersey** are comparatively lengthy. This skews the state's noncurrent loan ratio, as past-due loans being foreclosed would remain on balance sheets for an extended period. Bankruptcy levels also may affect noncurrent ratios, just as they have a correlation to credit card charge-offs. As of 1998, **Maryland** and Delaware are ranked 1 and 2 in noncurrent loans in the nation and have per capita bankruptcy ratios of 6.67 and 5.37, well above the 5.18 figure reported for the nation.

Although charge-offs for the Region's savings institutions are comparable to national levels, the higher noncurrent loan ratios suggest some elevated risk. The level of charge-offs has been low because most of the noncurrent loans are secured by real estate, which institutions use as collateral support to minimize losses in the event of loan default. This works as long as real estate prices remain stable or rise and there is sufficient equity available to secure the loan. Collateral margins are getting thinner, however, with the rising trend of low-down-payment mortgages (mortgages with 5 or 10 percent down payments) and the increasing popularity of high loan-to-value (LTV) home equity loans. Therefore, savings institutions may be becoming more susceptible to a real estate slump or a slowdown in the Region's economy.

Consumer Behavior and Lending Trends

Measures of Consumer Debt Suggest a Mixed Picture

A recent analysis by the ***St. Louis Federal Reserve Bank***[11] found that the nation's consumers were accumulating debt at a faster pace than their incomes were rising. In 1998, personal income grew 5 percent, compared with an 8.8 percent increase in the level of household debt. One explanation for the rising debt-to-income level is that households may be borrowing for consumption based on accumulated wealth rather than current income. The nation's net worth has been rising because of increasing household accumulation of corporate equities and mutual funds during the historic rise in the stock market. This is particularly true in this Region, where residents hold 25 percent of equity mutual fund assets.[12] To illustrate, national debt levels, as measured against household net worth, have been declining over the past several years as net worth has grown faster (see Charts 3 and 4). The proliferation of pension funds and 401(k) plans has made household balance sheets stronger, which may give consumers more confidence to borrow.

On the other hand, trends in the nation's debt service burden[13] seem to have leveled off in the past two years after rising sharply from 1994 to 1996. Lower interest rates, as well as tightened underwriting standards by lenders and higher personal income levels, may be contributing to the stabilization. Debt burdens also may be easing because mortgage-related debt is increasingly being substituted for credit card and other forms of consumer debt. Mortgages are the fastest growing category of consumer debt. In 1998, mortgage debt rose 9.9 percent, while other categories grew 5.5 percent. Mortgage debt, whether through first-lien mortgages or home equity lines, typically involves lower interest rates and longer repayment terms than consumer installment debt and credit card lines. *Consequently, annual principal and interest payments would be lower relative to disposable personal income, even though the amount of consumer household liabilities to disposable personal income continued to rise in 1998. This ratio has risen steadily from 85 percent in 1992 to 99 percent in 1997 (see Chart 5).*

Debt burden measures, however, do not capture all forms of consumer debt payments. Lease obligations are excluded from the calculation. In recent years, the number of automobile leases has risen dramatically, and

[11] "Monetary Trends: Is Household Debt Too High?" Federal Reserve Bank of St. Louis, December 1998.

[12] "1995 Mutual Fund Facts," Investment Company Institute.

[13] Debt service burden is the total interest and principal payments on all consumer and mortgage debt in the household sector compared with disposable personal income. Debt service burden levels for 1998 are assumed to have leveled off in the "Monetary Trends" article cited in footnote 11, although the ***Federal Reserve Board*** stopped officially calculating this ratio in 1997.

CHART 3

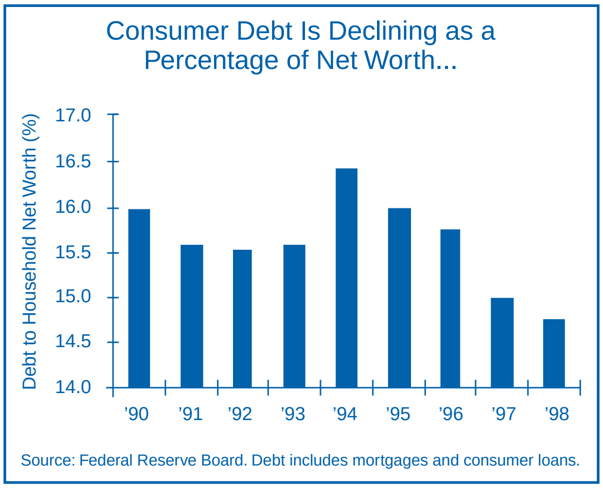
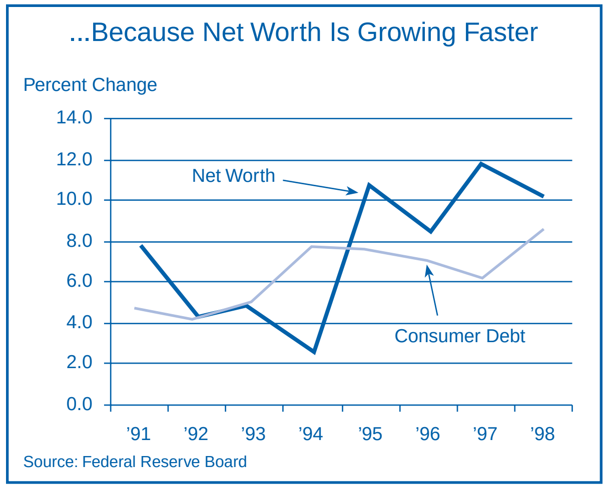


CHART 4



they now account for about 25 percent of personal new car transactions, compared with 10 percent in 1991.[14] Current total household debt obligations, if adjusted to include contractual lease payments, may actually exceed previous highs.

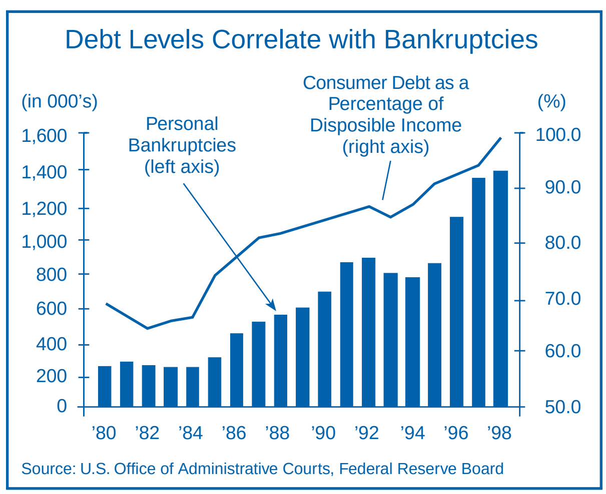
One trend that supports the concerns raised by high debt burdens and growing consumer debt levels is the continued increase in personal bankruptcy filings. Bankruptcies have increased as the level of debt to income has climbed in the last few years (see Chart 5). Nationally, personal bankruptcy filings in 1998 totaled a record 1.4 million, and filings in the fourth quarter of 1998 were the highest ever recorded in a fourth quarter. Nonetheless, bankruptcies grew by only 3.6 percent in 1998, compared with the much higher 20 percent rise in 1997. According to Samuel J. Gerdano, executive director of the ***American Bankruptcy Institute,*** "This third consecutive record year of bankruptcies correlates closely with the increase in debt load carried by American families."

While changing consumer borrowing patterns have led to apparent improvements in households' ability to service debt, high debt levels are a cause for concern among bank regulators. Households are committed to an unprecedented level of debt in the future, whether expectations of higher income growth materialize or not. Rising asset prices may give households the confidence to borrow heavily against future income growth, but consumers may not be able to rely on using capital gains to repay debt in the future if that income growth does not materialize. For example, retirement plans increase net worth, but their liquidity is restricted. Consumers may be overextending themselves, and in an economic slowdown, borrowers may be less able to pay off their debt obligations. (For more information on consumer lending trends, please see ***In Focus, page 8.***)

Credit Card Growth Slows, although Unfunded Commitments Surge

Consumer borrowing behavior is very important to the New York Region because of the Region's concentration

CHART 5



[14] "Breaking the Cycle: It Could Finally Be Different This Time for the Autos," Credit Suisse First Boston, January 29, 1999.

of credit card banks.[15] Credit card loans in the Region totaled $97 billion on December 31, 1998, which represents 40 percent of the $242 billion in total credit card receivables outstanding in the nation. The Region's 14 credit card banks hold 75 percent of its credit card loans. The growth rate of the Region's credit card banks recently has slowed; managed receivables[16] actually declined by 2 percent in 1998, compared with a 21 percent increase in 1997, although this decline may be partly because of asset sales. Nationally, total managed receivables increased by 16 percent in 1998.[17] The record-high consumer debt levels and refinancings to lower-rate, tax-deductible home mortgages and home equity loans are dampening credit card receivable growth.

Although the rate of increase of card receivables declined in 1998, unfunded commitments on credit cards surged 24 percent. Although this may suggest that consumers are using credit prudently, sizable credit lines suggest that banks are aggressively courting consumers, which may haunt lenders should the economy weaken. For all banks in the nation, unused credit lines topped $2 trillion at year-end 1998, which means that consumers are only using 20 percent of their available credit card lines. The Region's banks have a similar percentage of unfunded commitments, which grew 25 percent in 1998. With $216 billion in managed receivables and $927 billion in unfunded commitments, their customers are using about 19 percent of their available credit. Institutions that do not monitor card usage closely could be more vulnerable to credit quality problems, because cardholders could draw down unused lines when they face financial distress. Although banks can reduce card lines voluntarily, knowing when to do so is difficult; warning signs may not be readily apparent, and trouble may be noticed only after cardholders have run up their balances.

Intense Competition Leads to Consolidation among Credit Card Issuers

Fierce competition within the credit card industry has led to consolidation in the form of mergers as well as portfolio acquisitions. The economies of scale and marketing muscle of the largest card issuers are increasingly seen as necessities for success, leading several middle-tier players to leave the business altogether. According to ***R.K. Hammer Investment Bankers***, a record $32 billion of receivables changed hands in 1998, compared with $11 billion in 1997 and $7 billion in 1996. In this Region, middle-tier players such as Chevy Chase Bank, PNC Bank, and Mellon Bank sold their portfolios last year, saying that they cannot be profitably competitive in such a scale-driven business line. At the same time, MBNA Bank and Chase Manhattan, among others, expanded their presence by purchasing portfolios.

The advantages of specialization in this highly competitive sector can be illustrated in the performance of credit card banks. The Region's credit card banks reported an aggregate ROA of 3.66 percent for the year ended 1998, compared with 0.94 percent for the Region as a whole. This is the highest ROA the credit card banks have reported in more than three years, despite a NIM that has not changed much over time. The improvement in ROA stems from a significant increase in noninterest income as a percentage of earnings assets, which rose to 17.47 percent as of December 31, 1998, from 9.35 percent three years ago. By comparison, noninterest income to earning assets averaged 3.24 percent for the rest of the Region's institutions. Credit card banks have been very aggressive in finding ways to increase fee income in order to offset the effects of various competitive pressures (such as teaser rates) on margins.

Credit card banks' high ROA comes despite charge-offs that have exceeded the peak levels seen during the last recession. While charge-offs in 1998 fell to 4.84 percent of total loans, almost 80 basis points lower than in 1997, past-due levels increased. In 1998, past-dues on credit card loans were 5.09 percent, slightly higher than a year earlier. High delinquencies suggest that charge-offs may not drop significantly in the coming quarters, as lower-quality loans migrate through the payment cycle.

'125' Home Equity Loans Increase in Popularity

In recent years, home equity loans have expanded beyond the traditional market to a hybrid product now commonly known as high LTV loans or "125s." These loans are typically second liens wherein the combined LTV ratio is 125 percent or more. They usually are offered to borrowers of high credit quality because collateral protection is limited; however, this is not always the case. (See ***"High Loan-to-Value Lending: A New Frontier in Home Equity Lending,"*** in ***Regional Outlook,*** First Quarter 1999, for more details on these loans.)

[15] Credit card banks are defined as banks with total loans equal to at least 50 percent of total assets and credit card loans of at least 50 percent of total loans.

[16] Managed receivables include on-balance-sheet credit card loans and securitized credit card loans. On-balance-sheet credit card loans in the Region were up about 5 percent from a year earlier, although nationally growth was flat.

[17] Based on Reports of Condition and Income for December 31, 1998.

More and more consumers are using home equity loans for debt consolidation. A survey by the ***Consumer Bankers Association*** found that 40 percent of borrowers used their home equity loans for debt consolidation in 1997. Americans borrowed $183 billion in home equity loans and lines of credit in 1986, roughly one-third of all consumer borrowing excluding mortgages, according to the ***Federal Reserve Board***. By 1997, that figure had jumped to $697 billion, or more than half of all consumer borrowing (excluding mortgages). Much of that growth can be attributed to lower mortgage interest rates and the relaxation of collateral requirements in the past decade, plus banks' aggressive marketing of such products. But many people who use home equity loans to consolidate debt may not be able to control their spending. According to a 1998 study by ***Brittain Associates***, 4.2 million American homes converted $26 billion of credit card debt into home equity debt from 1996 to 1998. Two-thirds of those surveyed charged their credit cards back up again in less than a year.

While this market segment has been served predominantly by nonbank lenders, some banks and thrifts in the Region have entered the high LTV market. The growth of 125s poses several risks to insured institutions. While there are limited data on the performance of high LTV loans, the loss potential is starting to become visible. Vintage analysis[18] shows that charge-off rates on high LTV loans are increasing at a rapid rate. Both the severity and frequency of default are much higher than for traditional "A"-quality home equity loans and are even higher than subprime home equity loans (loans to borrowers of weaker credit quality but with full collateral protection). These statistics raise questions regarding the actual credit quality of the borrowers and suggest that high LTV loans may result in increased risk of loss because of the lack of collateral protection. A recent ***Office of the Comptroller of the Currency*** survey[19] suggested that underwriting standards on home equity loans were easing. Further, because these loans have been in existence for only a few years, they have not been tested in a recession, and loss rates in an economic downturn are uncertain. ***Moody's Investor Service*** has suggested that loss rates should track unsecured consumer loans, such as credit cards, which are very susceptible to downturns in the economy.

Subprime Lending Also Increases

Just as high LTV lending is growing because of industry competition and consumer demand, a subprime market has emerged to cater to borrowers with less-than-stellar credit. "Subprime" refers to a borrower's characteristics, not a specific type of loan. Subprime borrowers usually have high debt-to-income levels, blemished credit histories, little or no equity in their homes, or a combination of these factors. The most common forms of subprime loans are mortgages, credit cards, debt consolidation loans (home equity loans), or automobile loans. While there is no centralized reporting of subprime lending, growth in the various sectors is rapid. ***Inside Mortgage Finance*** estimates that originations of subprime mortgages, for example, amounted to $150 billion in 1998, up from $125 billion in 1997.

As with high LTV borrowers, subprime borrowers have been served predominantly by nonbank lenders; however, some banks and thrifts in the Region have entered the subprime market, across various loan types. Subprime lending poses several risks to insured institutions. First, and perhaps most apparent, is the increased credit risk associated with lending to borrowers of weaker credit quality. Some lenders attempt to compensate for this risk by charging higher interest rates and more fees. Nonetheless, the success of risk-based pricing varies among institutions, and many pricing models have not been tested in an economic downturn. This may be especially relevant to the subprime credit card lenders, who have lower-quality borrowers and little or no collateral. Second is the intense competition in the market, which may lead to price competition and looser underwriting standards. Already, underwriting guidelines in the subprime market can differ substantially across originators, and seemingly minor differences can have a significant effect on the credit quality of the loans. For bank management and regulators, understanding the effect of subtle differences in underwriting standards, evaluating the management and control of exceptions to written guidelines, and gauging the effect of the changing competitive landscape are all critical to the understanding and evaluation of risk in the subprime market.[20]

The New York Region Staff

[18] Vintage analysis involves analyzing portfolios of loans made at different times by using the length of time the loans have been outstanding (seasoning) as a benchmark for comparison.

[19] "1998 Survey of Credit Underwriting Practices," Office of the Comptroller of the Currency, 1998.

[20] For more information, please refer to Financial Institution Letter 20-99, "Interagency Guidance on Subprime Lending," FFIEC, March 4, 1999. Also see OCC supplemental letter on subprime lending risk issues, dated April 5, 1999.

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