
◆ Regional Outlook ◆

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In Focus This Quarter

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

● **Indicators of Industry Performance**—The reported financial condition of insured banks and thrifts is strong. However, despite projected growth in earnings, bank and thrift stocks underperformed the broader market through October 1999. *See page 3.*

● **Economic Conditions**—The economy remains generally strong, and the outlook calls for continued growth. Growth is likely to slow, however, in order to correct financial imbalances that have developed as a result of a rapid creation of household and commercial credit and borrowing from abroad. There is a threat that the adjustment process could be a volatile one. *See page 4.*

● **Emerging Risks in Banking**—Rising indebtedness on the part of businesses and households raises concerns about future loan performance. Industry responses to intense competition have created greater credit, market, and operational risks. *See page 8.*

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

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

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

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

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

By the Analysis Branch Staff

Regional Perspectives

◆ **Economic and Banking Conditions**—The Region's employment and income levels continue to rise, and joblessness remains low. Wage and salary levels have been increasing faster than the rate of inflation, implying real gains for the Region's workforce. Banks and thrifts report healthy financial performance. Commercial banks in the Region have experienced modest growth in their commercial and industrial (C&I) lending portfolios in the past few years, although C&I loans account for substantially less of the banks' portfolios than in the late 1980s and early 1990s. Reported C&I loan asset quality indicators remain favorable, while aggregate past-due and charged-off C&I loan levels have risen since midyear 1997. *See page 18.*

◆ **New Bank Activity Occurs in Clusters**—Sixty new banks opened in the Region between June 30, 1996, and June 30, 1999. In fact, 1999 is shaping up to be a record year as 19 new banks opened in the first half of the year, compared with 21 for all of 1998. Pennsylvania and New Jersey have experienced the highest levels of new bank activity in the Region. Clusters of new bank formation seem to be associated with improving economic and demographic conditions as well as industry consolidation. *See page 21.*

◆ **Higher Interest Rates May Curtail the Region's Economic Expansion**—In 1994, higher interest rates slowed down the economy and reduced capital gains realizations in the subsequent year. It is uncertain, however, that if interest rates continue to rise, the Region's economy would react as it did in 1995. *See page 23.*

By the New York Region Staff

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Economic Conditions and Emerging Risks in Banking

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. Overall, conditions in the economy and banking industry are favorable at this time. However, signs point to vulnerability in the economy and in the banking industry that may make the years ahead much more challenging. Three broad themes emerge from this assessment:

- *Households' and businesses' debt levels are on the rise.* Spending by households and businesses is growing faster than cash income, resulting in rapidly increasing indebtedness. Consumer spending has been driven, in part, by large increases in the net worth associated with stock holdings and home equity. Businesses are restructuring and investing in new technologies to raise productivity and cut costs. Both consumer and business spending has been assisted by ready access to financing. Rising interest rates or slower economic growth could make debt service more difficult for borrowers.
- *Intense competition in banking is driving business strategies.* Competitive pressures have affected nearly every facet of the banking business. These pressures are evident in net interest margins, which have suffered from tighter loan pricing and higher funding costs. To maintain profits, some institutions are lending to less creditworthy borrowers, expanding into new or higher-yielding activities, creating more complex balance sheet structures, or cutting costs. These strategies may lead to greater credit, market, and operational risks.
- *The currently benign economic environment is vulnerable to rapid deterioration in the event of financial market instability.* During the 1990s, we have witnessed recurring, and perhaps more frequent, episodes of financial market turbulence. Recent episodes have arisen mainly overseas and have had little adverse effect on U.S. economic activity. However, the current economic expansion is closely tied to the ready availability of market-based financing for households and businesses and to wealth generated with the help of rising stock prices and falling interest rates. For this reason, the currently strong economic outlook may be subject to sudden deterioration in the event of market shocks that sharply raise interest rates or lower stock prices.

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

Indicators of Industry Performance

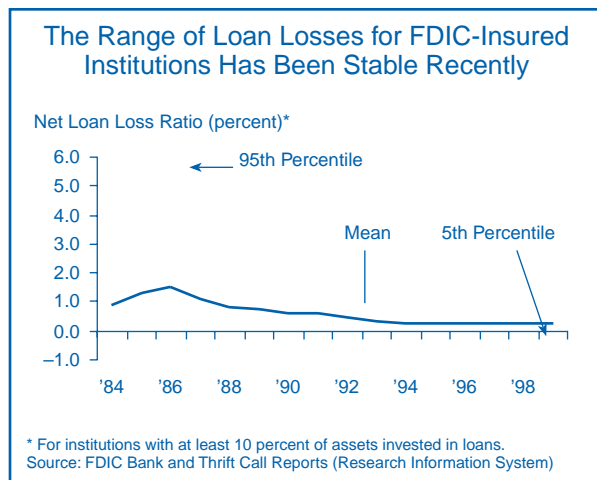
Industry Financial Performance Is Strong

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

and a decline in provision expense. However, the majority of the decline in net earnings resulted from a \$1.5 billion loss posted by one large bank.

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

CHART 1



Bank Stocks Underperform Despite Projected Earnings Growth

Analysts expect continued earnings growth for banks and thrifts in 1999 and 2000. Median growth in earn-

ings per share is projected to be 16.9 percent for publicly traded banks and 19.4 percent for publicly traded thrifts for 1999.¹ Ratings agencies also view the industry positively. The ratio of upgrades to downgrades for ratings issued by *Moody's Investors Service* improved in the second quarter, with nine companies receiving upgrades versus four receiving downgrades.

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

Economic Conditions

Overview

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

Commodity Industries Have Faced Pricing Pressures

One disadvantage of low inflation during this expansion has been that firms in certain commodity industries

have suffered from falling prices. Profit margins have declined in agriculture, mining, and some manufacturing sectors because of weak or negative revenue growth during 1997 and 1998.² Firms operating in these industries have aggressively cut costs to preserve profit margins. Nonetheless, profit growth has been flat or negative for a large proportion of *S&P 500* firms in the mining, textiles, chemicals, iron and steel, and oil and gas sectors since 1997. In response, some firms in these industries have chosen to consolidate through mergers. According to *Mergerstat*, the dollar volume of merger and acquisition transactions involving U.S. firms was a record \$1.2 trillion in 1998, more than 80 percent above 1997 levels.

Business Investment Is Outpacing Cash Flow

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

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

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

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

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

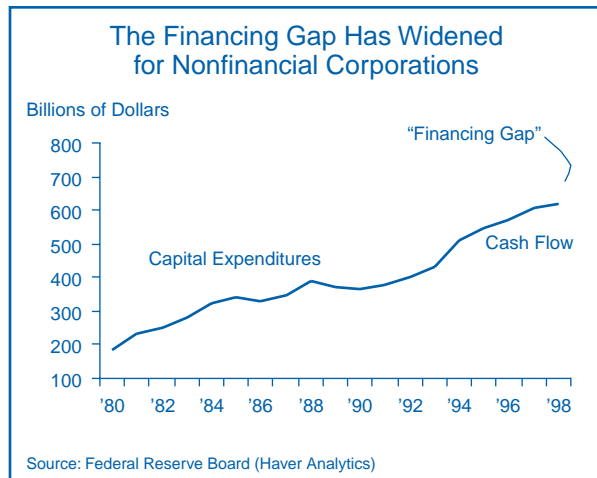
A widening financing gap and increasing debt levels could pose future problems if there are adverse changes in the financial environment. For example, a sharp rise in interest rates would increase the debt burden of businesses, hurt their profitability, and impair their creditworthiness. Under such a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

Consumer Spending Continues to Grow

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

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

CHART 2



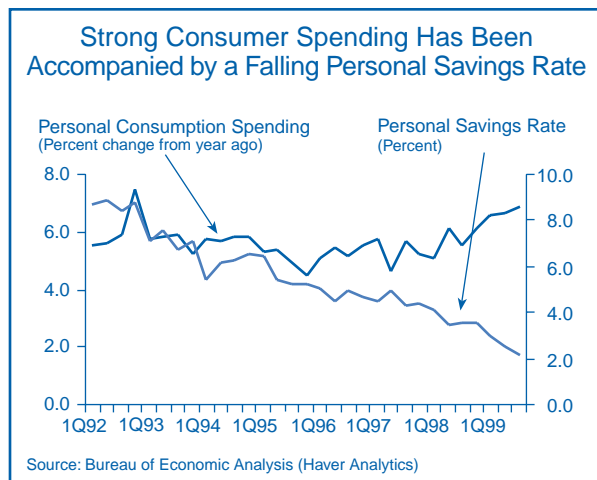
Rapid growth in consumer spending also warrants attention. Despite the highest rates of real income growth in nine years, consumer spending has grown more quickly than disposable personal income. The divergence in growth has resulted in a falling personal savings rate, which reached a record low in 1999.⁴ The recent decline in the personal savings rate continues a trend that has been under way for more than a decade (see Chart 3, next page).⁵

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

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

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

CHART 3



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

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

The Growing Private Deficit Raises Concerns

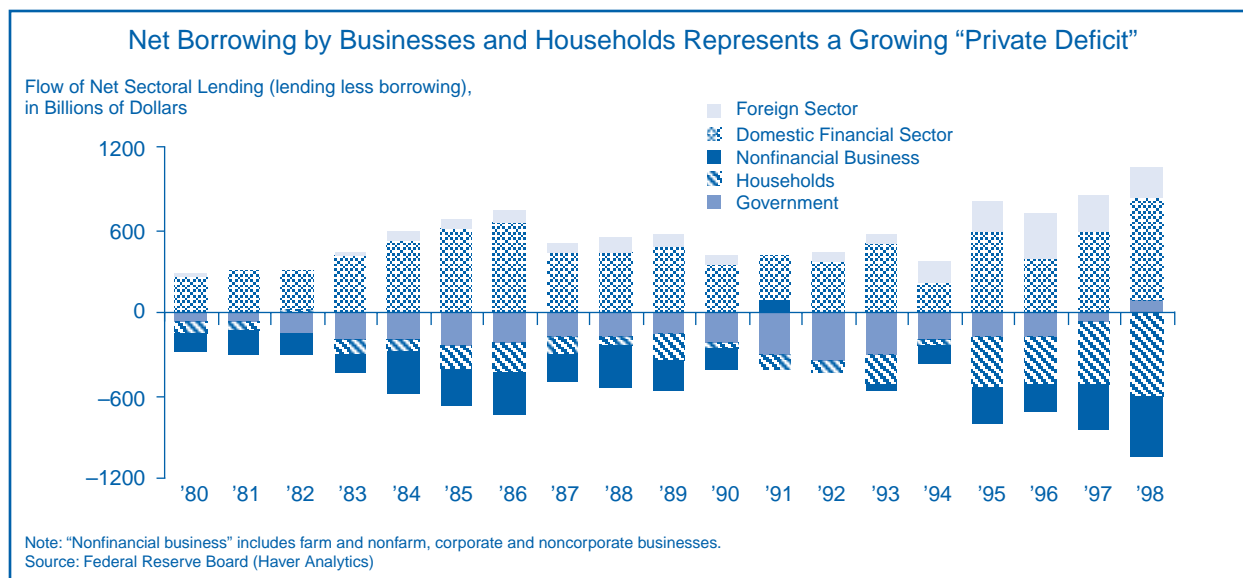
Taken together, the sum of annual net borrowing by businesses and households has been referred to as the “private deficit.” During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it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

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

Recovery Abroad Is Changing the Terms of Trade

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

CHART 4



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

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

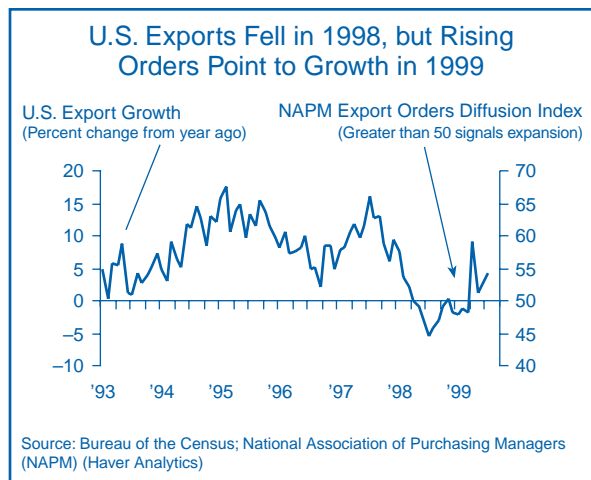
A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The *International Monetary Fund* estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent in 2000.⁶ Foreign investors, in anticipation of stronger growth and greater investment opportunities abroad, have started to convert excess dollar holdings to other currencies, including the yen and euro. This change in investment strategy has put downward pressure on the value of the dollar. Between July and September 1999, the dollar lost approximately 10 percent of its value against the yen.

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

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

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

CHART 5



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

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

The Economic Outlook Calls for Continued Growth

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

The *Blue Chip Economic Indicators* consensus outlook for the U.S. economy calls for a “soft landing.” Gross domestic product is projected to grow at a rate of 3.8 percent in 1999 with somewhat slower growth of 2.8 percent in 2000.⁷ Rising wage pressures, reflecting tight

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

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

Although the consensus forecast calls for continued expansion, an alternative scenario suggests the possibility of a steep decline in economic growth leading to a

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

Emerging Risks in Banking

Overview

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

Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured institutions are expanding into activities such as subprime consumer lending, high loan-to-value mortgage lending, and lending with minimal or no documentation requirements. Rapid growth in syndicated lending to leveraged companies also indicates that large commercial lenders have increased their tolerance for risk. Competition has made funding with deposits more difficult. As a result, some

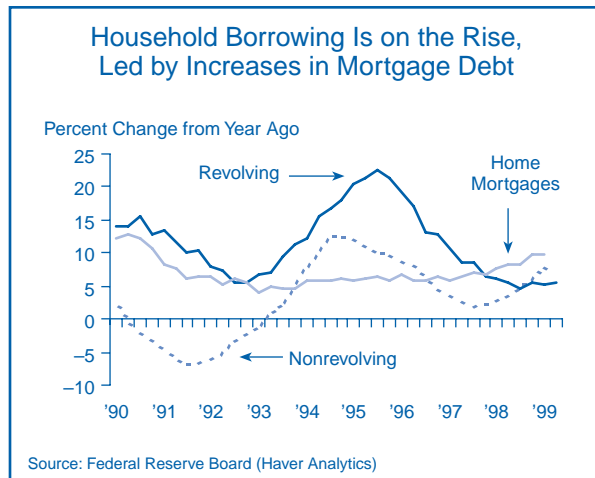
institutions are relying increasingly on securitizations and more expensive, market-based sources of funds, which can alter an institution's liquidity position, interest rate risk profile, and operational needs. Institutions have also responded to competitive pressures by cutting costs or merging in an attempt to achieve greater efficiencies. In some cases, deep reductions in operating costs support profits at the expense of less effective operational controls.

Consumer Lending

Household Borrowing Is on the Rise

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

CHART 6



A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

A key component of the recent shift by consumers from credit card debt to mortgage debt has been a surge in mortgage refinancing in 1998 and early 1999. The ***Mortgage Bankers Association's Refinancing Index*** peaked at over 4,300 in October 1998, compared with an average monthly index value of 527 during 1997.⁸

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

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

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

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

tions about whether consumers again will increase their use of credit cards to finance purchases. If so, there may be negative consequences for future consumer debt service burdens and consumer credit quality.

Credit Card Lenders Face Declining Returns

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

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

Shrinking margins have also prompted consolidation in the credit card industry. Today, the top five issuers control about 60 percent of the total managed assets in the credit card sector, up from just 35 percent in 1990.¹² Amid this changing competitive landscape, credit quality has improved. Credit card charge-off levels at insured commercial banks hit an all-time high of 5.5 percent in the third quarter of 1997 but have declined steadily to a level of 4.1 percent in the second quarter of 1999. This decline has been attributed to tighter underwriting standards, more aggressive collection efforts, and extra household cash flow generated through mortgage refinancings.



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

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

Subprime Lenders Have Riskier Characteristics than the Industry

Subprime lending to consumers has grown dramatically in recent years. Subprime mortgage originations have grown from 5 percent of the total mortgage market in 1994 to 15 percent in 1997.¹³ The percentage of originations fell somewhat in 1998 to 10 percent—not because the volume of subprime mortgage originations fell but because the volume of prime mortgage originations was at a record high. In fact, in terms of dollars, subprime originations grew by 20 percent from 1997 to 1998, to \$150 billion. That figure is up significantly from the \$35 billion in subprime originations in 1994. Estimates of the size of the subprime automobile loan market vary somewhere between \$50 billion and \$75 billion, but one source estimates that subprime automobile originations jumped from about 8 percent of all automobile loan originations in 1990 to over 18 percent in 1998.¹⁴ Analysts also have indicated that the subprime credit card market is the fastest-growing segment of credit card lending today. According to **RAM Research**, subprime receivables are growing 45 percent annually, compared with 16 percent or less for other segments of credit card lending.¹⁵



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

will overtake finance companies as leaders in the subprime industry.

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

- *Subprime borrowers are more likely to default than prime borrowers and may be more vulnerable to economic shocks, such as a recession.* Borrowers' previous credit problems suggest that they have limited financial resources to withstand economic difficulties.
- *Credit-scoring and pricing models used to underwrite subprime loans are untested in a recession.* Analysts have noted that credit-scoring models are less effective in predicting the likelihood of default for subprime borrowers than they are for prime borrowers.
- *Operational risks are greater in subprime lending.* Because defaults occur sooner and more often than in prime lending, subprime portfolios require a greater investment in servicing and collections resources. Subprime lenders run a greater risk that these resources could become severely strained if the level of defaults is not correctly anticipated.
- *Liquidity risks are greater in subprime lending.* Some large-volume subprime lenders heavily depend on the ability to securitize and sell loans to the secondary market. But investor demand for paper backed by subprime loans may be volatile, as was demonstrated during the financial market turmoil of late 1998. A number of nonbank subprime lenders experienced a liquidity crunch as a result of that market turmoil, and several opted for—or were forced into—bankruptcy.¹⁶
- *Reputation, legal, and compliance risks also are important for subprime lenders.* Subprime lenders generally run a greater risk of violating, or being accused of violating, consumer protection laws or regulations. The public perception of subprime

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

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

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

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

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

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

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

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

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

Slower profit growth and rising corporate bond defaults also point toward somewhat weaker business credit

quality. While corporate profits grew by an average of 15 percent per year between 1993 and 1996, economists polled by *Blue Chip Economic Indicators* project growth of 6.7 percent for all of 1999, followed by growth of only 3.5 percent in 2000.¹⁹ *Standard & Poor's* reported that 55 rated issuers defaulted on \$20.5 billion in debt during the first six months of 1999.²⁰ This pace of defaults is already nearly double levels experienced in the first half of 1998 and does not include more recent large defaults such as Iridium and Daewoo Group. Approximately 85 percent of the defaults that occurred during the first half of 1999 were among speculative-grade issuers. According to *Moody's*, junk bond defaults rose to 5.8 percent of issues outstanding during the 12 months ending in September 1999, the highest level since 1991.

Rising Losses May Be Attributable to Loose Underwriting

Analysts attribute the recent deterioration in commercial credit quality to weak underwriting standards in the corporate debt markets during 1997 and early 1998.²¹ Bank underwriting was reported to be particularly accommodating at that time. The *Federal Reserve Board* reported in its May 1998 *Senior Loan Officer Opinion Survey on Bank Lending Practices* that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." Subsequently, the November 1998 *Survey* reported a "broad tightening of business lending practices" associated with the financial market turmoil in progress at that time. However, regulators have continued to express concern about the assumptions underlying bank lending decisions. A Supervision and Regulation Letter sent by the *Federal Reserve Board of Governors* to its examiners in September 1999 noted the recent tightening of standards, but stated that "certain deeper issues remain," which relate mainly to overoptimistic assumptions about the future repayment capacity of business borrowers.²²

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

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

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

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

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

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

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

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

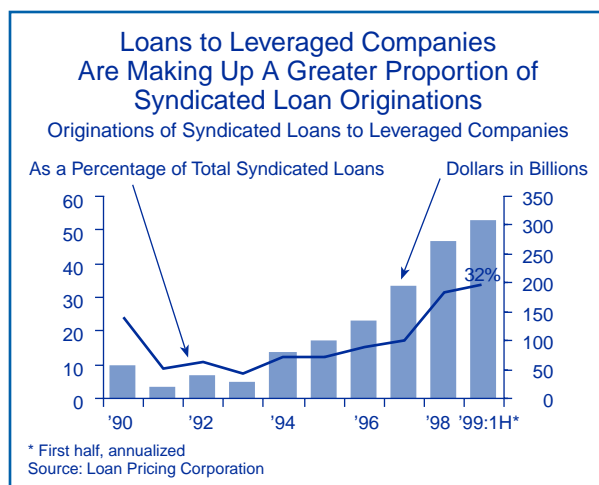
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.²⁵ While bank syndicators pass a large volume of these loans along to nonbank investors, a

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

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

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

CHART 7



substantial portion of these credits remains on bank balance sheets. *Loan Pricing Corporation* has reported that as much as 64 percent of the value of “highly leveraged” loans originated in the first half of 1999 was retained by banks.²⁶

Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

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

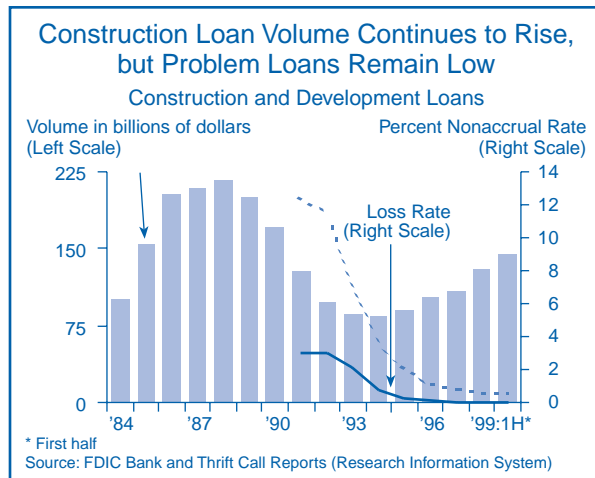
Office Vacancy Rates Are Rising in Many Top Markets

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

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

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

CHART 8



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

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

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

The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.²⁹ Results indicated that competition was generally driving pricing margins down to very low levels, particularly

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

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

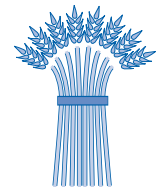
compared with the 1980s. In some instances, lenders have responded to competitive pressures by making structural concessions on loan-to-value, cash equity, and recourse terms, particularly for large borrowers. However, underwriting standards generally have not been as aggressive as practices observed in the 1980s.

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

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

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



Farm Banks Continue to Perform Well Overall

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

³⁰ “World Agricultural Supply and Demand Estimates,” USDA, October 10, 1999.

³¹ “Potential Impacts of an Agricultural Aid Package,” *Agricultural Outlook*, USDA, September 1999.

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

1999.³³ Loan loss reserves, which stood at 1.58 percent of total loans in June, remain high compared to historical levels. Loan performance at farm banks also appears to be strong at this time. Total past-due loans made up just 2.66 percent of total loans at farm banks in June, a level that is only 9 basis points higher than a year ago. Moreover, this increase in past-due loans is attributable entirely to nonagricultural loans; the level of past-due farm loans has not risen over the past 12 months. At the same time, higher-than-average nonperforming loan levels have been reported by farm banks in the upper Midwest and the South.

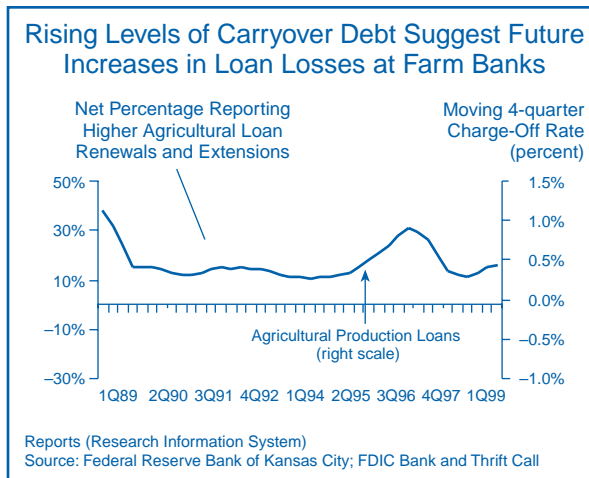
There are reasons to believe, however, that it will take time for financial distress among farm producers to significantly affect loan performance at farm banks. One such reason is the increasing use of carryover debt to restructure and extend operating loans that cannot be fully retired by borrowers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

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

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

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

CHART 9



Funding and Interest Rate Risk

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

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

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

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

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

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

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

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

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

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

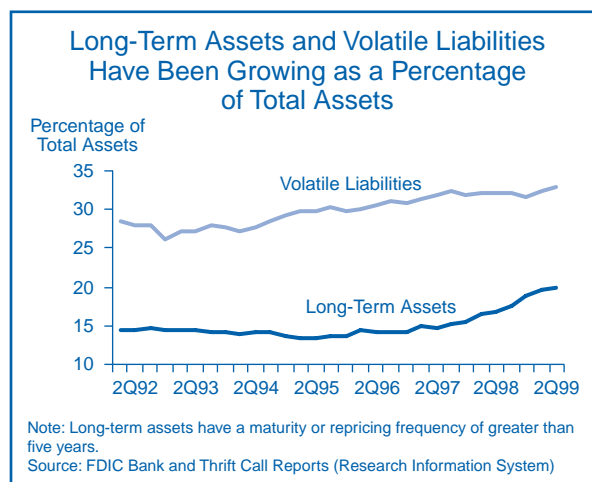
volatile and can lead to unstable earnings and capital if not properly controlled and administered.

Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

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

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

CHART 10



Operational Risks

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

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

Implications

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

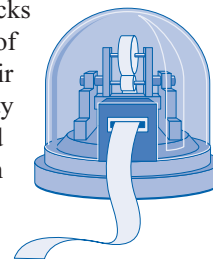
One issue raised by this report is rising indebtedness on the part of households and businesses, which represents a growing private deficit. Rising interest rates could

⁴⁰ “Operational Risk Management,” Basle Committee on Banking Supervision, September 1998 (<http://www.bis.org/publ/bcbs42.pdf>).

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

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

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



In Focus This Quarter

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Regional Perspectives

- The Region's economy continues to expand. Employment levels and salaries are rising, and office vacancy rates are tightening, particularly in New York City, Washington, D.C., and Wilmington, Delaware.
- Commercial and industrial loan concentrations are increasing slightly in the Region. Past-due and charge-off levels also are rising. Large banks are more aggressively pursuing the small-business lending market.
- The Region has experienced a significant increase in new bank charters, particularly in parts of New Jersey and eastern Pennsylvania.
- Higher interest rates, which have curtailed growth in the Region's economy in the past, could slow the Region's economy in the future.

Economic and Banking Conditions

Economic Indicators Remain Positive

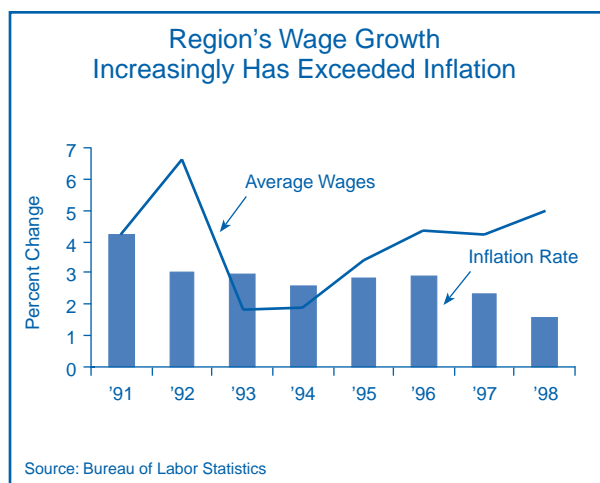
With the nation's economy enjoying its longest peacetime expansion on record, the Region's economy continues to strengthen. Employment levels and incomes continue to rise, and joblessness remains low. In the second quarter of 1999, the Region's employment level rose by 305,000 jobs or 1.4 percent. By contrast, employment levels in the nation rose 2.2 percent, reflecting faster rates of economic expansion in parts of the South and West. Personal income levels in the Region are forecast¹ to rise between 4 and 5 percent in 1999, more than twice the current 2.1 percent inflation rate. Wage and salary levels in the Region have been rising faster than the rate of inflation since 1995 (see Chart 1), implying real gains for the Region's workforce. Although unemployment rates in some states are somewhat higher than the second-quarter U.S. average of 4.3 percent, they are still the lowest in more than a decade and reflect the strong gains in new job formation. Unemployment rates also have been falling in **Puerto Rico**, which still has a comparatively high unemployment rate of about 11 percent.

Office Markets Tighten, with Some Exceptions

The Region's real estate markets continue to benefit from the healthy economy. Office market vacancy rates

in many of the Region's largest cities continue to tighten and are at their lowest levels in the 1990s. In midtown **New York City**, for example, office vacancy rates in 1999 dropped below 5 percent, and rentals in many buildings exceeded \$50 per square foot. Rents have been pushed higher, in part because of the relative lack of new office construction over the past decade. In **Wilmington, Delaware**, demand for office space from a thriving financial services sector has driven vacancy rates below 5 percent. In the **Washington, D.C.**, area, office vacancy rates also are close to 5 percent. Although the government workforce and government spending dominate, an influx of high-tech industries has helped tighten vacancy rates around the nation's capital.

CHART 1



¹ Forecast by **Regional Financial Associates**. Rate of inflation is measured by year-to-year percent change in the U.S. consumer price index during the second quarter of 1999.

New office building construction has been reported in the **Albany, New York, and northern and central New Jersey** office markets.² In the Albany area, new demand for office space resulted in a 22 percent increase in commercial building contracts during the first half of 1999 compared with the same period in 1998. The Albany area economy, although continuing to lag behind the Region's overall economic growth rate, finally appears to be benefiting from the healthier economic climate. The northern and central New Jersey markets, particularly along the Hudson River, are reaping benefits from the strong New York City economy. With rents ranging between \$22 and \$26 per square foot, office space can be one-half the cost of midtown Manhattan, which has attracted tenants unwilling or unable to pay the steep Manhattan prices. Approximately 3.8 million square feet of new office space is under construction in these New Jersey markets, some of it speculative. Some companies, however, have been consolidating their operations, thereby freeing up space that is competing with new buildings. This combination has pushed office vacancy rates above 10 percent. The increase is most pronounced in the I-78 corridor in **Somerset County**, where vacancy rates exceed 18 percent. In some local townships, office vacancy rates top 30 percent, reflecting new, unfilled construction. Most real estate observers, however, believe that the buildup of space is temporary and the space should be filled if the economy continues to grow. Nevertheless, there is potential for overbuilding of office space in these markets.

Despite signs of increased construction of office space in some markets, commercial real estate (CRE) loans in the Region's financial institutions have risen only slightly in the past year and are still below the levels reached in the late 1980s. In addition, asset quality indicators for CRE loans reported by the Region's banks remain strong.

Banks Report Healthy Performance, although Savings Institutions Lag

The Region's banks and thrifts reported generally healthy financial conditions in the second quarter of 1999. The Region's average return on assets (ROA) was

² For Albany, see "Construction on the Rise in the Region," *Albany Times Union*, July 30, 1999. For New Jersey, see "Office Space for Sublet Jumps as Companies Revamp," *New York Times*, July 4, 1999, and "Building Boom at Carnegie Center," *Trenton Times*, August 19, 1999.

0.89 percent, compared with 1.03 percent in the second quarter of 1998. The average net interest margin (NIM) declined to 3.89 percent in the second quarter, compared with 4.07 percent a year earlier and 4.20 percent two years earlier. The average reported leverage capital ratio remained strong, rising a solid 127 basis points over the second quarter 1998 figure. This figure is somewhat distorted by the influx of new banks, which have very high capital ratios in the beginning until assets begin to build. Aggregate past-due ratios continued to decline, down 20 basis points from a year earlier, to 2.27 percent. The decline reflects improvement in almost all loan categories, with the exception of commercial and industrial loans, which experienced a modest rise in past-due levels. Past-dues on credit card loans were stable, while credit card charge-offs were 3.46 percent in the second quarter of 1999, significantly lower than the near 5.0 percent level reported during much of the past three years.

Savings institutions (savings banks and savings and loan associations), which make up 38 percent of the Region's financial institutions (and 13 percent of assets), continued to report lower average ROA numbers than commercial banks did. In the second quarter of 1999, savings institutions reported an average ROA of 0.75 percent, compared with 0.97 percent for commercial banks. Savings institutions' profitability levels are lower than their commercial bank counterparts as reflected in lower NIMs; the group's average NIM of 3.31 percent was 95 basis points lower than the commercial banks' average. Although banks have faced narrowing interest margins in the past few years because of intense industry competition and a flat yield curve environment, savings institutions continue to rely heavily on low-yielding residential mortgages, resulting in a weaker bottom line. Savings institutions reported 40 percent of assets in residential mortgages on June 30, 1999, compared with about 10 percent for commercial banks. Savings institutions also reported less noninterest revenue to bolster the bottom line (median noninterest income to earning assets was 0.30 percent compared with the commercial banks' 0.68 percent). These factors contributed to savings institutions' weaker earnings performance. For more information on the challenges facing savings banks, please see "Savings Institutions Underperform Commercial Banks" in the New York Region's ***Regional Outlook***, Second Quarter 1999.



Commercial and Industrial Lending Grows Slightly

Commercial banks in the New York Region have experienced modest growth in their commercial and industrial (C&I) lending portfolios in the past few years, although C&I loans account for substantially less of the banks' portfolios than in the late 1980s and early 1990s. C&I loans made up 17.9 percent of total loans and 9.7 percent of total assets on June 30, 1999, compared with 16.4 percent and 9.0 percent as of June 30, 1995, this decade's low point. These loan portfolio concentrations have been increasing steadily over the past four years, even though the total loans-to-assets ratio has declined in the past two years.

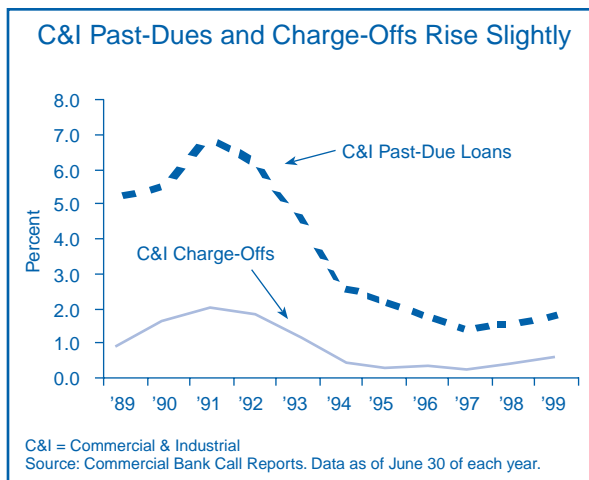
Small-business lending (C&I loans under \$1 million), traditionally the main niche of smaller financial institutions, is becoming particularly competitive. Larger institutions are becoming more aggressive in marketing products to small businesses. The Region's banks with assets over \$1 billion have increased small-business loans from 5.2 percent of total loans on June 30, 1995, to 6.5 percent on June 30, 1999. In contrast, community banks (institutions with less than \$1 billion in assets) have experienced relatively little growth in this type of lending, even though they traditionally have been more active, holding 12.4 percent of total loans in small-business credits.

Although reported C&I loan asset quality indicators remain favorable, aggregate past-due and charged-off C&I loan levels have risen since midyear 1997 (see Chart 2). The slightly weaker credit quality is influenced in part by rising past-dues at the Region's larger institutions. Community banks' aggregate past-due ratios are significantly higher but have been falling steadily for seven years. Community institutions also have higher charge-off ratios; as of June 30, 1999, the C&I charge-off ratio was 43 basis points higher than large banks. These differences have been consistent in the Region for several years.

Recent regulatory agency underwriting surveys³ report findings consistent with current favorable asset quality

³ The August 1999 Federal Reserve *Senior Loan Officer Opinion Survey on Bank Lending Practices* and the FDIC *Report on Underwriting Practices* for the period October 1998 through March 1999.

CHART 2



indicators, but note some concern in the event of an economic downturn. These surveys suggest that commercial and industrial loan underwriting standards have remained fairly stable since late 1998. Interestingly, one-third of banks surveyed recently by the **Federal Reserve Board (FRB)** stated that *their commercial and industrial loan portfolios have become more sensitive to periods of economic weakness*. This sensitivity was most often attributed to borrowers' increased financial leverage, borrowers' narrowing profit margins, and some previous easing of credit standards.

Competition for business loans is intensifying at a time when some potential weaknesses are emerging. Despite the strong economy, business bankruptcies rose 13 percent between the first and second quarters of 1999, the first increase since the second quarter of 1997. Further, there is some concern that the increase in nonperforming C&I loans results in part from looser underwriting standards because of competitive pressures. Corporate defaults also are on the rise. One **Standard and Poor's** analyst stated that he believes the rising default rate "is the result of credit-quality problems built into...loans from their inception."⁴ Any weaknesses in underwriting could become more evident if the economy falters, thereby affecting corporate profits, or if demand for corporate loans in the secondary market dissipates, which could make refinancing more difficult or more expensive.

⁴ Leo Brand, Structured Finance Analyst, Standard and Poor's, in *American Banker*, August 19, 1999.

New Bank Activity Occurs in Clusters

Consistent with national trends, the New York Region has experienced an increase in new bank activity over the past three years. Sixty banks opened in the New York Region between June 30, 1996, and June 30, 1999. In fact, 1999 is shaping up to be a record year—19 banks opened in the first half of the year, compared with 21 banks in all of 1998. Also, 16 additional new bank applications were approved in the first six months of 1999, but these institutions have not yet opened. Over 6 percent of the Region’s banks have been open for less than three years.

What is contributing to the growth in the number of new bank charters? Local economic and demographic factors, particularly in New Jersey and **Pennsylvania**, appear to be tied to clusters of new bank formation. Another key factor could be the ongoing industry consolidation (see Table 1). With the enactment in 1994 of the Riegle-Neal Interstate Banking and Branching Efficiency Act, barriers to interstate banking all but disappeared. As a result, expansion across state lines through mergers increased significantly. The number of banks and thrifts in the nation declined by almost 12 percent from June 1996 through June 1999. Consolidation in the Region occurred at about the same rate. Over the same period, the number of established banks (those chartered before June 30, 1996) fell by 17 percent in the nation and the Region.

Consolidation often results in workforce reductions as merged institutions combine operations; displaced

banking talent then begins to look for new opportunities, which may include chartering a new bank. In addition, as larger banks acquire neighborhood institutions, there may be a real or perceived loss of community involvement or gaps in service. The **acquisition of neighborhood institutions** may create potential niche opportunities in market segments underserved by larger banks.⁵

Record profitability of existing institutions over the past six years also has contributed to the increase in number of new bank charters. After the banking crises of the late 1980s and early 1990s, the industry began to recover. Industry profits have risen each year since 1993. Potential new bank investors, monitoring the industry’s record profits, may feel more secure that they, too, can profit from their investment. The number of new bank charters increased slightly beginning in the mid-1990s but surged in 1997 after a couple of years of improved profits reported by the industry, and has accelerated since that time. The strong economy also has played a role in the increase in the number of new bank charters as a strong and expanding economy is more attractive to entrants than a stagnating one.

⁵ However, a recent **FDIC Division of Research and Statistics** study that examined de novo activity between 1995 and 1997 concluded that industry consolidation was not positively correlated with new bank formation. Nonetheless, anecdotal evidence in the Region suggests that consolidations have contributed to recent new bank formation in some local areas.

TABLE 1

AS INDUSTRY CONSOLIDATES, NEW BANKS OPEN						
	NUMBER OF BANKS AS OF		DECLINE IN NUMBER OF BANKS (%)	NUMBER OF NEW BANKS*	NEW BANKS TO TOTAL BANKS (%)	DECLINE IN NUMBER OF BANKS EXCL. NEW BANKS
	6/30/96	6/30/99				
NATION	11,670	10,327	-11.5	618	6.0	-16.8
NEW YORK REGION	1,015	900	-11.3	60	6.7	-17.2
PENNSYLVANIA	337	310	-8.0	16	5.2	-12.8
NEW JERSEY	168	145	-13.7	21	14.5	-26.2
REST OF NY REGION**	510	445	-12.7	23	5.2	-17.3

* NEW BANKS ARE DEFINED AS BANKS THAT OPENED BETWEEN JUNE 30, 1996, AND JUNE 30, 1999.
 ** DELAWARE, DISTRICT OF COLUMBIA, MARYLAND, NEW YORK, PUERTO RICO, AND THE VIRGIN ISLANDS.
 SOURCE: BANK AND THRIFT CALL REPORTS, RESEARCH INFORMATION SYSTEM

Pennsylvania and New Jersey *See the Most Activity*

Pennsylvania and New Jersey have experienced the highest levels of new bank activity in the Region. New banks in Pennsylvania are clustered primarily in the **Philadelphia** metropolitan area (see Map 1). Although the Philadelphia economy has lagged the rest of the state, the surrounding counties have experienced strong economic growth in the past few years. These counties have benefited from new business formation and job expansion in technology-related industries and business services. The strong employment gains have driven unemployment rates down to the lowest point in the decade, and, in many cases, even lower than the national average. Increased business demand for space also has pushed down office vacancy rates. Philadelphia is home to three new banks, despite the city's relative economic weaknesses. With considerable merger activity occurring in Philadelphia during the past few years, comparatively few banks remain headquartered in the city, which may encourage new entrants.

In addition, Pennsylvania counties with multiple bank openings in the past five years⁶ have per capita income rates at or above the state's average, except for Philadelphia County. These counties also tend to have lower unemployment rates than both the state and the nation. Another measure of opportunity relates to market concentration, which is defined as personal income per branch by county.⁷ The five Pennsylvania counties with multiple bank openings report an average personal-income-to-branch figure of \$82,740, significantly higher than the state's median of \$49,790, and perhaps an indication that these counties may be fertile ground for new banks.

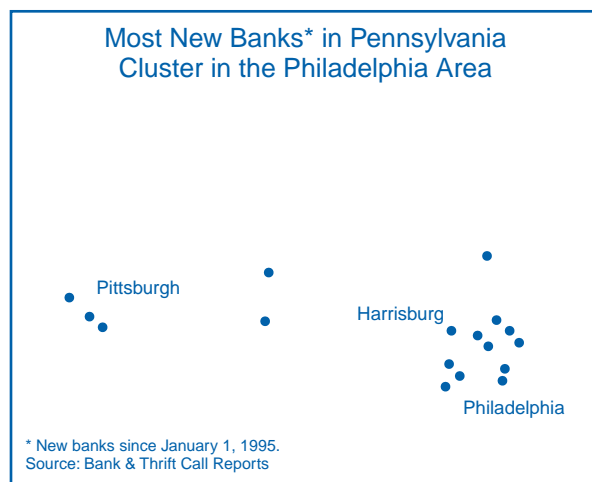
New bank formation in New Jersey is most evident in the central part of the state (see Map 2). Central New Jersey has benefited from a growing state economy and economic spillover from a vibrant New York City economy. The growing numbers of commuters who work in New York City but live in central New Jersey are responsible in part for a strong housing market and

growth in service and retail businesses. In addition, new commercial real estate construction has begun in response to the demand of new or relocating businesses, which find central New Jersey a reasonably priced alternative to Manhattan.

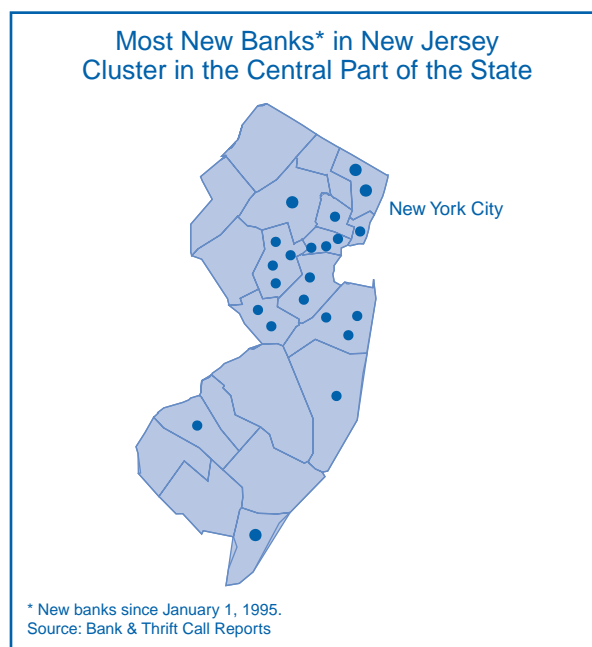
As with Pennsylvania, five counties in New Jersey⁸ have experienced multiple new bank charters over the past five years. Again, the per capita income level for these counties is at or above the state's average. Unemploy-

⁸ The counties are Mercer, Middlesex, Monmouth, Somerset, and Union. Data are from January 1, 1995, through June 30, 1999.

MAP 1



MAP 2



⁶ The counties are Allegheny, Bucks, Chester, Montgomery, and Philadelphia. Data are from January 1, 1995, through June 30, 1999. A county is said to have multiple bank openings if more than one new bank established headquarters there over that period.

⁷ Personal income data are from the Bureau of Economic Analysis as of December 31, 1995. Branch data are from the Federal Deposit Insurance Corporation/Office of Thrift Supervision Summary of Deposits as of June 30, 1996. The measure is county personal income divided by the number of branches in the county.

ment rates for these counties also favorably compare with the state average—four of them are below the average, and one is at the average. The counties also report an average personal income-to-branch figure of

\$90,975, compared with the state's median of \$79,320. This difference, again, may indicate that the counties may be attractive sites for new banks compared with other counties in the state.

Higher Interest Rates May Curtail the Region's Economic Expansion

Between October 1998 and August 1999, yields on short- and long-term U.S. Treasury securities began to rise. During this period, yields on Treasury securities increased by about 100 basis points, while the yield on the 10-year Treasury bond rose by about 140 basis points. In addition, the FRB raised the Federal Funds rate last summer by 50 basis points, to 5.25 percent. The FRB cited tightening labor markets, the threat of inflation, and a strong national economy as the rationale for the increase. Some analysts believe that left unchecked, continued strong demand for goods and services could eventually push up wages, which could result in renewed inflation and increased interest rates.

A study by the **Federal Reserve Bank of Philadelphia** stated that rising interest rates historically have had a dampening effect on the national economy. The study found that a 1 percent increase in the Federal Funds rate reduced personal income growth in the nation about 1.2 percent.⁹ Rising interest rates have similarly affected the Region's economic growth. In 1994, the Federal Funds rate doubled from 3 to 6 percent over the course of the year, hindering the Region's economic growth the following year. The Region's combined gross state product fell from 3 percent growth in 1994 to 1.3 percent growth in 1995 (see Chart 3). The relative effect on the nation was less with the gross domestic product dropping 1.2 percentage points to 2.3 percent in 1995. As interest rates gradually eased in 1995, the Region's economic growth started rebounding in 1996.

Higher interest rates in 1994 did not negatively affect the performance of the Region's financial institutions that year or in 1995. Perhaps because the higher rates led to a slowdown in economic growth but not a recession, the Region's banks reported an average ROA in 1995 near 1994 levels. Average leverage capital ratios rose slightly, and nonperforming and charge-off levels remained low. Further, loan demand did not appear to be slackening, according to merger-adjusted statistics.

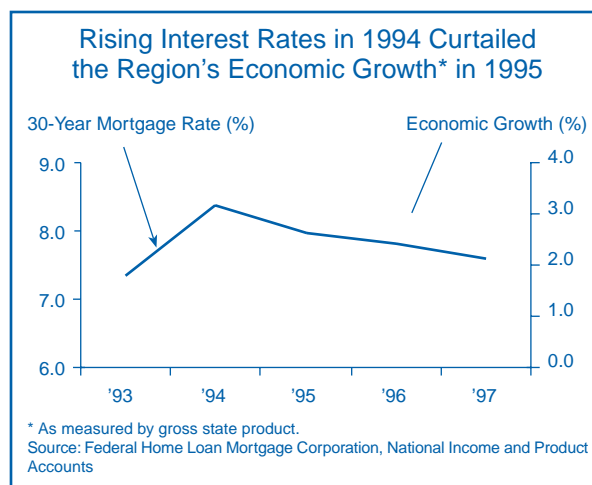
⁹ *Business Review*, Federal Reserve Bank of Philadelphia, July–August 1999.

Higher Interest Rates Curtailed Housing Activity and Capital Gains

Higher interest rates in 1994, however, dampened growth in the Region's housing industry. With mortgage rates exceeding 9 percent near the end of 1994, compared with a low of 6.8 percent the previous year, permits for single-family homes dropped 13 percent in 1995 and did not recover fully until 1998. In addition, the volume of existing home sales declined across the Region, and home prices in many parts of the Region fell or showed little increase.

The stock market also was negatively affected by higher interest rates. The S&P 500 Index rose only 1.3 percent in 1994. The slowdown in stock price appreciation reduced capital gains realizations in the Region by over 9 percent. Elsewhere in the country, realizations dropped by about 3 percent (see Chart 4, next page). When interest rates began to ease and the stock market recovered in 1995, realizations in the Region rose almost 24 percent compared with 21 percent in the rest of the nation. The higher volatility of capital gains in the Region underscores the stronger link between the stock market and the Region's economy relative to the rest of the nation. Also, more households in the Region own

CHART 3

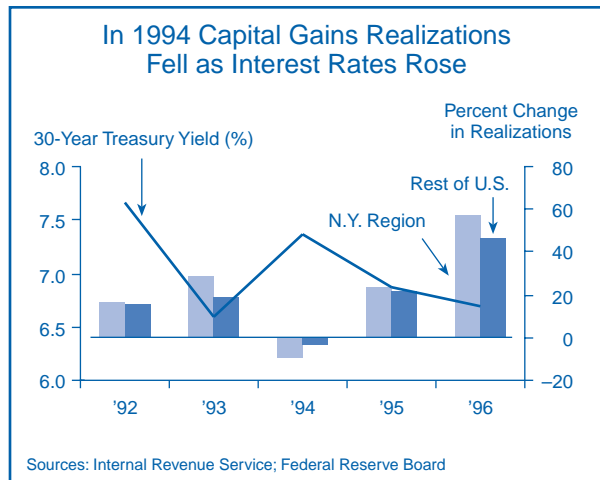


stocks and mutual funds now than before, suggesting that the effect of a decline in the stock market on the Region's economy could be more significant than earlier in the decade.

With inflation still appearing benign, it is unclear if interest rates will rise further this year and, if so, how much. Perhaps more important, it is uncertain whether, if interest rates rise, the Region's economy would react as it did in 1995.

The New York Region Staff

CHART 4



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