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

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

Emerging Risks in Banking

Overview

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

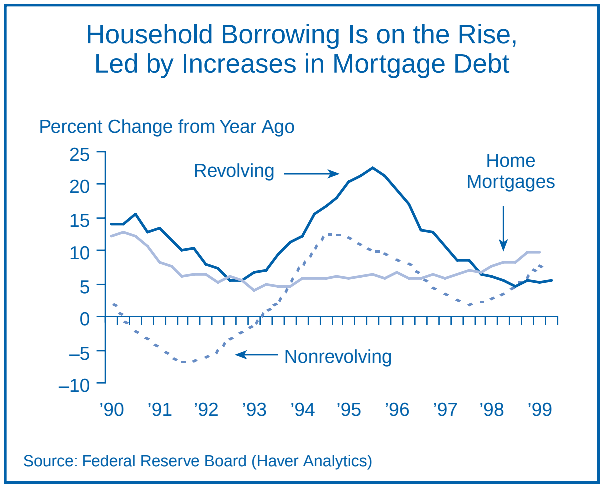
Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured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

Consumer Lending

Household Borrowing Is on the Rise

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

CHART 6



A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

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

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

Credit Card Lenders Face Declining Returns

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

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

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

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

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

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

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

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

Subprime Lenders Have Riskier Characteristics than the Industry

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

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

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

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

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

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

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

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

[13] ***The Mortgage Market Statistical Annual for 1999,*** Inside Mortgage Finance Publications, 1999.
[14] Ron Feldman, ***An Introduction to Subprime Auto Lending for Examiners,*** Federal Reserve Bank of Minneapolis, April 1998, and data supplied by CNW Marketing and Research.
[15] Lisa Fickenscher, "Credit Card Issuers Panning for Gold Among Tarnished Credit Histories," *American Banker,* October 22, 1998.
[16] Dominic DiNapoli and Ron Greenspan, "The Next Industry Crisis Could Be Even Bigger," *American Banker,* June 15, 1999.

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

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

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

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

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

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

Rising Losses May Be Attributable to Loose Underwriting

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

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

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

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

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

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

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

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

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

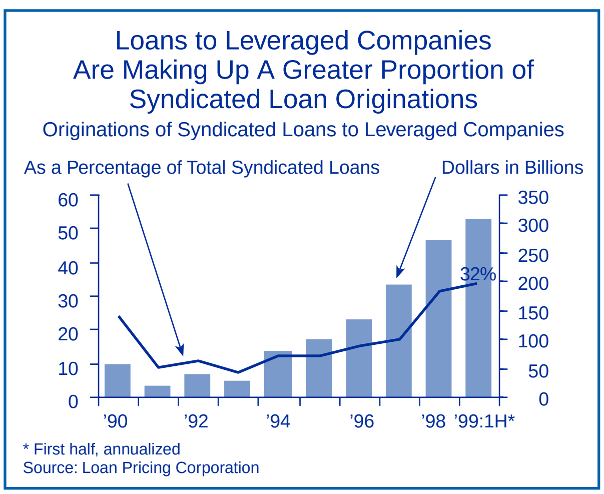
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank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

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

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

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

CHART 7



Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

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

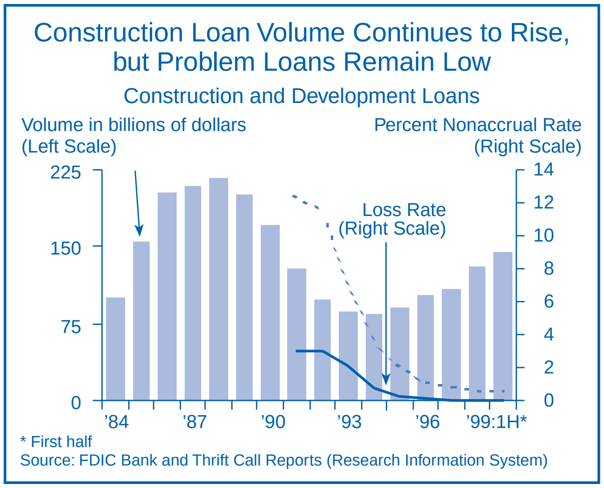
Office Vacancy Rates Are Rising in Many Top Markets

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

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

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

CHART 8



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

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

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

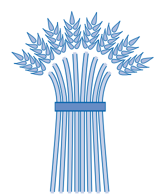
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to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

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

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

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



Farm Banks Continue to Perform Well Overall

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

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

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

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

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

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

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

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

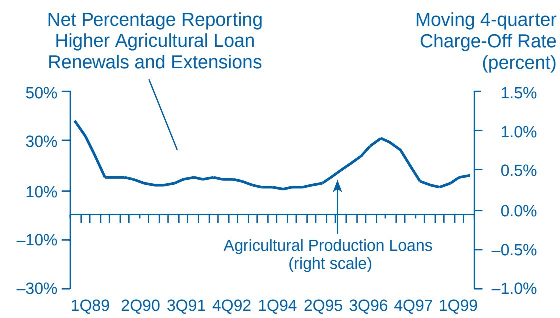
[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported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

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

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

Chart 9

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



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

Funding and Interest Rate Risk

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

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

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

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

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

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

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

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

[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.

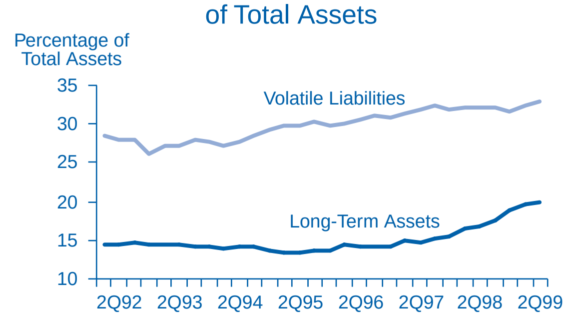
Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

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

Long-Term Assets and Volatile Liabilities Have Been Growing as a Percentage of Total Assets



Note: Long-term assets have a maturity or repricing frequency of greater than five years.
Source: FDIC Bank and Thrift Call Reports (Research Information System)

Operational Risks

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

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

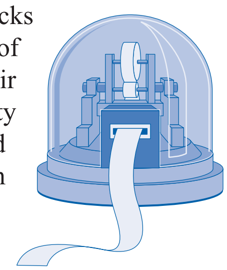
Implications

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

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

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

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



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

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

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Regional Perspectives

- **The San Francisco Region's job growth rate slowed during the first seven months of 1999 compared with the year-ago period. Nevertheless, jobs were created in the Region at a rate that exceeded the national average.**

- **The Region's financial institutions reported healthy conditions; weakness was noted, however, in institutions in Hawaii and Montana. Mortgage and agricultural lenders in the Region reported performance declines, while some smaller commercial lenders increased holdings of traditionally riskier assets.**

- **Low commodity prices and resulting declines in farm income negatively affected asset quality of the Region's agricultural banks, particularly in Montana and Washington.**

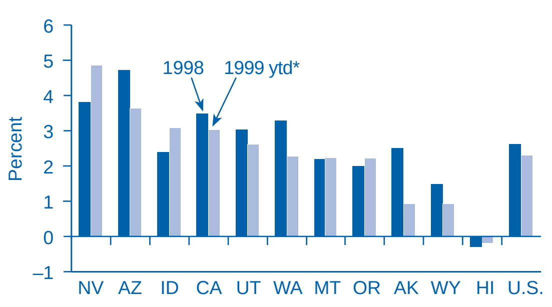
Economic and Banking Conditions

The San Francisco Region's Economy Continues to Outpace That of the Nation

Despite slowing since 1998, the San Francisco Region's economy is generally healthy. Total nonfarm job creation continued to exceed the national average, but slowed to an average year-over-year growth rate of 2.9 percent in July 1999 (see Chart 1). Strength in the services and construction sectors offset softness in the manufacturing, aerospace, energy, and agricultural sectors. In particular, rural areas of **Montana, Wyoming, Idaho, Utah, Oregon, Washington,** and **California** have been negatively affected by dependence on the agricultural sector during a period of sustained low commodity prices.

CHART 1

Nevada Outperforms Nation in Job Growth, while Hawaii Ranks Last in the Region



* Year to date; Jan–July average, annualized
Source: Bureau of Labor Statistics

As expected within such a large and diverse Region, job growth rates differed greatly during the first seven months of 1999. Five of the Region's eleven states—**Nevada, Arizona,** Idaho, California, and Utah—outpaced the nation in job growth during this period because of a strong services sector. Washington and Oregon experienced some weakening in job growth because of reliance on the weaker manufacturing and agriculture sectors. **Alaska,** Montana, and Wyoming were among the slower growing states in the Region because of lower commodity prices, and **Hawaii** grew more slowly than the nation because of its depressed tourism sector.

The Services and Construction Sectors Drove Growth in the Region's Best Performing States—Nevada, Arizona, Idaho, California, and Utah

These states' job growth rates outperformed the nation's during the first half of 1999 because of strong growth in the services and construction sectors. Rapid growth in Nevada's hotel and amusement sector boosted the state's overall job growth and accounted for nearly 40 percent of the jobs added in the state since January 1999. Specifically, recent openings of 3,000 rooms at the Paris Las Vegas hotel and nearly another 3,000 at the Venetian[1] hotel fueled Nevada's robust service-sector expan-

[1] According to the ***Las Vegas Convention and Visitors Authority,*** construction of the Venetian will take place in two phases. Three thousand rooms were completed in May 1999 during Phase One while another 3,000 are expected to be created during Phase Two. A date for the completion of the second phase has not been reported.

sion. Visitor volume in **Las Vegas** was expected to grow by roughly 3.1 percent through 1999 because of the addition of the new resorts and interest stimulated by the upcoming New Year's celebration. Like Nevada, California experienced fast growth in its services sector, particularly in Southern California's hotel and amusement and motion picture industries. In addition, the September 1999 ***UCLA Anderson Forecast*** noted that growth in software and Internet business services is expected to accelerate, reaching as much as 9 percent in 1999. Idaho, Utah, and Arizona continued to experience strength in the services sector; Utah and Idaho exceeded the national growth rate in the sector.

The Region's top-performing states experienced improved growth in the construction industry and outpaced the national average during the first seven months of 1999. Arizona and California saw the Region's fastest year-over-year growth in the construction sector—10 and 9.7 percent, respectively. Both states also experienced double-digit growth in total residential building permits during the first two quarters of 1999, likely because of strong population growth.

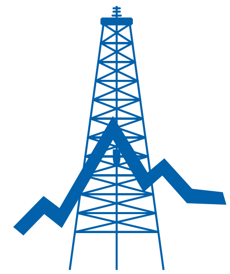
Washington and Oregon Experienced Some Weakening in the Manufacturing and Agriculture Sectors

Washington and Oregon, states that had performed well in the past, experienced a slight weakening during the first half of 1999 because of dependence on the manufacturing sector and, to a lesser extent, the agricultural sector. Washington's economy slowed earlier in the year as Boeing, the state's largest employer and a major past contributor to job growth, laid off 17,400 employees in the 12-month period ending June 1999. In Oregon, manufacturing job losses began in the third quarter of 1998 and continued through the second quarter of 1999. Oregon's manufacturing slump has been attributed primarily to slowdowns in the durable goods manufacturing sector, which includes information technology manufacturing. In addition, Oregon is the only state in the Region in which the number of business bankruptcies increased in the second quarter of 1999.

Furthermore, rural areas in Washington and Oregon are exposed to deterioration in the agricultural sector, primarily related to weakness in wheat and apple prices. A more in-depth discussion follows in the section entitled ***"Low Commodity Prices Pressure Some Farmers in the San Francisco Region,"*** page 21.

Lower Commodity Prices and Weak Eastbound Tourist Volume Hurt Some States in the Region

Alaska, Montana, and Wyoming remained among the Region's poorest performers at midyear 1999, partially because of low energy and agricultural prices. Alaska's economy was affected by weak oil prices from late 1996 through year-end 1998, resulting in a 10 percent year-over-year decline in mining employment for the first seven months of 1999. Nearly 7 percent of Wyoming's total employment is in the mining sector, compared with less than 1 percent for the Region and nation. More than half of these jobs are in the oil and gas industry, making the state's mining sector vulnerable to weakness caused by low oil prices. Wyoming experienced a 0.9 percent job increase through July 1999, but the mining sector experienced losses of 2.3 percent during the same period. Montana experienced weakness in the agricultural sector during the first half of 1999. Although the state saw total nonfarm employment growth keep pace with the Region, weakness in the farm sector will likely depress farm employment, given the low commodity prices experienced since 1997. These three states have government sectors much larger than the Region's average, and these sectors are funded, in part, by the mining industry. Therefore, weakness in the mining industry could affect many more workers than those directly employed in mining.



Hawaii's economy remained weak during the first half of 1999, affected primarily by the declining number of eastbound tourists. Although the hotel and lodging sector has not added jobs since mid-1997, the increase in the number of westbound visitors to the islands offset some of the negative affects caused by a slowdown in eastbound visitors. However, the ***Hawaii Visitors and Convention Bureau*** estimates that eastbound visitors spend significantly more money per day than westbound visitors, indicating that Hawaii may not recover quickly from its economic slowdown.

The San Francisco Region's Banking Conditions Remain Strong

Despite slowing in the Region's economic growth, its insured financial institutions reported generally strong earnings as of June 30, 1999. Insured institutions posted 1.33 percent aggregate return on average assets

(ROA) through second-quarter 1999, unchanged from the level reported one year ago. While net interest margins (NIMs) have continued to fall from a year ago, ongoing reductions in overhead and provision expenses have offset these declines. Strong and improving asset quality in most of the Region's institutions has reduced provision expenses. Reported past-due loans, currently at a low 1.59 percent of total loans for the Region's insured institutions, remained below the 1.98 percent reported for the nation.

Even though strength in earnings and asset quality was reported for the Region, institutions located in states with weak economies, such as Hawaii and Montana, underperformed peer institutions in the Region and the nation. The performance of Hawaii's 14 financial institutions, with total assets of almost $30 billion, continued to be hampered by the effects of the turmoil in Asia, which has contributed to the state's lingering economic weakness and weak real estate markets. In addition, Montana's 93 financial institutions, with over $11 billion in total assets, reported generally poorer asset quality than the Region and nation primarily because of the great number of institutions concentrated in agricultural lending.

Macroeconomic developments also have negatively affected the financial performance of some institutions concentrating in mortgages. The Region's 57 mortgage lenders[2] reported declines in NIMs and lower gains on securities and loan sales, likely as a result of the increase in interest rates and a steepening in the yield curve. The changes in the yield curve slowed fixed-rate mortgage origination, reducing mortgage banking revenue and increasing depreciation in available-for-sale securities in many of these institutions, most of which are located in California and Washington.

The Region's economic strength has contributed to the strong reported asset quality of its commercial lenders,[3] which account for over 31 percent of the Region's assets. These institutions, however, experienced declining NIMs and lower ROA. As a result, some commercial lenders increased higher-yielding and traditionally higher-risk assets such as commercial real estate, construction, and multifamily residential loans. The growing concentration in higher-yielding assets is particularly notable for commercial lenders with assets less than $1 billion located in Arizona, Nevada, Oregon, and Utah (see Table 1). As a result, these institutions reported higher NIMs and higher ROA figures than the Region and nation did. However, higher concentrations in these potentially higher-risk areas raise concerns, particularly in Oregon and Nevada, where these institutions are reporting increases in past-due loan levels. Hawaii is the only other state in the Region where small commercial lenders reported an upswing in past-due loans.

Finally, stress in the agricultural sector has resulted in lower earnings, falling NIMs, and rising reported past-due loan ratios in the Region's 93 agricultural banks,[4] primarily located in California, Montana, Washington, and Wyoming. The discussion that follows focuses on deterioration in the Region's farm sector.

[2] Mortgage lenders have single-family mortgage loans and mortgage-backed securities greater than 50 percent of total assets.

[3] Commercial lenders have commercial real estate, construction, multifamily, and commercial and industrial loans greater than 25 percent of total assets.

[4] Agricultural banks have 25 percent of their loans in agricultural production and real estate loans.

Table 1

Smaller Commercial Lenders Increase Holdings of Higher-Risk Assets

	Nation		Region		Arizona		Nevada		Oregon		Utah	
	Jun-99	Jun-98	Jun-99	Jun-98	Jun-99	Jun-98	Jun-99	Jun-98	Jun-99	Jun-98	Jun-99	Jun-98
Net Interest Margin	4.54	4.66	5.12	5.28	5.24	5.64	6.05	5.84	5.52	5.84	6.18	6.47
Return on Assets	1.23	1.28	1.19	1.24	1.29	1.45	1.19	1.20	1.50	1.77	2.01	2.34
Past-Due Ratio	2.09	2.13	1.76	2.06	0.71	0.88	2.03	1.44	2.46	1.93	2.49	3.00
CRE/TA	26.12	23.55	34.91	30.90	27.62	23.91	38.20	33.31	35.96	34.31	34.79	28.72
Construction/TA	5.63	4.87	7.57	6.22	9.58	7.53	11.79	14.26	12.32	11.80	14.58	12.50

CRE = The sum of commercial real estate, construction, and multifamily loans; TA = Total Assets
Source: Bank and Thrift Call Reports, Commercial Lenders under $1 billion excluding new banks and industrial loan companies, adjusted for mergers

Low Commodity Prices Pressure Some Farmers in the San Francisco Region

Low commodity prices, which have persisted since 1997 for some of the Region's agricultural products, have adversely affected the Region's farm sector. Deterioration in the agricultural industry is a concern in the San Francisco Region because of the size of the industry and the number of insured institutions lending to the sector. The Region's agricultural cash receipts represent over 20 percent of the nation's total, and California accounts for over half the Region's total. Although California produces the majority of the Region's agricultural crops, all 11 states are involved in agricultural production. Consequently, agricultural lending exposure is widespread; over 50 percent of the Region's 852 insured institutions have extended agricultural loans.

Unlike other areas of the country, in the San Francisco Region the size of agricultural lenders varies significantly, reflecting differences in the size of farm revenues. Average annual cash receipts range from a high of near $311,000 for farms in California to less than $100,000 for farms in Montana, Utah, Oregon, and Wyoming. California is home to three of the nation's largest agricultural lenders.[5] However, because of large institutions' product and geographic diversification, these institutions' relative risk exposure is not as high as that of the Region's agricultural banks. The Region has numerous smaller institutions with loan portfolios concentrated in the agricultural sector. Although these institutions range in size from $215 million in assets in California to $57 million in Montana, they all are more vulnerable than larger institutions to deterioration in agricultural portfolios because of a lack of product and geographic diversification. (For more information about the San Francisco Region's agricultural sector and agricultural banks, see the San Francisco ***Regional Outlook,*** second quarter 1998.)

Unlike many of the Region's metropolitan areas that have enjoyed strong economic growth through midyear 1999, many rural areas have experienced economic slowdowns, particularly in the agricultural sector. Declines in agricultural commodity prices appear to be the primary cause for the persisting weakness in the Region's farm sector since 1997, and, as a result, farm incomes in parts of the Region have declined. In addition, many insured institutions lending to agricultural borrowers have reported rising past-due ratios on agricultural portfolios, indicating that weakness in commodity prices and farm incomes in the Region is beginning to adversely affect agricultural borrowers' repayment ability.

Commodity Prices and Export Markets Appear Stressed

Among the variety of agricultural products produced in the San Francisco Region, the commodity groups that have recently experienced price declines are wheat, cattle, and vegetables and fruits (primarily apples). Domestic overproduction as a result of improved technology and low incidence of crop diseases is often cited as the primary reason for these declines. Farmers' response to the Federal Agriculture Improvement and Reform Act of 1996 (FAIR) also led to oversupply problems in the farm sector. When production restrictions were lifted, farmers began planting land that they had previously left fallow. Recent agricultural exports also have declined because of high worldwide production, reduced foreign demand, and a strong U.S. dollar.

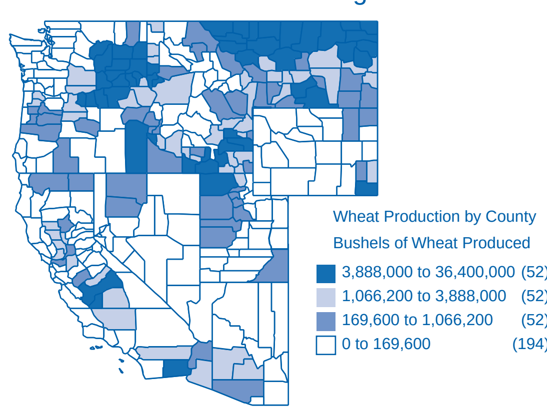
Severe price declines in wheat, which ranks[6] among the top ten commodities for eight of the Region's eleven states (shown in Map 1), concern analysts because of the adverse effects observed in many of the Region's rural areas where the crop is grown. The price of wheat

[5] Agricultural lenders are institutions that make agricultural loans. However, these institutions are not necessarily agricultural banks because some do not have 25 percent of loans in agricultural production and real estate loans.

[6] Rankings are measured by total state agricultural cash receipts unless otherwise stated.

Map 1

Montana, Idaho, Oregon, and Washington Produce Most of the Region's Wheat



Source: National Agricultural Statistical Service fell from $4.30 per bushel in 1996–1997 to $2.65 for the 1998–1999 marketing year, largely because of strong foreign and domestic production. In 1996, when FAIR was enacted, U.S. wheat supply growth began to outstrip increases in demand, not only because of domestic overplanting but also because of favorable growing conditions and low incidence of wheat diseases. As a result, the beginning stock of wheat[7] began to rise while the price continued to fall (see Chart 2).

In addition, major wheat-exporting countries have large supplies of the commodity, and the U.S. dollar is relatively strong. China, the world's largest wheat producer, reported record production of the commodity in the 1997–1998 marketing year, with 1996–1997 production and projections for 1998–1999 only slightly lower. Domestic wheat producers' competitiveness may be further diminished if China devalues the *renminbi* and the U.S. dollar remains strong.

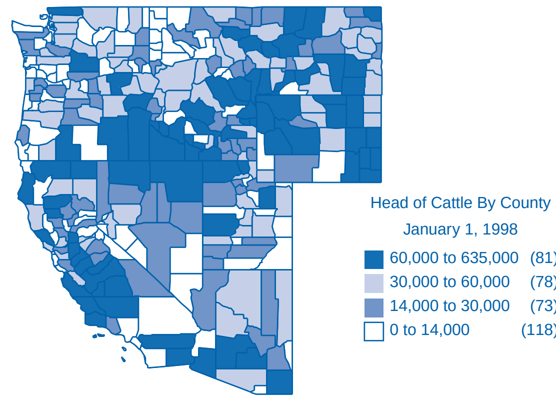
Cattle, which ranks among the top five cash-producing agricultural products in each of the Region's states except Alaska and Hawaii (see Map 2), have also been negatively affected by falling prices during the past decade (see Chart 3). Although prices edged up in late 1998 and early 1999, the sector remains weak because of farmers' decisions to sell animals for slaughter at already low market prices rather than retaining them for breeding. While such action likely will put upward pressure on cattle prices, those farmers who sold heifers at low prices will have to pay higher prices to rebuild their herds.

Apple prices have been under pressure since 1998, as shown in Chart 4. Apples are particularly important to the Washington economy, as well as to the economies of parts of Oregon and California (see Map 3). Specifically, an increase in Chinese apple exports and a decrease in Japanese demand for the commodity have hurt apple prices. In 1998, China brought 2 million more acres of apples into production. At the same time, the Chinese *renminbi* depreciated against the U.S. dollar, making Chinese apple exports more competitive in the U.S. market. In addition, China's increased apple production and exports to the U.S. market has negatively affected the price of apple juice concentrate in this country. Juice apple prices fell to $10 per ton in 1998 from $50 per ton

[7] The beginning stock is defined as the excess supply of a commodity not sold in a certain marketing year, causing it to carry over into the following year's supply.

MAP 2

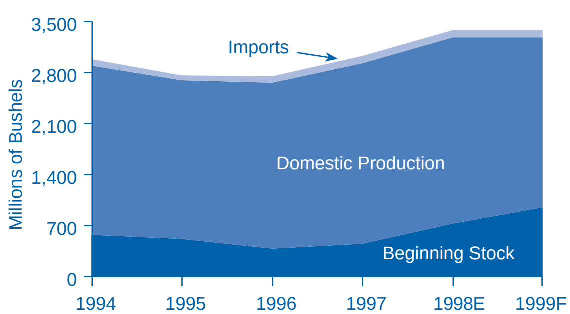
Cattle Are Important to Most of the States in the San Francisco Region



Source: National Agricultural Statistical Service

CHART 2

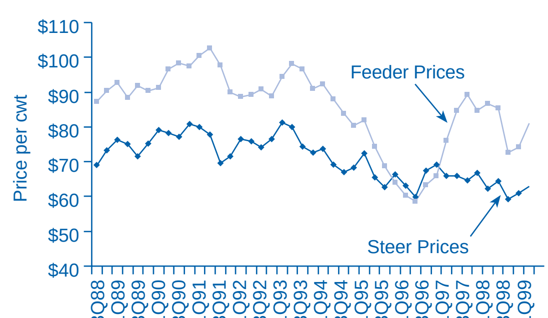
Increase in the Beginning Stock of Wheat Contributes to Oversupply



Notes: USDA = U.S. Department of Agriculture; E = USDA Estimate; F = USDA Forecast
Source: USDA Economic Research Service—Wheat Outlook

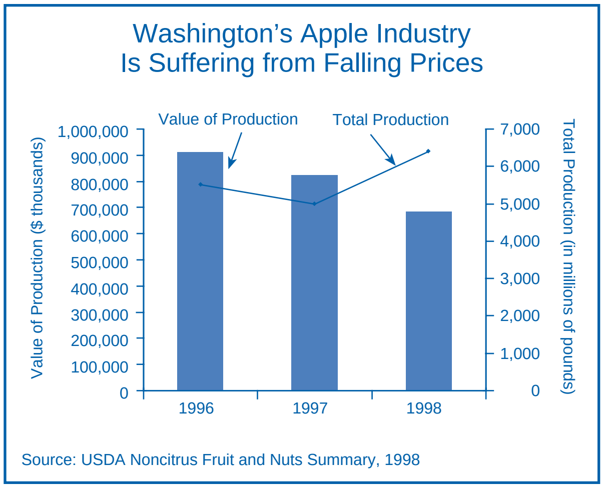
CHART 3

Cattle Prices Strengthen in Late 1998 and Early 1999

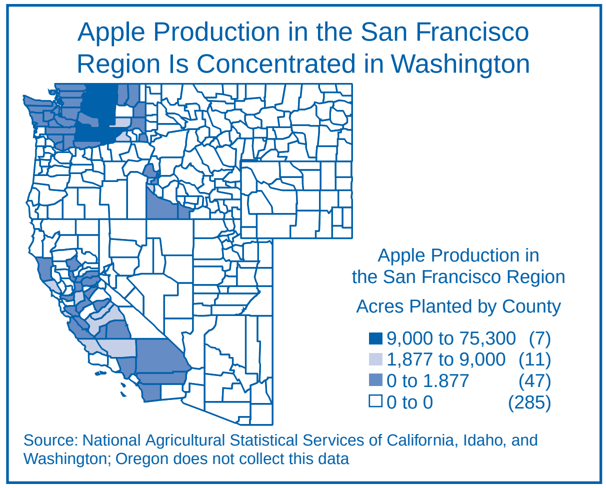


Source: *Wall Street Journal* (Friday average prices) via Haver Analytics

CHART 4



MAP 3



in 1997 and $180 per ton in 1995. In addition, because of Japan's economic downturn and the fact that apples are considered a luxury there, that country's demand for apples has declined since 1997.

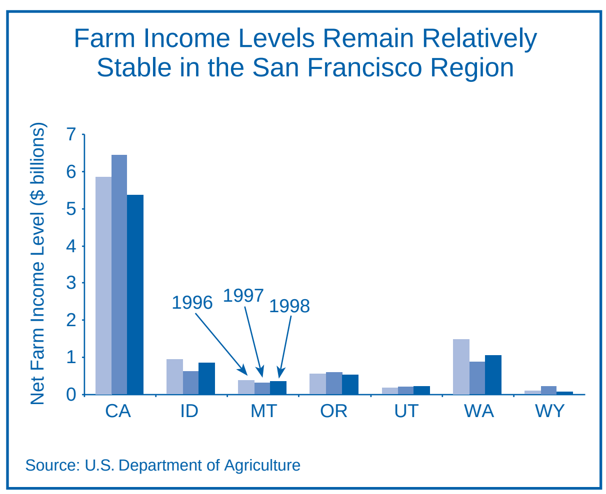
1998 Farm Incomes Are Weak in California, Montana, and Washington

In 1998, low commodity prices resulted in declining farm incomes, particularly in California, Montana, and Washington. However, in many states, weakness in crop or livestock revenue has been masked by large increases in government payments[8] to farmers, particularly in 1998. In addition, the existence of shared appreciation agreements (SAAs)[9] may increase individual farmers' debt burdens at a time when farm incomes are weakening.

California's net farm income experienced the largest decline in the Region during 1998, dropping over 16 percent from peak levels in 1997 to near the state's 1990 to 1997 average (see Chart 5). The largest declines were evident in cotton, almond, and grape crops, which had particularly strong yields in 1997 but fell to average levels in 1998. Montana's net farm income increased slightly in 1998 but remained at only 70 percent of the 1990 to 1997 average, primarily because of a decrease in the value of harvested food grains. Washington reported a decline in value of the state's important fruit and tree nut crop for the second straight year. This sector contributes nearly 20 percent of the state's total agricultural revenue.

However, high direct government payments and low feed and input costs mitigated weakness in farm income in the San Francisco Region. In 1998, Congress approved a $6 billion aid package to help farmers offset some of the effects of commodity price declines; a larger aid package of $8.7 billion was signed into law in October 1999. Consequently, in 1998 direct government

CHART 5



[8] Direct government payments are cash payments made directly to farmers and include Production Flexibility Contracts; Loan Deficiency Payments; payments made under the Conservation Reserve, Agricultural Conservation, Emergency Conservation, and the Great Plains Programs; and other miscellaneous payments.

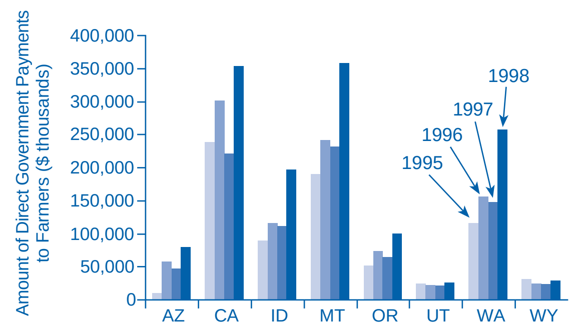
[9] In the mid-1980s farm income, farmland values, and the ability of many farmers to service their outstanding debt deteriorated significantly. During this troubled period, the Farm Service Agency (FSA), formerly the Farmer's Home Administration and the Agricultural Stabilization and Conservation Service, agreed to forgive some of the farmers' debts. However, after 1988, the FSA required farm program borrowers applying for a debt writedown to sign a shared appreciation agreement (SAA). SAAs allow for the recapture of a portion of farmland appreciation for ten years following the signing of the agreement. The amount of the recaptured debt is limited by the amount of the original writedown.

payments to several of the Region's states rose substantially, in most cases to record levels (see Chart 6). In addition, grain prices were low, which resulted in reduced feed costs for the livestock sector in 1998.

The existence of SAAs in certain states may result in larger debt burdens in 1999 for some of the Region's farmers as the first group of SAAs reaches the ten-year recapture date. Table 2 outlines the Region's SAA exposures. Idaho, which has the Region's greatest number of farmers holding the instruments, and Montana, which issued the Region's largest dollar value of agreements, have the greatest exposure to these agreements. Although this exposure is limited,[10] it may negatively affect some farmers, perhaps unexpectedly, by increasing debt levels and hindering their repayment ability.

CHART 6

Direct Government Payments Boom in 1998, Buoying Farm Income Levels



Source: U.S. Department of Agriculture Value Added Tables 1990–1998

Agricultural Banking Conditions

Analysts' concern about the Region's agricultural banks, which hold about $7.5 billion of the Region's assets, increased in 1999 because of deterioration reported in these institutions' agricultural loan portfolios. While earnings and capital levels declined slightly through the second quarter of 1999, asset quality at the Region's 93 agricultural banks has deteriorated noticeably compared with previous years. Insured institutions in Montana experienced the most severe past-due agricultural loan problems in the Region during the first half of 1999. As a result, the total past-due loan ratio for agricultural loans in the state was one of the highest in the Region (see Map 4). Farm banks in Idaho, California, and Washington are also seeing deterioration in asset quality. While government programs guarantee

[10] The Region's $182 million in SAAs account for only 11.8 percent of the total SAAs in the nation.

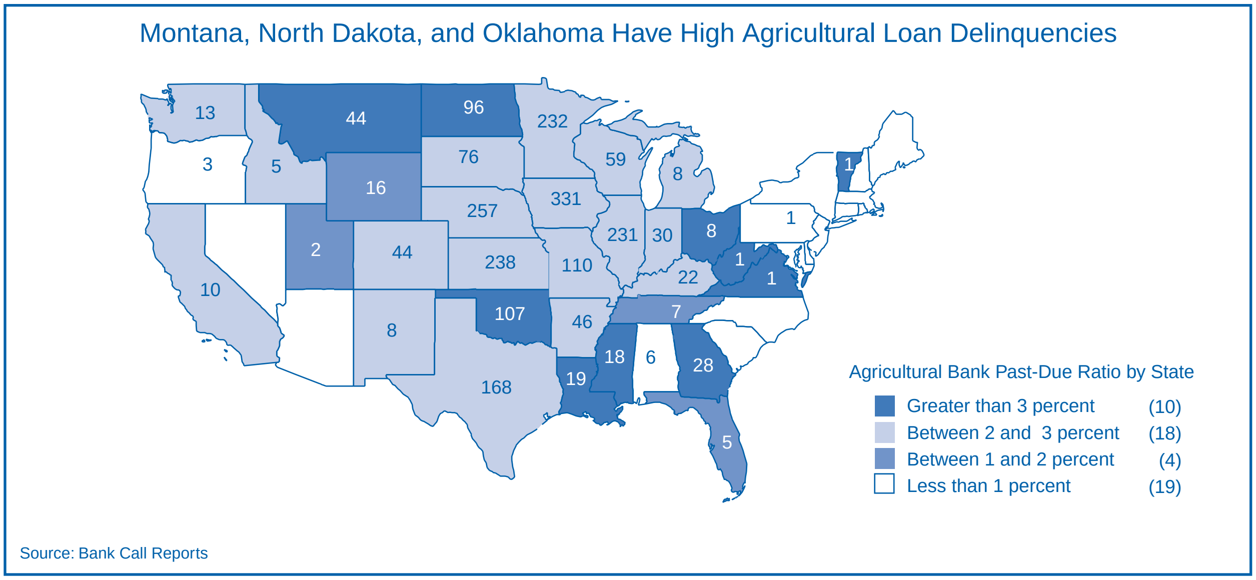
TABLE 2

SHARED APPRECIATION STATISTICS FOR THE SAN FRANCISCO REGION

State	Borrower Count	Borrower Count (Percent of U.S. Total)	Total Dollar Amount of SAAs ($ millions)	Total Amount (Percent of U.S. Total)	Farmland Value Appreciation (Percent Increase between 1989 and 1999)	Number of SAAs Reaching Recapture: During 1999	Number of SAAs Reaching Recapture: After 1999
Arizona	44	0.42	19.8	1.29	270	23	21
California	94	0.89	24.6	1.60	51	49	45
Idaho	284	2.68	43.6	2.84	79	137	147
Montana	212	2.00	48.5	3.15	47	84	128
Nevada	17	0.16	2.7	0.18	67	3	14
Oregon	100	0.95	16.7	1.08	81	44	56
Utah	28	0.26	3.2	0.21	91	4	24
Washington	65	0.61	9.4	0.61	54	37	28
Wyoming	89	0.84	13.6	0.89	53	31	58
Region Total	933	8.81	182.1	11.85		412	521
U.S. Total	10,582		1,538			4,267	6,315

Note: SAA = Shared appreciation agreement
Source: U.S. Department of Agriculture (USDA)/Farm Service Agency and USDA/NASS Agricultural Land Values Report, March 17, 1998

Map 4



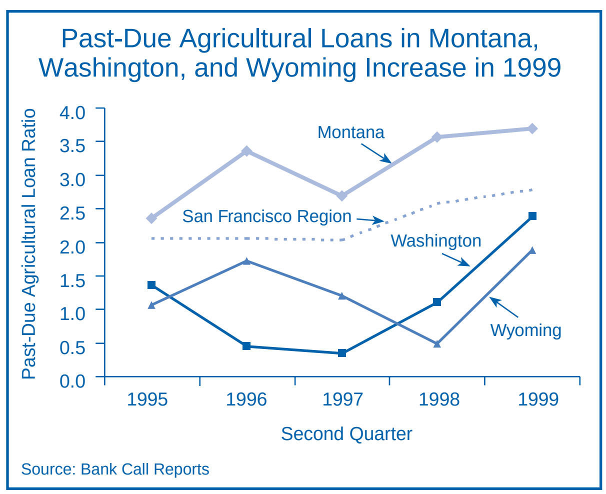
some of these institutions' loans, many loans are not guaranteed, leaving lenders at risk of default if commodity prices continue to fall.

As of second quarter 1999, ROA at the Region's agricultural banks was 1.25 percent, noticeably lower than a year ago, but higher than the national average for agricultural banks. However, the strength in the Region's ROA may be somewhat distorted because of the existence of 13 Subchapter S agricultural banks in Montana, Wyoming, and California; these institutions tend to have a higher ROA because of their tax-advantaged status. Furthermore, the Region's Tier One leverage capital ratio of 9.91 percent for the second quarter of 1999 was at its lowest second-quarter level in the past five years.

Despite slightly lower earnings and capital levels, weakened asset quality is the most serious problem facing the Region's agricultural banks in 1999. This situation may be exacerbated if commodity prices or farm income levels continue to weaken. The Region reported a past-due agricultural loan ratio of 2.78 percent in the second quarter of 1999, which is near the national average for the period. It is the Region's highest level for that period during the past five years, suggesting that low commodity prices are beginning to negatively affect agricultural borrowers. Montana, Washington, and Wyoming, home to 73 of the Region's agricultural banks, reported increasing levels of past-due loans (as shown in Chart 7). While Montana is the only state with a past-due loan ratio exceeding the national level, Wyoming and Washington reported increases compared with the past five years. This upswing in the Region's total past-due agricultural loans is attributed to increases in agricultural production and real estate past-due loans. In addition to declines in asset quality, Montana and Washington have experienced marked deterioration in coverage ratios[11] because provision expenses have not kept pace with large increases in noncurrent loans.

[11] Coverage ratio is defined as the allowance for loan and lease losses divided by noncurrent loans and leases.

Chart 7

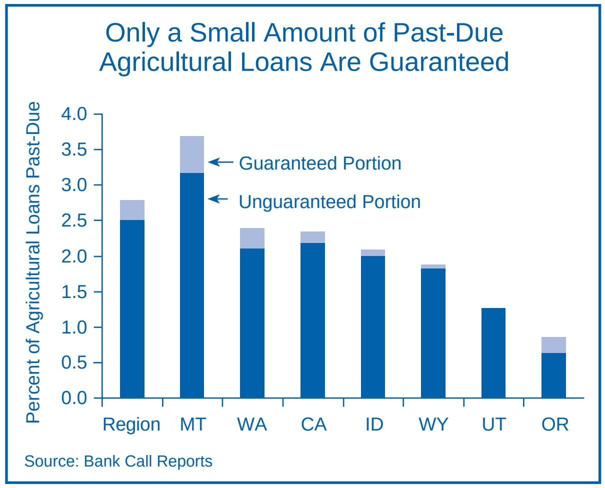


Because some of the loans are guaranteed by government programs, it may appear that high past-due loan ratios in the Region's banks are not a serious concern. However, the level of guaranteed past-due loans in the Region is very small. Chart 8 shows the structure of the Region's past-due loans, assuming that all past-due guaranteed loans are agricultural loans. Even from this conservative perspective, the volume of past-due agricultural loans remains a concern. Montana appears to be most at risk because, even with the guaranteed portion of the portfolio excluded, the state exceeded the Region's average as of June 30, 1999.

Implications for the Region's Agricultural Banks

The San Francisco Region has significant exposure to the agricultural sector, given the volume of agricultural products produced in the Region and the number of insured institutions involved in farm lending. The Region's weakness is concentrated in agricultural banks, particularly those in Montana and Washington. These states have large wheat crops, and Washington is also exposed to the decline in apple prices, which has persisted since 1997. While most states have yet to experience significant declines in net farm income, crop income has fallen. However, this decline has been mitigated by the increase in direct government payments to farmers.

CHART 8



Conditions at the Region's agricultural banks reflect the stress experienced in the agricultural sector since 1997. While earnings and capital levels weakened slightly in the second quarter of 1999, analysts are primarily concerned about the asset quality deterioration experienced at these institutions. Past-due agricultural loan ratios are high in Montana and have risen in Wyoming and Washington in the second quarter of 1999, compared with 1998 and 1997 levels. This trend suggests that farmers have been negatively affected by low commodity prices and, as a result, could experience repayment problems.

San Francisco Region Staff

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