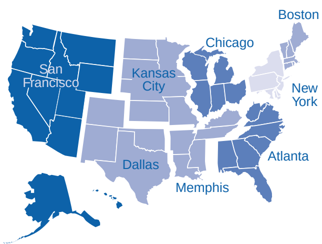
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FIRST QUARTER 2000

FDIC NATIONAL EDITION



DIVISION OF INSURANCE

In Focus This Quarter

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

By Arlinda Sothoron, Alan Deaton

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

By Paul C. Bishop

Regional Perspectives

◆ ***Atlanta***—**Strong economic growth in Atlanta Region urban areas may be driving a resurgence in de novo banks, which have greater innate risks early in their life cycle.** *See page 18.*

◆ ***Boston***—**The Boston Region's economy continued to expand in 1999 but showed signs of slowing. Insured institutions reported healthy financial conditions, and the Region's credit risk profile showed no material adverse trends.** *See page 19.*

◆ ***Chicago***—**Although the Region's economy remains healthy, job growth has slowed. Agricultural concerns are centered in Illinois. Commercial and industrial loans are growing rapidly, and rising interest rates may dampen profitability of residential real estate lenders.** *See page 20.*

◆ ***Dallas***—**Record levels of government payments are helping to maintain net farm income above the decade average. NAFTA's effect on job growth has been marginally positive.** *See page 21.*

◆ ***Kansas City***—**Population continues to decline in a significant number of the Region's rural counties; as a result, institutions in those areas likely will continue to have difficulty growing loans and core deposits within their markets.** *See page 22.*

◆ ***Memphis***—**Many insured financial institutions are changing asset compositions to improve yields; some may be accepting greater levels of credit risk and market sensitivity in the process.** *See page 23.*

◆ ***New York***—**The Region's economy is healthy, although employment growth has slowed. Over the past five years, noninterest income has increased to 50 percent of operating income and has offset the effect of lower net interest margins on bank earnings.** *See page 24.*

◆ ***San Francisco***—**The San Francisco Region's economy continues to outperform that of the nation; however, economic and banking conditions differ between urban and rural areas. Strong economic growth in urban areas has helped drive merger and acquisition and de novo activity to the highest level in the past decade.** *See page 25.*

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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Recent Trends Raise Concerns about the Future of Business Credit Quality

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

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

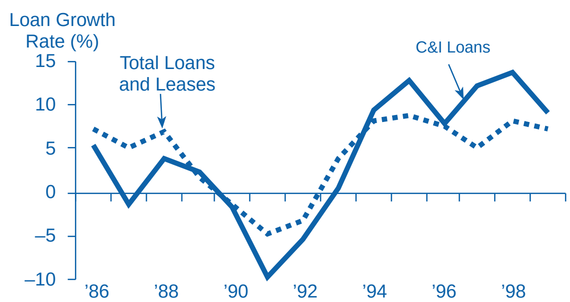
High rates of growth in commercial lending and weakening indicators of C&I credit quality raise concerns about the future of credit quality at insured institutions. This article examines the factors that have contributed to high C&I loan growth rates and discusses the drivers that will determine the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

C&I Loan Growth Has Accelerated

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

CHART 1

Commercial and Industrial (C&I) Loans Are Growing at a Faster Rate than Total Loans and Leases



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

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

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

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

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

Is This Rapid Loan Growth a Cause for Concern?

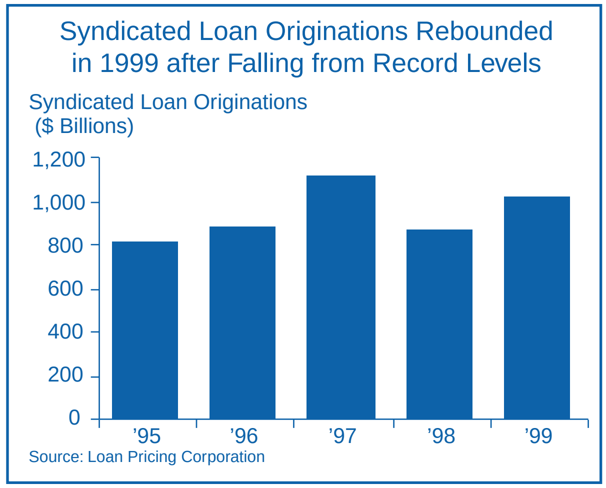
The effect of rapid loan growth on subsequent credit quality has been the subject of a number of articles. A recent study by the ***Federal Reserve Bank of Kansas City*** found that high rates of loan growth in the early 1980s and early 1990s appeared to be positively correlated with future higher loss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

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

Recent economic conditions have been particularly conducive to rapid growth in domestic C&I lending. Business investment has expanded at double-digit annual rates as firms have invested in new technologies to raise productivity and keep costs down. These productivity gains have been instrumental in allowing the economy to grow at a relatively rapid pace with low inflation. Strong growth in real wages has helped boost the consumer confidence index to an all-time high of 144 in January 2000. Robust consumer demand for goods and services has kept business profits growing, further spurring business borrowing to finance inventories, new construction, and fixed assets such as computer networks. Amid all of these favorable trends, C&I loan charge-off rates have remained at record lows of less than 0.5 percent since 1994. Recently, however, despite a continuation of generally favorable conditions in the economy and the financial markets, signs of credit quality deterioration have begun to appear in C&I loan portfolios.

CHART 2

Syndicated Loan Originations Rebounded in 1999 after Falling from Record Levels



Source: Loan Pricing Corporation

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

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

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

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

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

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

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

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

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

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

[6] The annual interagency process reviews commercial loans over $20 million that are shared by three or more participants.

[7] Federal Reserve Board Press Release. November 10, 1999.

[8] "OCC's Williams Warns of Credit Risk in the Banking System; Calls for Bankers to Scrutinize Loan Portfolios More Closely." OCC Press Release. October 5, 1999.

[9] "Leveraged Loans: The Plot Thickens." Banc of America Securities Syndicated Finance Research. November 15, 1999. This loan amendment analysis was completed using only publicly available information from Loan Pricing Corporation and Banc of America Securities LLC.

Corporate Bond Defaults Soared in 1999

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

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

[11] "Moody's Default Rate Pendulum." Moody's October 1999 Commentary. Moody's Investors Service. October 18, 1999.

CHART 3

The Default Rate on Corporate Bonds Has Been Driven by Defaults on Speculative Issues

Source: Moody's Investors Service

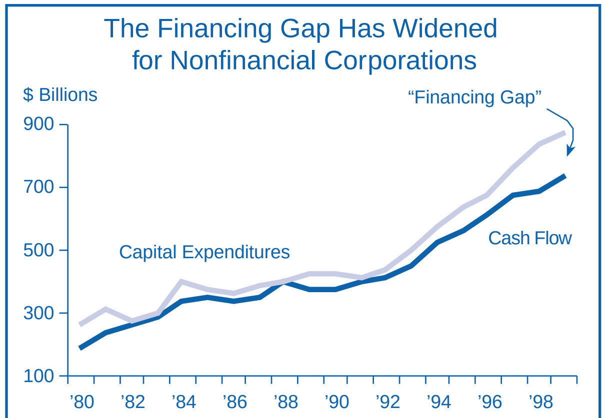
Why Are C&I Loan Losses Increasing Amid Strong Economic Growth?

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

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

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

CHART 4



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

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

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

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

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

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

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

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

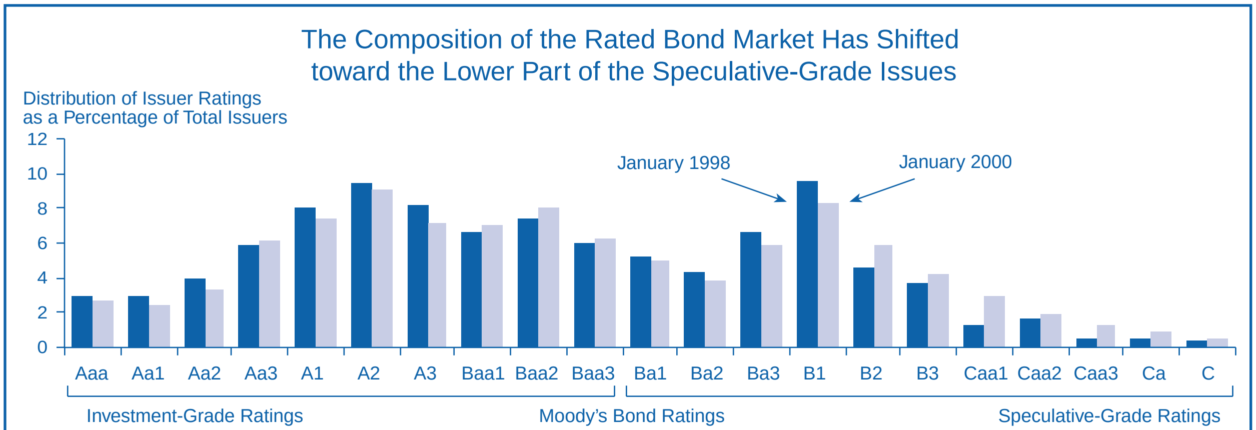
Financial markets have evidenced greater risk appetite. While the ratio of speculative-grade bond issues to total corporate bond issues has remained fairly stable at approximately 40 percent during the past decade, the composition of borrowings has shifted substantially. ***Moody's*** reports a shift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

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

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

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

CHART 5

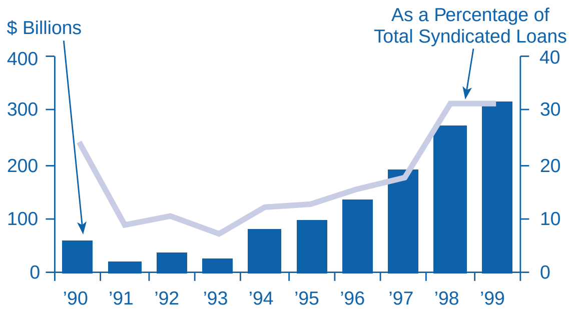


Note: Unrated issues of corporate debt fall below the speculative-grade "C" rating.
Source: Moody's Investors Service

CHART 6

Loans to Leveraged Companies Represent a Greater Portion of Syndicated Loans

Originations of Syndicated Loans to Leveraged Companies



Note: 1999 data are annualized based on 3Q99 data.
Source: Loan Pricing Corporation

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

Where Is Business Credit Quality Heading?

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

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

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

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

[22] Houlihan Lokey's *Mergerstat.* www.mergerstat.com.

[23] "The Biggest Secret of Wall Street." May 14, 1999.

[24] "Global Financial System Stress: The Weak, the Vulnerable, and Those Limping Toward Recovery." Standard & Poor's. December 17, 1999.

[25] KMV's® proprietary calculation for EDF™ is based on (1) the current market value of the firm, (2) the structure of the firm's current obligations, and (3) the vulnerability of the firm to large changes in market value. Multiplying industry originations by median industry EDF™ scores provides an estimate of expected default volumes. This figure provides a more meaningful measure of aggregate lending risk exposure than pure origination volumes alone and can be used to rank industry exposures.

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

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

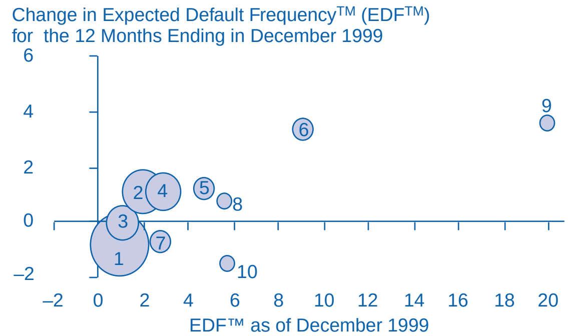
Refunding risk continues to be a concern for speculative-grade borrowers as they face potential problems refinancing the maturing portions of long-term debt. The current tightening of terms in the C&I market and increasing default rates heighten refunding risk to borrowers. Rising interest rates or limited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

Potential growth in new markets presents both opportunities and challenges. The Internet and European syndicated loan markets represent both future potential growth areas and possible sources of credit risk for C&I lenders. The Internet has introduced large new markets to the loan and bond markets and has

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

CHART 7

Lending to Some Industries May Involve Higher Risk Exposures



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

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

increased market efficiency. The "Internet economy" grew 68 percent from the first quarter of 1998 to the first quarter of 1999, with annual revenue expected to exceed $500 billion in 1999.[27] Internet technology has improved the efficiency of the syndicated loan markets, with recent changes including the development of public price reporting, credit ratings, and Internet sites for online trading.[28] Increased levels of credit risk could result from the volatility of Internet stock prices and the competitive disadvantage faced by firms that do not have an Internet presence but must compete against firms that do.

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

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

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

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

Underwriting Remains the Key to Assessing C&I Credit Quality

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

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

Summary

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

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

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

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

Local Industries in the Global Economy

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

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

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

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

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

International Trade Is of Growing Importance

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

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

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

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

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

Table 1

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

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

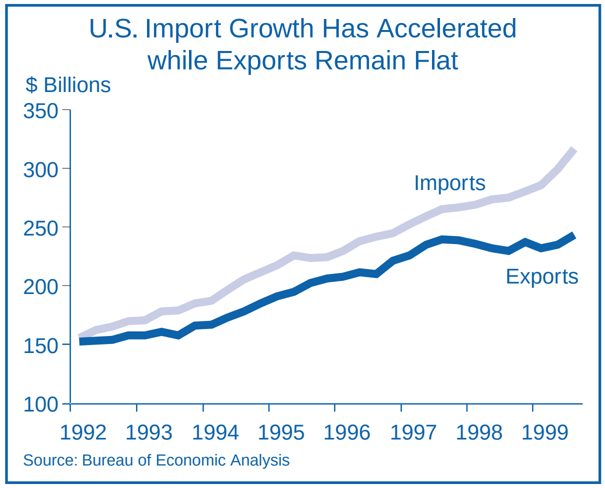
During the past two and a half years, for example, the international economy has been buffeted by a series of crises that resulted in steep exchange rate depreciations for a number of countries and a marked slowdown in economic growth in many emerging markets. Although the U.S. economy remained surprisingly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

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

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

The slowdown in U.S. export activity and the acceleration of import growth have resulted in an increasing trade imbalance (see Chart 1). The U.S. trade deficit, which reached a record $26.5 billion in November, has raised concerns among analysts about the vulnerability of the dollar. Faster growth abroad or a slowdown in U.S. growth could convince foreign investors to increase purchases of assets outside the United States, resulting in a sell-off of the dollar. Depending on the severity and speed of a sell-off, heightened financial market volatility and rising U.S. import prices could result. Although potentially many forces are at work in such a scenario, rising inflation or a falling dollar may ultimately result in higher interest rates and slower U.S. growth. The extent to which U.S. trade would be affected by such a scenario is difficult to assess, since changes in the prices of either imports or exports would result in both positive and negative effects on firms' costs, revenue, and profitability.[2]

Chart 1



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

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

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

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

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

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

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

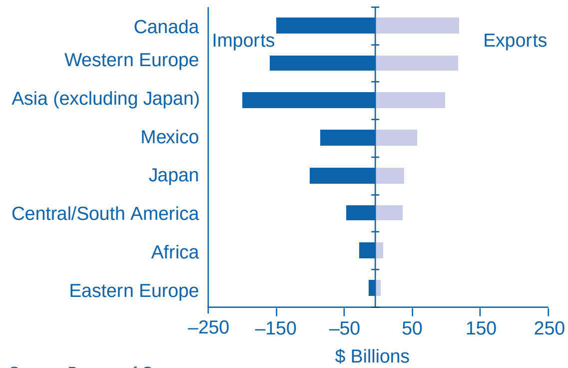
The Importance of Trade Varies among Industries

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

Industries also differ in the share of total spending devoted to imports. Imports account for a relatively

CHART 2

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



Source: Bureau of Census

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

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

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

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

TABLE 2

INDUSTRY EXPOSURE TO INTERNATIONAL TRADE				
		IMPORT SHARE OF U.S. CONSUMPTION		
		LOW	MEDIUM	HIGH
EXPORT SHARE OF U.S. PRODUCTION	LOW	Printing and publishing Food products	Lumber and wood products Petroleum and coal products Agricultural services, forestry, and fishing Furniture and fixtures	Oil and gas extraction
	MEDIUM	Coal mining Tobacco products Nonmetallic minerals, except fuels Fabricated metal products	Metal mining Paper and allied products Textile mill products Stone, clay, and glass products Rubber and plastic products Primary metal industries	Miscellaneous manufacturing industries Apparel products
	HIGH	Farm products	Chemicals and allied products Instruments and related products	Transportation equipment Industrial machinery and equipment Electronic equipment Leather and leather products

Highly Exposed Industries (Oil and gas extraction; Miscellaneous manufacturing industries; Apparel products; Farm products; Chemicals and allied products; Instruments and related products; Transportation equipment; Industrial machinery and equipment; Electronic equipment; Leather and leather products)
Moderately Exposed Industries (Lumber and wood products; Petroleum and coal products; Agricultural services, forestry, and fishing; Furniture and fixtures; Coal mining; Tobacco products; Nonmetallic minerals, except fuels; Fabricated metal products; Metal mining; Paper and allied products; Textile mill products; Stone, clay, and glass products; Rubber and plastic products; Primary metal industries)
Less Exposed Industries (Printing and publishing; Food products)

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

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

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

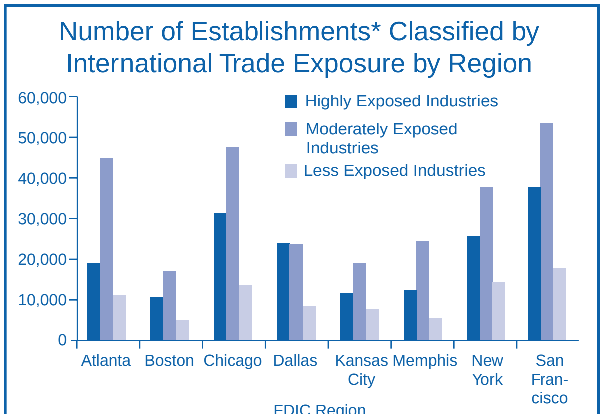
The industries in each column are categorized by the share of U.S. consumption expenditures in a particular industry that are satisfied by imports. Again, the Low and High categories each include 7 industries, and the Medium category includes the remaining 12 industries.[6] On the basis of this analysis,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

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

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

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

CHART 3



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

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

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

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

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

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

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

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

Summary

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

Paul C. Bishop
Senior Financial Economist

Atlanta Regional Perspectives

Economic growth in the Atlanta Region continues but risks persist. The Atlanta Region's economy remains strong as the nation's expansion approaches record levels; however, setbacks in new and traditional industries could jeopardize continued growth in the future. Rapid gains in the economy, however, can result in their own challenges. Development of new industries can result in new risks to local economies. Construction activity in high-growth areas, if not controlled, could lead to overbuilding. Recent development in coastal areas could increase the risk exposure to hurricanes. These risks, however, exist side by side with the perennial threats to areas dependent on more traditional types of industry, such as coal mining and apparel manufacturing. Consequently, as the expansion enters its ninth year, the Atlanta Region is not without risk.

Economic factors affecting de novo banking. Banking is like other services provided by an economy: As the market expands, so does the demand for financial services. One way to measure market expansion is through population increases. The 1990s saw a strong relationship between aggregate population growth and the formation of de novo banks at the county level. Since the recession of 1990/91, most economic growth has occurred in metropolitan areas in the Atlanta Region, a fact that readily correlates with de novo banking activity. Given the apparent strong relationship between the increase in population and greater de novo banking activity, a demand-side argument could be made that, in order for new bank charters to occur, favorable market growth conditions likewise may need to exist. Demand-side factors may not be the only contributors to de novo banking activity: It appears that supply-side forces—displaced management and available capital pool—manifest to form a new bank when demand forces are favorable.

De novo banks in the 1980s and the 1990s. The number of de novo banks in the Atlanta Region have risen substantially since their cyclical low in 1993. Although the current cyclical upswing in de novo banking is similar to the trend experienced in the 1980s, there are differences between the two eras. First, far fewer financial institutions were chartered during the current expansion than in the 1980s. Second, the market location of de novo banks in the 1990s differs from the 1980s. While the **Atlanta** and the **Tampa-St. Petersburg-Clearwater** metropolitan areas are still the most active in new openings during both cycles, the volume in both areas is lower thus far in this cycle. The biggest difference in this cycle versus the last one is more activity in urban areas along the I-85/40 corridor in **South Carolina** and **North Carolina** and in other urban areas in **Florida.**

De novo banks of the 1980s performed poorly during the last recession. De novo banks that opened from 1984 through 1991 performed poorly relative to established commercial banks[1] during the economic recession of 1990/91. The post-recession vintage of new banks in the 1980s were much more likely to have a problem bank designation[2] or fail than their established cousins. The poor performance of de novo banks relative to established banks were more pronounced in urban areas. A de novo bank had a much greater chance of being designated as a problem bank if its operations began three or more years before the recession of 1990/91. It is likely that this difference derives from the innate life cycle of a de novo bank.[3] Typically, new banks grow assets very rapidly and suffer operating losses during the early years of their life cycle. In response, regulatory authorities typically require a minimum amount of capitalization to assimilate the rapid asset growth and absorb operating losses and impose higher capital ratios for new banks during their first three years of existence. Generally, after three years these capital restrictions are eased and a typical de novo bank will leverage its equity to the same degree as a well-managed established bank to improve return on capital. The ability of a new bank to deploy its capital fully after three years when paired with a loan portfolio that usually has a higher percentage of unseasoned loans contributes to the poorer performance of new banks relative to established banks. It is likely that the crucial period in the life cycle of a de novo bank, as it matures into an established bank, extends beyond the first three years of operation until its first experience of a recession.

[1] Established commercial banks are those that opened before January 1, 1984.

[2] Problem bank designation results from a Uniform Bank Rating of 3, 4, or 5.

[3] For further discussion see DeYoung, Robert, "Birth, Growth, and Life or Death of Newly Chartered Banks," Economic Perspectives, Federal Reserve Bank of Chicago, Third Quarter 1999.

Boston Regional Perspectives

Economy continued to expand in 1999, but rate of growth eased. The Boston Region's economy continued to expand during 1999, but showed signs of slowing. Although job growth remained positive, net job losses in the manufacturing sector and slower net gains (relative to 1998) in most other sectors combined for a reduced rate of nonfarm job growth. Per capita income growth likely exceeded the national average for the sixth consecutive year. However, income growth has been gradually decelerating in the Region since peaking in 1995. Home sales growth eased during 1999, and permit issuance for new homes dropped modestly. Both of these economic indicators made strong advances in 1998, and some slowdown was inevitable. With financial markets anticipating further interest rate increases, economic activity in the Region could decelerate further in 2000.

Surging home prices may lower the Boston area's cost-competitiveness. Home price appreciation accelerated again in 1999 to its fastest pace since 1987. The Region's states experienced some of the highest levels of price appreciation in a decade during the past two years, with **Massachusetts** posting the most rapid advance. Other data and anecdotal reports suggest that the Massachusetts gain has been driven primarily by the greater **Boston** area. Meanwhile, other metropolitan areas reported less robust gains. As home prices appreciate strongly in greater Boston, companies may find it more difficult to attract new workers from other parts of the Region and nation that have more affordable housing prices. Rising mortgage rates and rapidly rising rental rates may further constrain housing affordability during 2000. To the extent that businesses are forced to relocate or expand elsewhere, smaller insured institutions operating in the Boston area could see more competition for new and existing business, which could negatively affect pricing and underwriting standards.

Insured institutions continue to perform well. Insured institutions in the Boston Region reported healthy financial conditions during the first nine months of 1999. Despite falling margins for most institutions over the past two years, profitability levels remained fairly stable largely because of rising levels of noninterest income, slightly lower loan loss provisions, and lower effective tax rates. The Region's insured institutions continue to experience funding shifts and a decline in the ratio of core deposits to assets. On an aggregate basis, the Region's insured institutions are outperforming the nation in terms of profitability, net interest margin, and past-due loan levels. The Region's loan growth is driven by an increase in commercial and industrial loans, which continue to outpace overall loan growth.

The Region's aggregate credit risk level appears stable and is below the nation's. Commercial lending activity has been brisk in the Boston Region for several years. To help determine whether this strong growth in commercial loans should be a concern, we developed a methodology for analyzing trends in loan portfolio composition and assessing overall credit risk. Results of our analysis suggest that the rapid growth of commercial loans in many of the Region's insured institutions does not appear to be adding an inordinate amount of incremental credit risk. Rapid commercial loan growth has been partially offset by slow growth or even declines in other higher-risk sectors of the loan portfolio. In most instances, the increasing exposure to commercial loans remains low relative to capital. Also, the Region's overall loan mix remains heavily weighted in what have historically been lower-risk residential real estate loans. Meanwhile, institutions are maintaining a lower weighting of loans to total assets, and the loan mix is decidedly more conservative than it was in the mid- to late 1980s. Finally, the Region's median loan loss reserve, although slowly declining during the past few years, has remained well above the nation's. Considering all of these facts, the risk profile of the Region's insured institutions currently shows no material adverse trends. Indeed, the Region's credit risk profile is much improved from that seen during the mid- to late 1980s. The Region's credit risk profile remains low relative to the nation's.

Chicago Regional Perspectives

The health of the Region's banks and thrifts is starting to show modest signs of weakness. Although aggregate banking measures generally appear solid, profitability has edged downward, adversely classified loans have increased modestly relative to capital, and capital levels have decreased slightly over the past year.

Continued manufacturing job losses have dampened job growth. Weakness in hiring in the manufacturing industry, an important swing sector in the Region, should be watched carefully as a possible leading indicator of changes in the Region's economy. Manufacturing employment in **Illinois** and **Wisconsin** declined by nearly 1 percent in third quarter 1999 compared with a year earlier. Should recent manufacturing employment cutbacks continue and the economy slow as estimated by the consensus forecast, the Region's key economic sectors and some communities could experience varying degrees of stress.

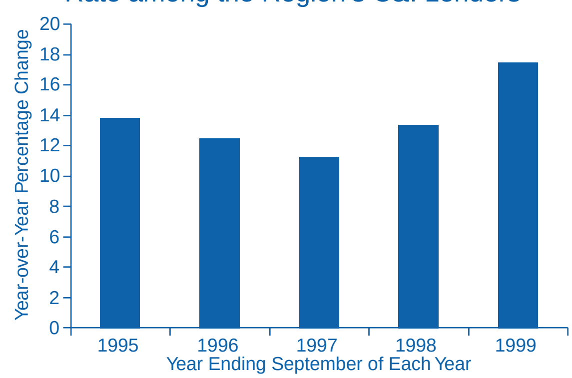
Strong household spending for goods and services continues to surprise many forecasters. However, last year's significant boost to households' purchasing power from mortgage refinancing stalled when mortgage rates stopped falling. In addition, rising interest rates over the past year have increased the cost of financing homes and other major purchases. Any weakening in demand for durable goods, such as motor vehicles and appliances, will likely be felt promptly by some of the Region's manufacturers and their employees.

Agricultural concerns are centered in Illinois, where balance sheets and earning statements reflect the financial strains experienced by crop farmers. Asset quality has deteriorated and reserve coverage of delinquent loans has declined for agricultural banks. The number of agricultural institutions with significant past-due and nonaccrual levels continues to rise. This situation, along with a ***U.S. Department of Agriculture*** forecast for continued low corn and soybean prices, highlights the need to carefully evaluate the relative level of the allowance for loan losses.

The strain felt by borrowers in Illinois agricultural communities is evident in lending lines other than the agricultural loan portfolio. Illinois agricultural banks report consumer and one- to four-family past-due and nonaccrual loan ratios notably higher than those reported by Illinois banks that are focused on consumer or residential lending.

Commercial and industrial loans are growing rapidly. Many of the Region's institutions reported commercial loan growth rates in excess of 20 percent. Small commercial loan activity has been particularly robust. A rising share of commercial loans could indicate greater credit risk, particularly in areas that are less economically diverse. For example, 18 institutions with significant and rapidly growing commercial loan portfolios are located in the **Milwaukee** and **Madison** metropolitan statistical areas, which have moderate levels of industrial diversity.

C&I Loans Are Growing at Faster Rate among the Region's C&I Lenders



Source: Bank and Thrift Call Reports

Recent interest rate increases may affect the profitability of banks that specialize in residential real estate lending. These lenders have exhibited wide earnings variability and are showing the effects of recent interest rate increases. The tighter monetary policy of 1999 has weakened mortgage markets and real estate conditions, reduced fee income, and resulted in securities portfolio depreciation.

Mortgage refinancing activity dropped significantly in 1999. Already, the industry has experienced layoffs and restructurings at some of the nation's largest lenders. Mortgage lenders, in an attempt to maintain volume, may be forced to compete strongly on price, which may lead to further margin erosion.

Dallas Regional Perspectives

Banks and thrifts in the Dallas Region continued to report strong earnings and solid credit quality. The Region's financial institutions reported a combined return on assets (ROA) of 1.32 percent for the third quarter of 1999, just slightly below the national average. Reported equity for the Region's institutions also was strong as measured by the 8.05 leverage ratio, essentially unchanged from third quarter 1998.

Loan loss reserve coverage has declined over the past year. As of September 30, 1999, the Dallas Region reported a loan loss reserve to gross loans ratio of 1.23 percent, 25 basis points below the national average. A mitigating factor is the Region's low charge-offs compared with the nation's. Thanks to a very strong economy, loan loss reserves have proven adequate to cover charge-offs incurred over the past several years. Should the economy weaken, however, and loans begin to deteriorate, many institutions may find themselves without adequate buffers against future losses.

Increasing domestic and global agricultural production and a decline in demand over the past three years have depressed exports and commodity prices. Cash receipts are at or below breakeven for most producers. Three years of declining agricultural prices have placed many of these producers in a net operating loss position. Given large world inventories, this problem will likely persist, with relief coming slowly over several years.

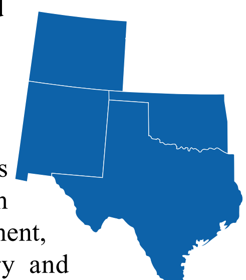
The effects of depressed commodity prices have not yet surfaced in bank financial statements. Owing in large measure to government support, the Region's agricultural banks have yet to show signs of deterioration in key operating measures. As of third quarter 1999, agricultural banks in the Dallas Region reported a strong 1.40 percent ROA, the highest for the past 12 quarters. However, this level of profitability may be attributed, in part, to the fact that a large percentage of agricultural banks have elected Subchapter S status.

Record levels of government payments are helping to mitigate the immediate threat to farm producers. Without these payments many agricultural banks would likely be facing a significantly higher level of asset quality deterioration. Continuation of this level of support is neither realistic nor a viable long-term solution. A prolonged period of low prices could compound borrower problems, resulting in a decline in profitability and lower capital cushions for many agricultural lenders. Institutions with higher levels of credit exposure may be particularly vulnerable.

Under the North American Free Trade Agreement (NAFTA), regional exports to Canada and Mexico grew by almost $14.5 billion, or 77.7 percent, between 1993 and 1998. Of course, not all of the regional growth in exports to Canada and Mexico can be attributed to NAFTA. Other important factors influencing regional exports were macroeconomic developments (e.g., exchange rates), previously implemented trade agreements and economic reforms, trends in the high-tech sector, and Mexico's maquiladora industry.

Regional export growth was broad-based, with 26 of 32 industries that export to Canada and Mexico experiencing positive growth rates. U.S. industries that benefited most from NAFTA were generally high value-added, highly skilled industries; industries hurt most by NAFTA were typically labor-intensive, low-skilled industries.

Leading NAFTA exports from the Region included electric and electronic equipment and industrial machinery and computers, totaling $4.7 billion and $8.2 billion, respectively, in 1998. Other leading exports to NAFTA countries included chemicals, petroleum products, transportation equipment, scientific instruments, primary and fabricated metals, and textiles and apparel.



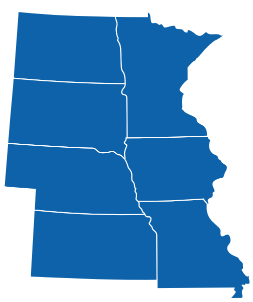
Some issues have yet to be resolved, including Mexico's failure to enforce U.S. intellectual property rights, and the U.S. refusal, based on perceived safety concerns, to permit entry of Mexican trucks into the United States according to the agreed-upon NAFTA timetable.

Kansas City Regional Perspectives

Since 1970, more than half the Kansas City Region's 618 counties have lost population. While this trend has been evident for several decades, a significant subset of the Region's counties is losing population at an increasing rate. According to the ***U.S. Census Bureau's 1998 County Population Estimates,*** 94 of the Region's counties lost population at a greater rate in the 1990s than in the previous two decades. Of these 94 counties, 84 are rural counties not adjacent to metropolitan areas.

Population trends in the Region are part of the larger story of rural-to-urban migration that has occurred through the nation's history. Farm population declines have come about as farmers have adopted new capital-intensive technologies, leading to a surplus of farm labor and subsequent outmigration from rural areas.

A number of the Region's rural counties have seen adverse population trends accelerating. The 84 counties in which population is declining at an increasing rate exhibit demographic characteristics that distinguish them from other rural counties, including lower average population, higher levels of outmigration, low rate of natural population increase, and a high proportion of elderly residents. Low population density most clearly distinguishes these counties, with average density of 6.9 people per square mile in 1998, compared with 12.0 people per square mile for other counties that have declined in population since 1970.



Many demographers argue that communities whose populations fall below a critical mass are destined for irreversible decline, as local economies no longer have sufficient human resources to maintain viability. Given low population bases and densities, some of the counties whose populations are declining at an accelerating rate may already exhibit these characteristics.

Trends at rural financial institutions tend to track the changes in population. Analysis of the Region's insured financial institutions with less than $250 million in total assets as of September 30, 1999, shows substantial differences in the performance of banks located in three types of rural counties not adjacent to metropolitan counties: counties that are losing population at an increasing rate (counties with accelerated declining populations or "AD" counties), counties that are losing population but not at an increasing rate ("Other Declining" counties), and "Growing" counties. Institutions in AD counties reported the lowest asset, loan, and deposit growth rates. Community institutions in Growing counties reported the most robust growth rates.

Core deposit growth at rural institutions is also tracking these population trends. Institutions in all three types of counties increasingly relied on nontraditional funding sources, but AD county institutions' low core deposit growth rates may have also affected their ability to grow loan portfolios. In addition, institutions in AD and Other Declining counties are more highly concentrated in agricultural lending than are institutions in Growing counties, which leaves them more exposed to long-term (rural depopulation) and short-term (low commodity prices) agricultural problems.

If rural depopulation continues, many banks and thrifts may eventually be located in counties with inadequate population bases. This could lead to consolidation among rural banks or increased risk-taking to maintain loan and deposit bases.

Memphis Regional Perspectives

After peaking in the mid-1990s, payroll employment growth in the Region consistently has lagged the nation's; in fact, the gap between national and regional growth widened during the first nine months of 1999. This slowing in the job creation rate results from tight labor markets, a second consecutive year of declining exports, and weaknesses in the manufacturing and agricultural sectors.

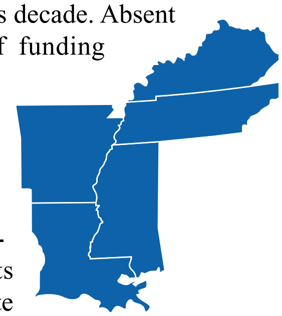
Banking conditions remain favorable. With the exception of agricultural lenders, asset quality indicators at the Region's banks and thrifts generally improved in the third quarter of 1999. The ratio of median total past-due loans to total loans was 2.17 percent, down 21 basis points from the prior year. However, earnings performance declined during the same period, primarily because of the continuing slide in net interest margins (NIMs) resulting from increased competition for loans and funding. The median NIM was 4.23 percent, 14 basis points lower than one year ago. In an effort to bolster slumping margins, many insured financial institutions are changing asset compositions to improve earning asset yields. In the process, many institutions may be accepting increased credit risk and greater market sensitivity.

Recent loan growth has been concentrated in traditionally higher-risk loan types. Although commercial and industrial (C&I) and commercial real estate (CRE) loans accounted for less than one-third of aggregate loans at institutions with less than $1 billion in total assets on September 30, 1997, these two loan types comprised almost half of net loan growth during the subsequent two years.

Although insured institutions report strong C&I and CRE credit quality, some businesses face narrowing profit margins, declining cash flow, and rising leverage as discussed in "Recent Trends Raise Concerns about the Future of Business Credit Quality" (***In Focus,*** this issue). These factors could increase the potential that more companies will default on debt obligations.

An increasing number of regulatory examination rating downgrades in the Region suggests that the level of credit risk could rise. The composite examination rating reflects a bank's overall condition and encompasses several factors; asset quality is but one of these factors. However, asset component downgrades have been typical among institutions with composite rating downgrades in recent years. These trends suggest that although aggregate loan loss rates and past-due loan ratios remain relatively low, examiners are increasingly concerned with how institutions are managing credit risk, the strength of loan underwriting practices, and the potential for future credit problems.

Market sensitivity also may be rising at some insured institutions. The volume of assets with maturities in excess of five years has grown steadily since 1995 and is now at its highest level of this decade. Absent a corresponding extension of funding sources, the lengthening of asset repricing opportunities may expose banks' earnings to greater risk with rising interest rates. At a minimum, the lengthening of asset reinvestment opportunities highlights the need for strong interest rate risk management practices.



Efforts to improve earnings performance by accepting additional market sensitivity, however, could compress NIMs following recent interest rate hikes. As assets and liabilities reprice to the new interest rate environment, funding costs likely will rise faster than asset yields.

Recent changes in asset composition prompt bank and thrift management to review their institutions' balance sheet positions in line with their own risk preferences. With favorable economic and banking conditions, now may be an opportune time to perform some level of strategic risk assessment. As a part of this strategic review, managers may wish to consider the strength of internal risk management systems and the adequacy of earnings, allowances for loan losses, and capital positions as a cushion against potential risk. Going forward, managers will need to continue to balance the desire for current-period earnings against the need for strong financial condition and performance in the future.

New York Regional Perspectives

The Region's economy is healthy, although employment growth is beginning to slow. Major economic drivers, which include Wall Street, new high-tech industries, and commercial real estate, were highly profitable in 1999. The Region has recovered from the recession of the early 1990s, and labor shortages are now more common than layoffs. Nonetheless, the Region's rate of job growth has been gradually declining, and the gap between employment gains in the Region versus the nation has been widening. Analysts traditionally ascribe the Region's slower job growth (relative to the nation) to more expensive labor, less space to build, and higher taxes. Limited population growth and, more recently, labor shortages are now being cited as contributing to slower employment growth.

The New York Region's banks reported generally healthy financial conditions in the third quarter of 1999, although profitability measures reflected competitive pressures on bank margins. The average return on assets slightly improved to 1.15 percent in the third quarter of 1999 from 1.13 percent reported one year ago. Increased noninterest income offset the effect of narrowing net interest margins (NIMs) on bank earnings. Despite preparations for Y2K, the Region's banks controlled expense growth, as the average efficiency ratio, the ratio of an institution's operating or overhead expenses to operating income, held steady at 64 percent.

Asset quality measures improved in most loan categories. Past-due loans to total loans declined slightly from 2.5 percent to 2.4 percent between the third quarters of 1998 and 1999. Delinquency rates were down for credit card, commercial real estate, and consumer loan portfolios. However, the commercial and industrial past-due ratio increased slightly from the prior year. Aided by a declining rate of personal bankruptcy filings in the nation and a strong economy, the charge-off rate on the Region's credit card loans declined to 5.16 percent in the third quarter of 1999 from 5.90 percent a year earlier.

Noninterest income has grown in importance as a share of operating income, as banks have attempted to diversify income sources, enhance profitability measures, and mitigate pressures on NIMs. In the Region, noninterest income has increased from 39 percent to 50 percent of operating income over the five years ending September 30, 1999. The Region's large, midsized, and community banks reported higher proportion of noninterest income to operating income. Increased noninterest income results from more fees for traditional banking services, such as charges on deposit accounts and credit cards, as well as expansion by banks into new services including trading, investment advisory activities, and the sale of insurance products. However, some of these newer income sources may be more susceptible to changes in financial market conditions than traditional banking services.

Despite the Region's robust economy and after a brief turnaround in the late 1990s, the Region's manufacturing sector is once again losing jobs. These losses can be attributed in part to higher energy prices, which hinder expansion by existing manufacturing companies and make New York a less attractive site for new manufacturing. A ***New York City Comptroller's Office*** study found that electricity rates in many of the Region's cities are among the highest in the United States. In addition, **New Jersey** and **Maryland** have a higher dependency on petroleum as a source of energy than does the nation. A doubling in oil prices between December 1998 and December 1999 and OPEC production cutbacks could place businesses in these states at a competitive disadvantage if oil prices remain high.

San Francisco Regional Perspectives

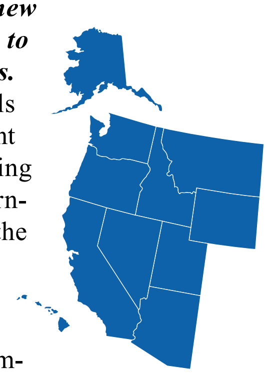
Despite tight labor markets in many urban areas and weakness in some states' economies, the San Francisco Region experienced strong economic conditions through third quarter 1999. Strength in the services sector resulted in robust employment growth in **Nevada, Arizona,** and **California.** However, softness was evident in the economies of **Washington, Oregon, Alaska,** parts of **Montana,** and **Hawaii.** Employment growth rates in Washington and Oregon declined because of slowing in the aerospace industry and lingering weakness in the Asian export markets. Alaska continued to feel the effects of consolidation in the oil industry, and areas of eastern Montana suffered because of weak agricultural conditions, specifically lower wheat prices. Although still lagging the Region and nation, Hawaii, during third quarter 1999, benefited from improving tourism activity and retail sales. Overall, despite softness in several states, the Region continues to outperform the nation, primarily because of strength in its metropolitan areas.

Per capita personal income levels and in-migration trends differ between the Region's rural and urban counties. Metropolitan counties in the Region, which have concentrations in high-tech employment, reported higher levels of per capita income and in-migration. However, rural areas lagged because of stagnating growth in the agricultural, mining, and logging sectors.

Despite weaker credit quality in some rural areas, the Region's insured institutions' overall earnings, credit quality, and capitalization remain strong. Financial institutions reported a return on assets of 1.38 percent as of third quarter 1999, higher than the nation's 1.27 percent. Continued improvements in noninterest income and provision expenses drove earnings higher for the third consecutive quarter. In addition, net interest margins, which were gradually declining in the Region from late 1997 until mid-1999, have stabilized. Improving credit quality, as evidenced by the third consecutive quarter of declines in the net charge-off rate and past-due loan ratio, has made reductions in provision expenses possible. Capital ratios have also remained strong but relatively stable despite robust earnings. This stability is likely due to increases in dividend payments and stock buyback programs.

Heightened merger and acquisition (M&A) activity, as well as increasing numbers of de novo institutions, have materially altered the San Francisco Region's banking landscape over the past decade. The Region began 1991 with 1,254 total charters, but this number had declined to 847 as of September 30, 1999. In addition to institution failures and relocations, 505 charters were eliminated through M&A and consolidation. New charters, however, partially offset this decline. For example, 114 de novo institutions are currently operating in the San Francisco Region, the highest number since year-end 1990. In fact, de novo charters in the Region as a percentage of total charters are higher than at any time during the past decade.

Increased out-of-market M&A and de novo bank chartering activity during the 1990s is attributed to several factors, including liberalized branching laws, favorable interest rates, excellent bank earnings performance, and strong equity markets, as well as robust economic conditions in the San Francisco Region.



Both types of entry into new banking markets pose risks to insured financial institutions. Out-of-market M&A entails risks such as melding different corporate cultures, integrating technology, and meeting earnings estimates. However, the risks presented by the record number of de novo institutions in the Region, none of which have endured an economic downturn, may be more significant. Over the past ten years, the Region reported 67 commercial bank failures; more than 76 percent of these failures were "unseasoned" institutions, between 4 and 14 years old. In addition, the majority of these institutions were headquartered in Southern California or Arizona, areas that suffered recessions and devaluations in commercial real estate.

The Region's current group of de novo institutions appears to have greater exposure to commercial real estate loans and a higher cost of funds than do established institutions. In addition, the earnings performance of this group of institutions has been trending downward over the past several years. Therefore, these institutions may be vulnerable in the event of an economic downturn.

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