Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 2000

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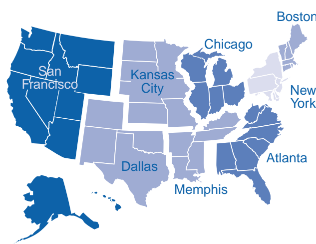

DIVISION OF INSURANCE

In Focus This Quarter

◆ ***Banking Risk in the New Economy*—This article summarizes current economic conditions, with a primary focus on potential risks to insured depository institutions. It explores the implications of long-term trends that have led to the *New Economy.* Recent high rates of economic growth with low inflation have been made possible by increases in productivity arising from new technologies, higher investment spending by businesses, and large-scale industrial restructuring. Underlying these trends has been a financial environment that has largely accommodated the growing borrowing needs of consumers and businesses. Market-based financing, provided in large part through securitizations and mutual funds, has made capital readily available to start-up "new economy" firms as well as mature companies that seek to merge or restructure. Despite the clear benefits of market-based financing in supporting economic activity, there are also concerns. A recurrence of financial market turmoil, such as that experienced in fall 1998, has the potential to quickly change the currently positive economic outlook to one that is far more challenging. Detail is provided on commercial credit quality, market sources of revenue, and other risks to watch in banking.** *See page 3.*

By the Analysis Branch Staff

Regional Perspectives

◆ ***Atlanta*—Economic strength in the Atlanta Region, low interest rates, and adequate available sources of credit have promoted growth in residential real estate construction in recent years, particularly in urban areas.** *See page 15.*

◆ ***Boston*—The Boston Region's economy continued to expand in 1999, but at a slower rate than a year ago. Recent trends suggest that insured institutions have become increasingly exposed to interest rate risk.** *See page 16.*

◆ ***Chicago*—Capital ratios among the Region's insured financial institutions remain high, but a recent downward trend is not consistent with a rising risk profile.** *See page 17.*

◆ ***Dallas*—While the makeup of liabilities in the Dallas Region has not changed significantly, many of the Region's banks have shifted to longer maturities for a large portion of assets, potentially increasing these institutions' vulnerability to rising interest rates.** *See page 18.*

◆ ***Kansas City*—Prices for major commodities remain depressed, prolonging farmers' reliance on government payments. Office construction in St. Louis poses a risk of overbuilding, given current population and employment trends.** *See page 19.*

◆ ***Memphis*—The rural economy is suffering from continued weaknesses in manufacturing and agriculture. Agricultural conditions are expected to worsen with a third year of low commodity prices and sharp reductions in tobacco production.** *See page 20.*

◆ ***New York*—In 1999, the strong stock market strengthened the Region's economy. Higher interest rates and changes in mortgage preferences could challenge the interest rate risk management programs of the Region's banks.** *See page 21.*

◆ ***San Francisco*—Commercial lenders headquartered in states registering strong economic growth during the 1990s reported rapid growth and increased concentrations in traditionally higher-risk loan types as of year-end 1999.** *See page 22.*

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Banking Risk in the New Economy

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. At this time, the banking industry as a whole continues to enjoy record profits and solid financial ratios.[1] Much of the industry's strength derives from the remarkable performance of the U.S. economy, which has been expanding for the past nine years. This article explores factors that have shaped this unusually robust economic environment and discusses how changes in the economy may create new types of risks for insured depository institutions.

During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. This loss primarily resulted from an uptick in unanticipated and high-cost bank failures. Some of these failures were associated with high-risk activities such as subprime lending, and some were related to operational weaknesses and fraud. The emergence of these problems in the midst of a strong economic environment raises concerns about how the condition of the banking industry might change if economic conditions deteriorate.

The Longest U.S. Expansion

In February 2000, the U.S. economy entered its 108th month of expansion, making this the longest period of uninterrupted growth in U.S. history.[2] This record-setting performance has also been marked by a recent acceleration in the rate of real gross domestic product (GDP) growth, which has exceeded 4 percent in each year since 1997. Meanwhile, price inflation has remained relatively subdued. The core inflation rate, which excludes the volatile food and energy components, was just 2.1 percent in 1999, the lowest core rate since 1965.

Recent economic conditions have been highly conducive to strong loan growth, low credit losses, and record earnings for the banking industry. The important question going forward is how long these favorable conditions might last. Is this remarkable economic performance the result of some long-term upward shift in the pace of economic activity, or is it the temporary result of a few transitory factors? More important, are there new and unfamiliar dangers that, at some point, could significantly impair banking industry performance? To evaluate these questions, we must assess the factors that have contributed to recent economic performance and think ahead to possible developments that could end this expansion.

What Is the New Economy?

The term used most often to describe the recent period of economic performance has been somewhat controversial: the *New Economy.* Much of the controversy has arisen because people interpret the term in different ways. Wall Street analysts use the term to refer to the high-technology sectors of the economy, such as computers and software, biotechnology, and especially the Internet. Some of these New Economy firms have been able to raise large amounts of capital and command market valuations in the tens of billions of dollars well in advance of earning a profit or even booking significant cash revenues.

Economists tend to employ the term New Economy in a slightly different way. To them, it refers to evidence that some of the traditional economic relationships have changed. For example, intangible assets now appear to play a much larger role in the valuation of investments than they have in the past.[3] Firms in some industries now may exhibit increasing returns to scale (rather than diminishing returns), reflecting the fact that the value of their product rises as it becomes a de facto industry standard.[4] Individual decision making, too, may be changing. Some believe that investors have reduced the risk premium they demand to hold equity positions

[1] For a recent summary of financial performance and condition of the banking and thrift industries, see the FDIC *Quarterly Banking Profile,* fourth quarter 1999, http://www2.fdic.gov/qbp/.

[2] The chronology of U.S. business cycles is available from the National Bureau of Economic Research, http://www.nber.org/cycles.html.

[3] Nakamura, Leonard. Federal Reserve Bank of Philadelphia. July/August 1999. Intangibles: What Put the New in the New Economy? *Business Review.* http://www.phil.frb.org/files/br/brja99ln.pdf.

[4] Brown, William S. March 2000. Market Failure in the New Economy. *Journal of Economic Issues,* 219–27.

because of their perception that holding equity is not, after all, substantially riskier than holding debt.[5] Such a shift in investor attitudes could help explain why the price-to-earnings ratio for the S&P 500 index has recently approached all-time highs.[6]

Perhaps the most important underlying change in the economy is the relationship between high rates of economic growth and changes in inflation. Economists have long maintained that rapid growth in economic activity has a tendency to lead to excess demand for goods (thereby raising consumer and producer prices) and excess demand for labor (thereby raising wage rates). But during the late 1990s, as growth accelerated and inflation remained low, economists began to reevaluate their notions of these trade-offs. Some argued that the low rate of inflation during this expansion was the fortunate result of temporary factors, such as a strong dollar and low energy prices, both of which could diminish or reverse direction over time.[7] Only a few analysts were so bold as to suggest that the fundamental workings of the economy had changed in such a way as to allow a sustained period of high economic growth with low inflation.

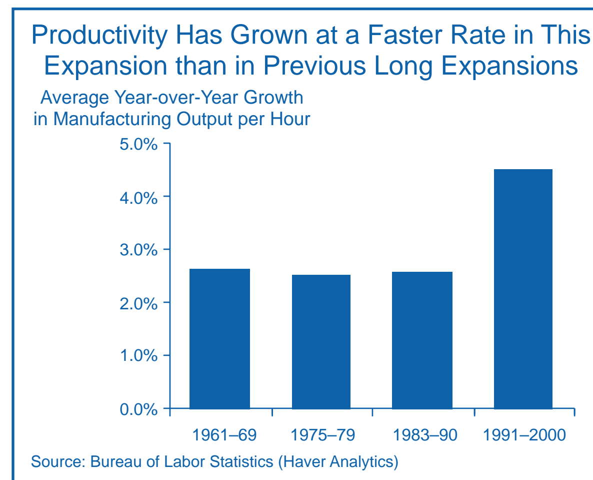
An early Wall Street description of the New Economy appeared in an article released by ***Goldman Sachs*** in January 1997.[8] It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than they have in the past. At the same time, it warned that longer economic expansions might have a tendency to contribute to greater financial excess and the possibility of more severe recessions and more sluggish recoveries.

If this hypothesis is correct, and an emerging New Economy would contribute to longer expansions and more severe recessions, there may be implications for how banks manage risks. Since the Great Depression, U.S. business cycle recessions have not necessarily been catalysts for large numbers of bank and thrift failures. During the period from 1983 to 1989, when the U.S. economy was in the midst of a long expansion, some 1,855 insured banks and thrifts failed. This wave of failures has been attributed to a variety of factors, including severe regional economic downturns, real-estate-related problems, stress in the agricultural sector, an influx of newly chartered banks and banks that converted charters, and high nominal interest rates.[9] However, the potential for significantly more severe national recessions would represent largely uncharted territory that could cause losses and loss correlations to depart from historical norms, posing a new set of risk management challenges for the industry going forward.

The Productivity Revolution

As the essential element that links faster economic growth and low inflation, productivity growth is the cornerstone of the New Economy. Productivity refers generally to the amount of output that can be obtained from a fixed amount of input. Labor productivity is usually measured in terms of output per hour. Chart 1 shows that output per hour in manufacturing has risen at an average annual rate of 4.5 percent during the current expansion, compared with rates of just over 2.5 percent in the three previous long economic expansions. Moreover, productivity growth accelerated in 1999 to a rate of 6.3 percent. Why is productivity growing so fast now compared with previous expansions? Even economists who believe that economic relationships have funda-

Chart 1



[5] January 24, 2000. Has the Market Gone Mad? *Fortune.*

[6] September 1999. Earnings: Why They Matter. *Money.*

[7] Brown, Lynn Elaine. Federal Reserve Bank of New England. May/June 1999. U.S. Economic Performance: Good Fortune, Bubble, or New Era? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer399a.pdf, and Brinner, Roger E. Federal Reserve Bank of New England. January/February 1999. Is Inflation Dead? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer199c.pdf.

[8] Dudley, William C., and Edward F. McKelvey. January 1997. The Brave New Business Cycle: No Recession in Sight. *U.S. Economic Research,* Goldman Sachs.

[9] FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s,* 16–17. http://www.fdic.gov/bank/historical/history/contents.html.

mentally changed are hard-pressed to explain why all of the factors came together in the late 1990s and not before.[10] Still, explanations for the increase in productivity tend to focus on three main factors.

Increased Competition. Expanding global trade during the 1980s and 1990s has subjected U.S. firms to new competition from around the world. Annual U.S. exports of goods and services grew by over 230 percent (after inflation) between 1982 and 1999, while imports grew by 315 percent. The construction of new production facilities around the world in industries such as autos and chemicals has led to excess manufacturing capacity that has kept prices low. In other industries, including air travel, trucking, telecommunications, and banking, competition has been intensified through domestic deregulation. Facing intense competitive pressures and a low rate of general price inflation, firms cannot rely on annual price increases to help expand top-line revenue. Instead, there is pressure to continually cut costs in order to increase earnings. For many firms, this means adopting new technologies and new ways of organizing operations.

Expanded Investment. U.S. firms of all sizes have invested in new technologies at a rapid pace during this expansion. Chart 2 shows that business investment in equipment and software represents almost one-quarter of total net GDP growth during this expansion, compared with around 15 percent or less during previous long expansions. While this investment has been motivated by the need to cut costs, it has also been fueled by the availability of new computer technologies that have fallen in cost over time and by the ready availability of financial capital on favorable terms.

Industrial Restructuring. The third aspect of the productivity revolution is large-scale restructuring in the U.S. corporate sector. Chart 3 shows that both the annual number and dollar volume of mergers in the late 1990s far exceeded the pace of the so-called merger mania of the late 1980s. Two classes of firms are leading the new wave of mergers. First, companies in mature industries such as oil, autos, and banking are faced with excess productive capacity and intense price competition. For these firms, mergers are useful in expanding market share and removing redundant operations. Second, the largest dollar volume of mergers is in some of the most volatile emerging industries, including telecom, media, and the Internet. It is in these sectors of the economy, in particular, where the business models are evolving rapidly and where technological standards are still being determined. Firms in these industries that can grow rapidly through mergers have the chance to achieve long-term market dominance in what appear to be some of the fastest growing industries of the new century.

The implications of the productivity revolution for the banking industry have been decidedly positive. Higher productivity has allowed a long expansion and faster economic growth with low inflation, all of which are conducive to robust financial performance by depository institutions. Higher rates of business investment

Chart 2

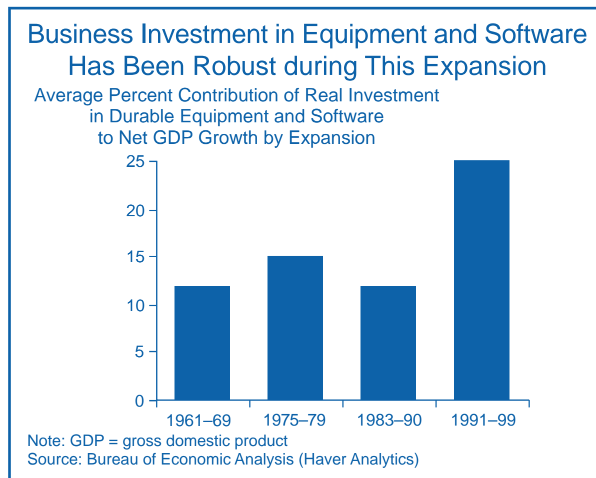
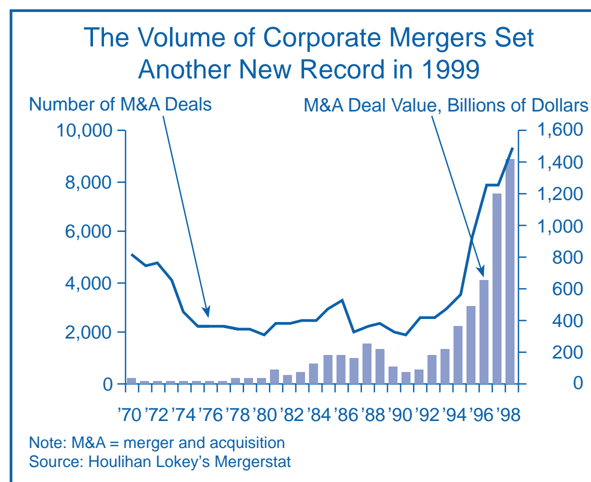


Chart 3



[10] One possible explanation is that there is a learning curve for adopting new technologies and that technology diffusion is an inherently slow process. David, Paul A. Organization for Economic Cooperation and Development. 1991. Computer and Dynamo: The Modern Productivity Paradox in a Not-Too-Distant Mirror. In *Technology and Productivity: The Challenge for Economic Policy,* 315–47.

have generated demand for credit that is supplied, in part, by banks and thrifts. Perhaps most important, the recent large-scale industrial restructuring has been highly supportive of strong business credit quality. This process has moved economic resources to more productive uses in an orderly fashion, without the high levels of bankruptcies and defaults that often accompany industrial restructuring. Given the volumes of corporate assets that have changed hands in recent years (more than $1.4 trillion in 1999 alone), it is fortunate indeed that this restructuring has proceeded in this fashion.

The Role of the Capital Markets

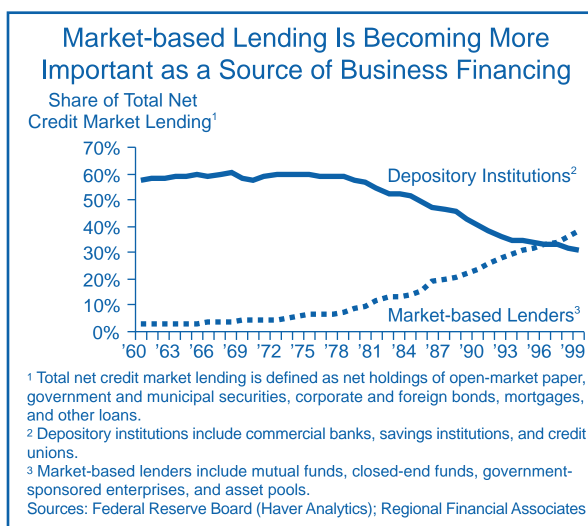
A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the cost of capital for publicly traded corporations has been sharply rising stock prices. Many of these firms have been able to use equity shares as a currency with which to finance mergers. Furthermore, existing accounting rules do not always require the amortization of good will that comes onto the balance sheet as a result of a merger.[11]

By far the largest amount of external business financing has been debt financing. U.S. nonfinancial corporations issued net debt in the amount of $535 billion in 1999 and repurchased equity shares, on net, for the sixth consecutive year. Businesses have used this debt to purchase capital equipment, finance mergers, and buy back equity shares. This increase in debt issuance has not been limited to highly rated corporations. Venture capital financing amounted to almost $15 billion in the fourth quarter of 1999 alone, with over 60 percent of that amount going to Internet firms.[12]

Banks have been active participants in nearly every facet of this financing activity. Syndicated loan origination volumes rose by 17 percent in 1999 to just over $1 trillion, despite relatively high credit costs and facility fees, factors that helped keep total volume below 1997's record $1.1 trillion in issuance. Syndicated loans to leveraged companies also rose 17 percent in 1999 to a record $320 billion. More impressive still was the growth in high-yield transactions, which rose nearly 50 percent in 1999 to $190 billion. It is difficult to determine precisely how much syndicated loan exposure resides on the books of insured institutions or, more important, how much high-yield exposure is retained by commercial banks. ***Loan Pricing Corporation*** estimates that 64 percent of high-yield volume in the first half of 1999 was retained by banks.[13] Insured commercial banks are the dominant originators of syndicated loans, with a 79 percent market share of investment-grade originations and a 56 percent market share of non-investment-grade originations in 1999. Commercial banks have also expanded their presence in the venture capital market. For some of the largest banks, profits from venture capital operations account for a large portion of total earnings. Chase Manhattan reported venture capital investment earnings of $2.3 billion in 1999, accounting for 22 percent of total net income.[14]

Innovation in the capital markets continues to provide new and more efficient vehicles for business financing. For example, issuance of asset-backed securities totaled $346 billion in 1999, up from only $50 billion in 1990. In this ongoing revolution in finance, market-based intermediaries, such as mutual funds and asset pools, have assumed an increasing role in the credit markets. Chart 4 shows that net holdings of credit market instruments by mutual funds, government-sponsored enterprises, and asset pools exceeded the debt held by depository institutions for the first time in 1997.

CHART 4



1 Total net credit market lending is defined as net holdings of open-market paper, government and municipal securities, corporate and foreign bonds, mortgages, and other loans.
2 Depository institutions include commercial banks, savings institutions, and credit unions.
3 Market-based lenders include mutual funds, closed-end funds, government-sponsored enterprises, and asset pools.
Sources: Federal Reserve Board (Haver Analytics); Regional Financial Associates

[11] April 17, 2000. Techdom's New Bean-Counting Battle. *Business Week.*

[12] May 2000. Venture financing data are derived from a PriceWaterhouseCoopers/Money Tree survey, as cited in *Upside,* 43.

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

[14] April 3, 2000.What's Really Driving Banks' Profits. *Business Week.*

While the expansion in market-based financing has made credit more available to business and consumer borrowers, it also creates some concerns. One issue is the susceptibility of the financial markets to periodic bouts of turmoil. These episodes, such as the one triggered by the Russian government bond default and the near-failure of the Long Term Capital Management hedge fund in the fall of 1998, can result in the interruption of capital flows even to creditworthy borrowers. During the 1998 episode, private yield spreads widened sharply as investors sought the safety of U.S. Treasury securities. Some companies that had planned to issue debt to the markets during that period were unable to do so. For companies whose business models depend heavily on a continuous supply of liquidity from the financial markets, the effects of these episodes can be catastrophic. For example, the relatively short-lived episode of financial turmoil during late 1998 resulted in significant liquidity problems for a number of commercial mortgage firms. Nomura, Lehman Brothers, CS First Boston, and others incurred losses, while Criimi Mae, Inc., was forced to declare bankruptcy.

Because market-based financing has played such a large role in facilitating the orderly restructuring of the U.S. economy through mergers and the formation of new businesses, a recurrence of financial market turmoil could contribute to the end of the current expansion. Moreover, such an event could have serious consequences for business credit quality. A prolonged interruption of market-based financing could, in this very competitive economic environment, prevent businesses from restructuring themselves through mergers and deprive them of capital needed to invest in cost-cutting technologies. The loss of financial flexibility would leave businesses much more vulnerable to the effects of competition and could result in more firms seeking bankruptcy protection. Such a scenario has the potential to bring about a significant increase in charge-off rates for business lenders.

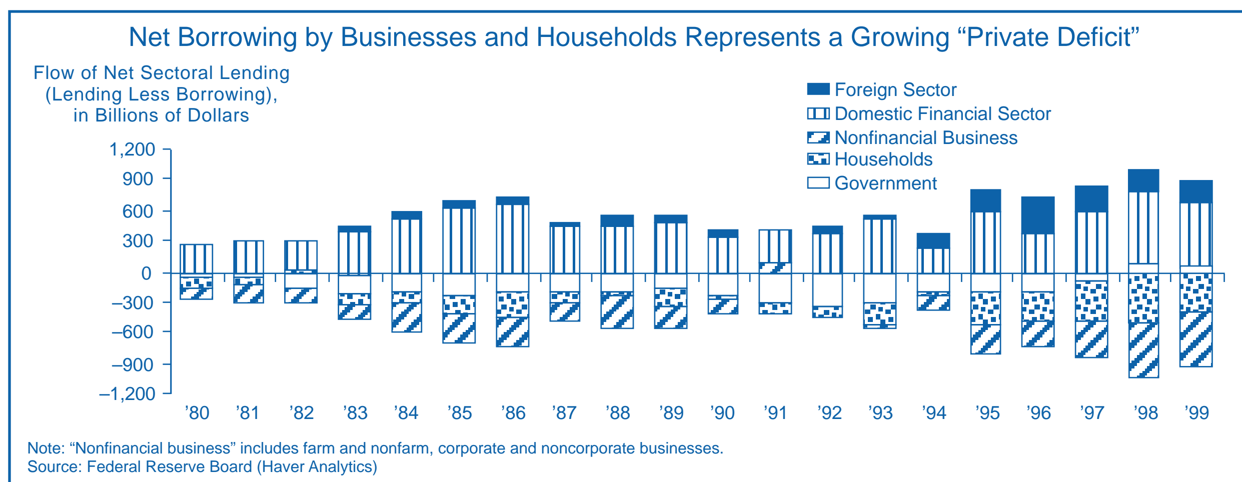
Financial Imbalances

Another concern that arises from increased dependence on market-based financing is that it may contribute to the emergence of financial imbalances in the economy. These imbalances could, in turn, increase the potential for financial market turmoil as a result of some unforeseen shock to the markets.

As recently as 1993, the public deficit was near the top of the list of economists' concerns about the U.S. economy. During that year, the combined deficit of the federal, state, and local government sectors exceeded $300 billion. However, on the strength of a long economic expansion, lower interest rates, and lower federal spending on defense, the consolidated government sector posted its second consecutive surplus in 1999 (Chart 5).

As the government has moved from deficit to surplus, households and businesses have continued to borrow hundreds of billions of dollars every year. Taken together, the annual net borrowing of businesses and households has been referred to as the "private deficit." In 1999, the private deficit narrowed to $913 billion from a record $1.02 trillion the year before. Although this private borrowing indicates confidence on the part of consumers and businesses about future prospects, it also raises concerns about the ability to service debt if interest costs rise or if incomes level off or decline.

CHART 5



The largest part of the private deficit was again financed in 1999 by domestic financial institutions ($649 billion) and an inflow of capital from abroad ($207 billion). Both of these sources of financing are potential causes for concern. The rapid expansion in credit created by the financial sector raises questions about credit quality. Financial institutions theoretically serve as the gatekeepers of the economy, financing only the most creditworthy projects and rejecting those that are not viable. The sheer volume of credit extended to businesses and households—almost $1.4 trillion in new net lending over the past two years—raises the possibility that underwriting has become more lax and that average credit quality is slipping. (See the inset box on page 17 for a discussion of recent trends in commercial credit quality.)

Reliance on inflows of foreign capital raises a different set of issues. The fact that the U.S. economy has been growing significantly faster than the economies of its major trading partners has contributed to a U.S. trade deficit that reached $268 billion in 1999 and could exceed $300 billion in 2000. This deficit puts hundreds of billions of dollars annually in the hands of foreign investors. As long as foreign investors largely choose to reinvest their excess dollars in U.S. factories and financial instruments, as has been the case in recent years, the United States can continue to enjoy a strong dollar and relatively low inflation and low interest rates. However, if foreign investors should choose to invest elsewhere, they must sell their dollars in foreign exchange markets. Doing so would put downward pressure on the dollar and upward pressure on U.S. inflation and interest rates.

Recent Shocks to the U.S. Economy

Despite the potential for a declining dollar as a result of U.S. reliance on foreign capital, other adverse developments have confronted the U.S. economy over the past year. The two factors of most consequence to the macroeconomic outlook have been rising energy costs and rising interest rates. These trends have played a role in recent equity market volatility that may have implications for the future direction of the economy.

Rising Energy Prices. After declining to a low of around $10 per barrel in December 1998, oil prices have risen dramatically over the past year and a half. The spot price per barrel of West Texas Intermediate crude peaked in March 2000 at just under $30 before declining slightly in April. The rapid increase in oil prices during 1999 was sparked by a cutback in output by oil-producing nations that was instituted just as global economic growth was recovering from the crisis of 1998. The OPEC nations and other major oil producers reached a new agreement in March 2000 that provides for a production increase of some 1.5 million barrels a day. But, because demand is rising and gasoline inventories remain lean, analysts do not look for a significant decline in gasoline prices in the near term.[15]

The effects of higher oil prices on the U.S. economy at this time are uncertain. According to some estimates, the economy is only half as dependent on oil as it was 25 years ago, when the United States was experiencing the effects of its first "oil shock."[16] Still, higher oil prices were responsible for nearly all the increase in consumer price inflation during 1999. While year-over-year growth in the Consumer Price Index rose from 1.6 percent in December 1998 to 2.7 percent in December 1999, the core rate of inflation (excluding food and energy items) actually fell. The question now is whether higher energy prices will be passed along to the rest of the economy through rising wage and price demands during the remainder of 2000.

Rising Interest Rates. From low points at the end of 1998, both short-term and long-term interest rates have risen substantially, contributing to a higher cost of debt service for businesses and households. At the short end of the yield curve, the Federal Reserve (the Fed) raised the Federal Funds rate six times between June 1999 and May 2000, for a total increase of 175 basis points. While part of this increase merely reversed the reduction in rates that took place in late 1998, the Fed also voiced concerns that inflationary pressures might be emerging because of continued rapid U.S. economic growth. Given the stated commitment of the Federal Reserve to price stability, most analysts expect the Fed to continue to push short-term rates higher until growth in the economy slows to a more sustainable pace.[17]

Bond markets also pushed up long-term interest rates during this period. The yield on the ten-year Treasury

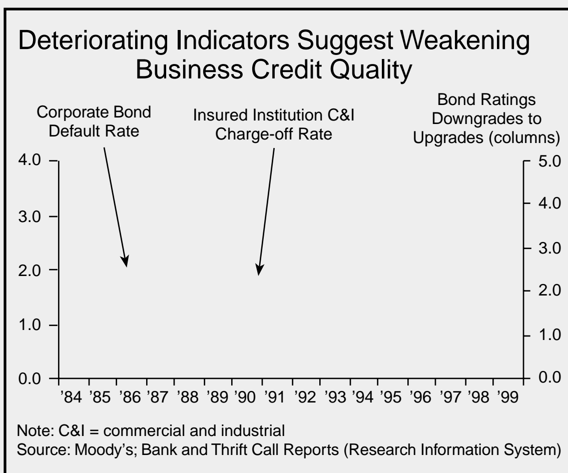
[15] Energy Information Agency (U.S. Department of Energy). April 2000. Short-Term Energy Outlook. http://www.eia.doe.gov/emeu/steo/pub/contents.html.
[16] March 11, 2000. Fueling Inflation? *The Economist.*
[17] See, for example, U.S. House of Representatives. February 17, 2000. Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services. http://www.federalreserve.gov/boarddocs/hh/2000/February/Testimony.htm.

As Commercial Credit Quality Indicators Slip, Trends in Commercial Lending Come to the Forefront

Commercial lending, which includes both commercial and industrial (C&I) and commercial real estate (CRE) loans, represents the greatest source of credit risk to insured institutions and the deposit insurance funds. C&I loan growth continued to be strong in 1999, although it did moderate from 1998 levels, and recent underwriting surveys have reported a slight tightening of terms.[18] Nevertheless, there are signs that commercial credit quality is deteriorating.[19] Most notably, as seen in Chart 6, C&I loan charge-off rates, corporate bond defaults, and corporate bond rating downgrades relative to upgrades have all been trending upward recently. For example, C&I loan loss rates rose to 0.56 percent of total loans in 1999, nearly double the rate of loss experienced in 1997. Although C&I loan loss levels are well below historical highs experienced throughout the 1980s and early 1990s, these signs of credit quality deterioration are occurring despite extremely favorable economic conditions.

At least three factors have contributed to weakening in corporate credit quality. First, corporate indebtedness has been rising, as businesses have been spending to increase productivity, cut costs, repurchase equity, and finance mergers and acquisitions. The second factor relates to a greater risk appetite in the financial markets. For example, originations of leveraged syndicated loans—in particular, highly leveraged loans—have tripled over the past five years. Finally, stresses within industry sectors hard hit by structural changes, global competition, and deflationary pressures have resulted in challenges for borrowers.

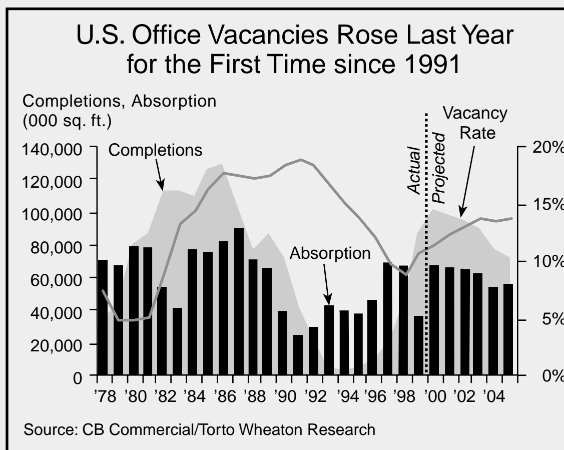
Chart 6



Construction and development (C&D) lending continues to be one of the fastest growing segments of banks' loan portfolios, while loss rates among CRE and C&D loans remain extremely low. However, there are indications that conditions could be worsening in some markets. In particular, as shown in Chart 7, strong office completions and construction activity have begun to outpace absorptions and are projected to continue to do so over the next several years. Moreover, these trends have implications for vacancy rates. The national office vacancy rate moved higher during 1999 for the first time since 1991 and is projected to climb higher.

In addition, some local CRE markets continue to show signs of overbuilding. Last year, the FDIC's Division of Insurance identified nine markets in which the pace of construction activity threatened to outstrip demand for at least two property sectors.[20] Seven of these nine markets reported an increase in office vacancy rates in 1999.

Chart 7



[18] Both the 1999 *Senior Loan Officer Opinion Survey* (Federal Reserve Board) and 1999 *Survey of Credit Underwriting Practices* (Office of the Comptroller of the Currency) point to more stringent C&I loan terms since the latter part of 1998. This tightening follows a four-year period of easing C&I loan standards and predominantly reflects an increase in loan pricing.

[19] For additional detail, see Sothoron, Arlinda, and Alan Deaton. FDIC Division of Insurance. First quarter 2000. Recent Trends Raise Concerns about the Future of Business Credit Quality. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro20001q/na/Infocus1.html.

[20] These markets are Charlotte, Orlando, Salt Lake City, Dallas, Las Vegas, Phoenix, Nashville, Atlanta, and Portland. See Burton, Steve. FDIC Division of Insurance. First quarter 1999. Commercial Development Still Hot in Many Major Markets, But Slower Growth May Be Ahead. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19991/na/Infocus2.html.

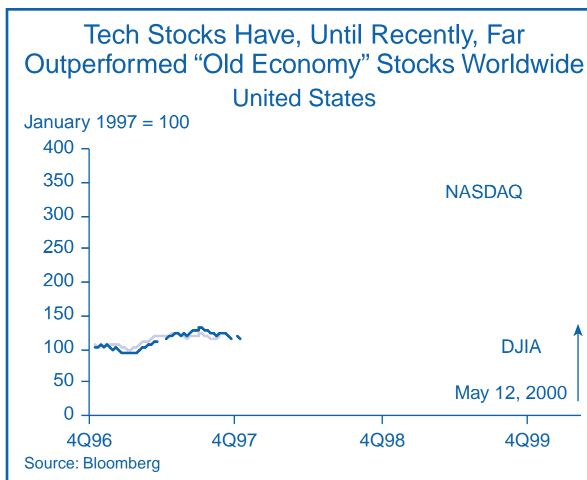
note rose from a low of 4.5 percent in October 1998 to 6.5 percent by May 2000. Analysts have cited renewed demand for credit by a recovering world economy as well as concerns about inflation arising from the increase in energy prices as factors behind the rise in long-term rates.

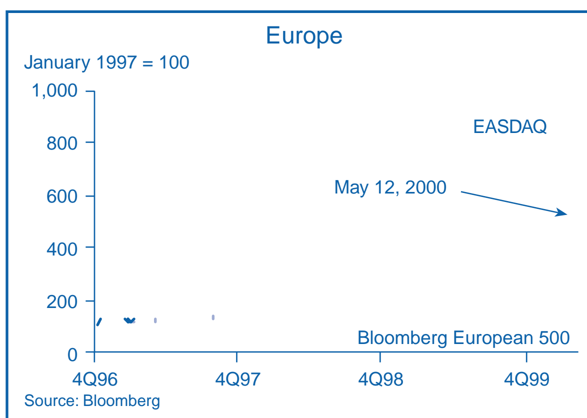
Higher energy costs and higher interest rates do not appear to have significantly slowed the pace of U.S. economic activity during the first quarter of 2000. The preliminary estimate of real gross domestic product growth during the quarter was 5.4 percent—a slowdown from the 7.3 percent rate of the fourth quarter of 1999 but still well above what is considered a sustainable pace. Home construction, usually a sector that is particularly sensitive to movements in long-term interest rates, has remained surprisingly resilient. Still confident of their future prospects, homebuyers have increasingly turned to adjustable-rate mortgages to avoid some of the immediate costs of higher fixed mortgage rates.

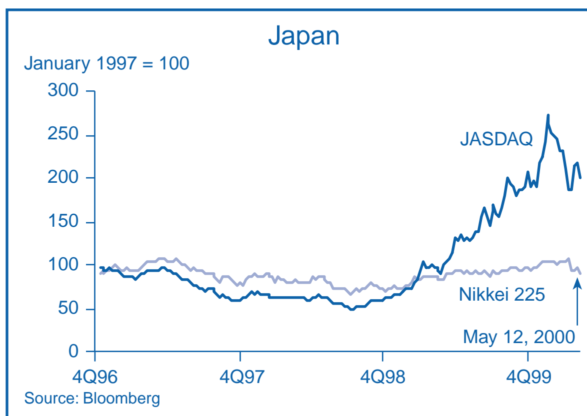
As for the business sector, higher costs for energy and debt service are most significantly affecting "Old Economy" firms that purchase commodity inputs and carry significant debt on their balance sheets. Airline companies in the S&P 500, for example, posted a year-over-year decline of 27 percent in net income from continuing operations during the first quarter of 2000.[21] Analysts have argued that New Economy firms, by contrast, are less vulnerable to recent economic shocks because they tend to carry little debt and consume relatively little energy.

Equity Market Volatility. The notion that New Economy firms are less vulnerable to the effects of higher energy costs and higher interest rates may be one of the reasons that equity shares of firms in the technology sector began to dramatically outperform the broader market, beginning around the middle of 1999. Chart 8 shows that the technology-heavy NASDAQ index performed more or less in tandem with the Dow Jones Industrial Average between the end of 1996 and the middle of 1999, but thereafter the NASDAQ soared far ahead of the Dow. Between October 1, 1999, and February 29, 2000, the NASDAQ rose by 72 percent while the Dow declined by 4 percent. Moreover, this striking divergence between the equity returns of Old and New Economy companies was not limited to the U.S. markets. Parallel trends were observed in Europe, Japan, Korea,

CHART 8







and Hong Kong. The similarity in performance of the high-tech sectors across three continents suggests a worldwide flow of liquidity from investors to the shares of technology firms.

However, emerging concerns about the technology sector contributed to significant volatility in technology

[21] Bloomberg. The S&P 500 airline industry is composed of AMR Corp., Delta Air Lines, Southwest Airlines, and U.S. Airways Group.

shares during March and April 2000. The NASDAQ index lost 30 percent of its value between March 10 and May 12, 2000. Analysts cited the Justice Department finding against Microsoft and doubts about the ultimate profitability of business-to-consumer Internet firms as two factors in the sell-off.

Equity market volatility also poses a threat to the economic outlook. One concern is the so-called "wealth effect" that a declining stock market may have on consumer spending. Since 1995, rising stock prices have helped raise the market value of equities held by U.S. households, plus their holdings of mutual funds, by some $5.7 trillion. This windfall is an important reason that households have continued to reduce annual personal savings (to just 2.4 percent of disposable income in 1999) and increase spending on homes, autos, and other consumer goods. Although it is uncertain what effect a prolonged stock market correction might have on consumer spending, the potential wealth effect has surely grown as more households hold a higher percentage of wealth in corporate equities and mutual fund shares. (See the inset box at right for a discussion of how financial market volatility could affect banks.)

The Economic Outlook

Despite the effects of rising energy costs, increasing interest rates, and equity market volatility, the U.S. economy continues to grow at a robust pace. The consensus forecast of 50 corporate economists surveyed by the May 1999 ***Blue Chip Economic Indicators*** suggests that the economy will grow by 4.7 percent in 2000, while consumer prices are projected to rise by 3.0 percent from 1999 levels. Short-term interest rates are projected to rise only slightly by year-end from early May levels. In short, the consensus forecast indicates that the New Economy formula of rapid economic growth combined with low inflation will continue for the foreseeable future. If actual events conform to this forecast, the result will likely be another year of generally low loan losses and solid earnings for much of the banking industry. (See the inset box on the following page for a discussion of other risks to watch in banking.)

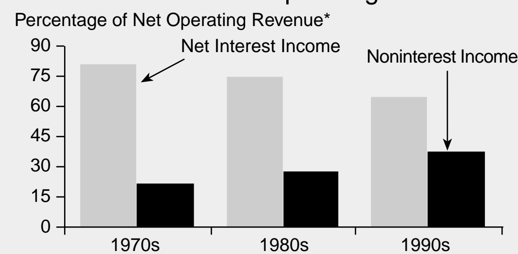
Clearly, risks are associated with the economic outlook. Recently, higher oil prices and higher interest rates have been the most visible signs of trouble for the economy. New Economy companies may be less vulnerable to these effects, but even these firms have experienced a sharp decrease in equity valuations as investors reeval-

Financial Market Volatility Could Pare Earnings for Banks Most Reliant on Market Sources of Revenue

FDIC-insured banks are deriving an increasing proportion of earnings from noninterest sources (see Chart 9), particularly market-sensitive sources of revenue. This is especially true for larger institutions. According to ***Deutsche Banc Alex. Brown,*** the 18 most active generators of market-sensitive sources of revenue earned over 25 percent of net operating revenue from these potentially volatile business lines.[22] While market-sensitive sources help to diversify revenue streams, they can also introduce increased income volatility in the event of financial market turbulence. Deutsche Banc Alex. Brown also reports that for those 18 banks that generated the largest amounts of market-sensitive revenues during the third quarter of 1998, the share of total revenue derived from market-sensitive sources declined from 23 percent to 13 percent. Thus, a more sustained downward trend in the financial markets could particularly affect the earnings of large banking companies that rely heavily on income from sources such as venture capital, asset management and brokerage services, and investment banking.

CHART 9

Noninterest Revenues Account for a Growing Share of Bank Net Operating Revenue



* Net operating revenue is the sum of net interest income and noninterest income.
Sources: FDIC Historical Statistics on Banking; FDIC Quarterly Banking Profile

[22] Net operating revenue is the sum of interest income and noninterest income less interest expense. According to Deutsche Banc Alex. Brown, these companies are Bank of America Corporation; Bank of New York Company, Inc.; Bank One Corporation; Bank Boston; BB&T Corporation; Chase Manhattan Corporation; Citigroup, Inc.; First Union Corporation; FleetBoston Financial; JP Morgan; KeyCorp; Mellon Financial Corporation; National City Corporation; PNC Bank Corp.; SunTrust Banks, Inc.; US Bancorp; Wachovia Corporation; and Wells Fargo & Company.

Other Risks to Watch in Banking

Subprime Lending

- ***Subprime consumer loan portfolios contributed to the large losses associated with recent high-cost bank failures.*** During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. The loss was primarily the result of an uptick in unanticipated and high-cost bank failures. FDIC-insured institutions with at least 20 percent of Tier 1 capital in subprime loans accounted for 6 of the 13 bank failures that occurred between January 1998 and March 2000. Fraud and inappropriate accounting for residuals also played a role in some of these failures.[23]

- ***Subprime lending remains an area of concern.*** Insured depository institutions that engage in subprime lending represent a disproportionate share of problem institutions. Of the 79 banks and thrifts on the problem bank list as of year-end 1999, 21 percent were institutions with at least 20 percent of their Tier 1 capital in subprime loans.[24]

Agricultural Lending

- ***While a majority of agricultural institutions remain relatively strong, external conditions have put pressure on some agricultural producers***. Many agricultural areas are experiencing low commodity prices as well as weather- and disease-related problems. Strong global competition and high worldwide production over the past several years have resulted in increasing inventories of many crops and poor prospects for a price turnaround in the near term. Moreover, in spite of record government farm payments in 1999, the U.S. Department of Agriculture projects that in the year 2000 one in four farms will not cover cash expenses, up to 20 percent of farmers will experience repayment problems, and 5 percent of farmers will be "vulnerable."[25]

- ***Some signs point to growing stress for agricultural institutions.*** Forty-two percent of FDIC-supervised banks active in agricultural lending showed a moderate or sharp increase in the level of carryover debt during third quarter 1999, compared with just 26 percent during third quarter 1998.[26] In addition, net loan loss rates for agricultural production loans increased in 1999 to the highest level since 1991. However, at 0.32 percent, the 1999 net loss rate is just one-tenth the rate experienced during the height of the agricultural crisis of the mid-1980s.[27]

Operational Risk

- ***Operational risks are becoming more prominent in the banking industry.*** Driven by consolidation and expansion into new product lines and markets, financial institutions are seeing an increase in operational complexity. Operational risk encompasses a host of factors not related to credit or market activities, including risks associated with processing transactions, legal liability, fraud, strategic missteps, and internal control weaknesses. Operational risks tend to be more pronounced when institutions engage in rapid growth, far-flung operations, and complex business processes.

- ***Greater attention is being paid to operational risks in the financial industry***. Recently, analysts have noted that the pressure to meet ambitious postmerger earnings predictions can result in cost-cutting measures that jeopardize the comprehensiveness and integrity of risk-management systems. In addition, the role that fraud has played in recent bank problems and failures reinforces the importance of adequate internal controls and audit procedures. The significance of operational risks to financial institutions has been noted in industry surveys and information-sharing efforts among financial firms.[28] NetRisk Inc., a Greenwich, Connecticut, consulting firm, recently estimated that operational losses among financial institutions have exceeded $40 billion over the past five years.

[23] See Puwalski, Allen. FDIC Division of Insurance. Second quarter 1998. Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings. *Regional Outlook.* http://fdic01/division/doi/outlook/2q1998/atlanta/infocus1.html.

[24] The problem bank list includes all insured depository institutions rated a composite "4" or "5."

[25] "Vulnerable," as defined by the U.S. Department of Agriculture Economic Research Service, applies to institutions that have debt/asset ratios above 0.40 and negative income such that they cannot meet current expenses or reduce existing indebtedness.

[26] September 1999. *FDIC Report on Underwriting Practices*.

[27] See Anderlik, John M., and Jeffrey W. Walser. FDIC Division of Insurance. Third quarter 1999. Agricultural Sector Under Stress: The 1980s and Today. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/agricult.html.

[28] For additional detail, see March 2000. Operational Risk: The Next Frontier. *RMA/PricewaterhouseCoopers Survey.* April 6, 2000. Tech Bytes: Banks Join Forces Against Operational Risk. *American Banker.*

uate the long-term prospects. Equity market volatility threatens to dampen consumer confidence and the ability of businesses to continue to merge, restructure, and invest.

The economy has become particularly dependent on financing delivered through the capital markets. In this more permissive financial environment, rising debt levels and greater dependence on foreign capital have emerged as financial imbalances that may contribute to future problems for the economy. Businesses and households with high levels of debt are more vulnerable to problems if interest rates continue to rise or income growth falters. Rapid credit creation by the domestic financial sector suggests the possibility of lax credit underwriting standards. Reliance on foreign capital raises concerns about what would happen to the value of the dollar and to domestic inflation if foreign investors decide to invest elsewhere.

Some analysts suggest that the New Economy, driven by increased productivity, heightened competition, and robust investment, may be characterized by longer expansions. Financial market imbalances may, however, contribute to deeper recessions and more sluggish recoveries compared with earlier business cycles.

For the banking industry, it is clear that a recession would mean slower loan growth, deteriorating credit quality, and impaired profitability. But the biggest threat to the banking industry is a recession that is tied to disruptions in the financial markets. The ready availability of financing to start new businesses and restructure old businesses has been key to the New Economy. The process by which businesses have invested and restructured in response to competition has been orderly from the perspective of bank creditors. If this process should be disrupted, we could see a much more disorderly process, with more bankruptcies and higher losses to lenders.

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

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Atlanta Regional Perspectives

Economic growth in the Atlanta Region fueled residential real estate development. Economic strength in the Atlanta Region, combined with low interest rates and adequate available sources of credit, has promoted expansion in residential real estate construction in recent years, particularly in urban areas. Insured institutions in some of the Region's metropolitan areas are providing residential financing, permanent and construction, at a pace ahead of the national average, which may result in higher default rates in the event of an economic downturn.

Structural and cyclical changes in real estate financing also may have implications for banks in the Atlanta Region.

In tandem with the favorable economic drivers, some structural changes in residential real estate financing during this expansion could influence loss rates in a downturn. Low mortgage interest rates, ready availability of credit, and increases in loan-to-value ratios have contributed to the rising level of homeownership. Such factors have made home buying affordable for many first-time buyers who may not have the capacity to service debt should the economy falter. Also, rapid price appreciation has allowed many consumers to increase their debt levels through home equity lines. Any future weakening in housing values could strain households that have borrowed extensively on the expectation that housing prices will continue to rise. The combination of new homeowners and increased borrowing secured by home values may expose lenders to greater credit risk.

An additional significant risk to real estate markets is the recent rise in interest rates, which are approaching highs not seen since early 1997. According to ***Freddie Mac,*** mortgage rates as of the third week of March 1999 were at 8.2 percent, up from 6.5 percent in late 1998. Despite the current rise in mortgage rates, permit issuance, absorption of new supply, and existing home sales have yet to be significantly affected in the Atlanta Region. However, if mortgage rates reach double digits, a material effect likely will occur as absorption of new supply and existing home sales may slow.

Atlanta Region banks are exposed to residential construction and development lending. Residential construction and development (C&D) lending exposures at some banks operating in many of the Atlanta Region's urban areas are significant. In fourth quarter 1999, C&D loans represented 6.6 percent of community bank assets in the Region's metropolitan areas, nearly 50 percent higher than the U.S. metropolitan average. Moreover, compared with the nation, the Region is home to urban community banks with much larger than average C&D concentrations. Specifically, while the Region accounts for 15 percent of the nation's urban community banks, it is home to 22 percent (123 banks) of the nation's banks with C&D loan exposures above 10 percent of assets.

Commercial real estate development has increased in Northern Virginia. Throughout the latter half of the 1990s, commercial real estate (CRE) development has increased substantially as high-tech ventures and supporting industries have moved to or expanded in the suburban **Virginia** portion of the **Washington, D.C.,** metropolitan statistical area. However, technologies can change, industry growth can slow, and companies can fall out of favor. Also, many of these high-tech enterprises may not be recession-tested, and nationwide anecdotal evidence shows that some of these firms are making rent payments in the form of equity or stock options. The effects of any problems in the high-tech sector likely would be felt throughout the local economy. Continued balance in Northern Virginia's CRE markets will depend on the ability of the area's high-growth industries to continue to absorb new construction in the pipeline or in the planning stages.

Nearly all community banks (those headquartered locally with assets less than $1 billion) in Northern Virginia are actively involved in real estate lending, with C&D loans totaling more than $300 million. Some Northern Virginia banks hold C&D loans that account for more than 10 percent of total assets. Problems in the high-tech-fueled local economy could ultimately affect banks' C&D loan quality. Commercial absorption estimates could be reduced for specific types of space, and growth in supporting industries also could be adversely affected. The local banking industry's ability to weather an economic or industry downturn may be further complicated by the fact that one-third of Northern Virginia's banks have not been recession-tested, having been established after 1991.

Boston Regional Perspectives

The economy continued to expand, but at a slower rate. The Boston Region's economy experienced another year of solid growth in 1999, but the pace slowed from 1998. Total nonfarm job growth decelerated, with manufacturing the only sector to show a decline in net employment last year. Annual per capita income growth (first three quarters) was on par with the 1998 pace and rose faster than that of the nation, while housing markets showed some signs of slowing. The past year saw a slight decline in new home construction and a more modest gain in housing sales volume relative to 1998.

Low inventory slows existing home sales, increases resale prices. New England existing home sales growth slowed in 1999 compared with the previous year. Growth moderated significantly in most states in New England except **Maine,** which reported rapid growth. Sales in **Massachusetts** actually declined modestly in 1999. Much of the slowdown in that state was reportedly the result of a limited inventory of homes for sale, particularly in the state's dominant greater **Boston** market. Home resale price gains again exceeded those of the nation, led by gains in Massachusetts and **New Hampshire** that were attributable to low inventory and increased demand.

Insured institutions performed well despite falling margins. Boston Region insured institutions reported healthy financial conditions in 1999. On an aggregate basis, the Region's insured institutions continue to perform well compared with those of the nation.

Insured institutions in the Region (excluding credit card institutions) reported an aggregate return on assets of 1.09, down slightly from 1998 because of merger-related charges in the Region's larger institutions. Profitability was depressed by a declining net interest margin, caused in part by a flattening of the yield curve. Past-due ratios continued to decline and net charge-offs remained stable. However, noncore funding as a percentage of assets continued to increase in all asset categories. Commercial and industrial loans and consumer loans drove loan growth.

Many of the Region's insured institutions face increasing exposure to interest rate risk. Recent trends suggest that many insured institutions in the Region have become increasingly exposed to rising interest rates. This trend is particularly evident among savings institutions, which represent a large share of the Region's insured institutions. This situation suggests that the Boston Region faces greater interest rate risk exposure than other parts of the country. The concentration of assets that either mature or reprice in excess of five years has increased because of the prolonged low interest rate period of the past two years. At the same time, there appears to be little change in the maturity of liabilities to offset the growth in long-term assets and mitigate the increasing interest rate risk. Nor do institutions appear to be utilizing off-balance-sheet mechanisms to mitigate the rising level of risk. Our analysis of the sensitivity of nonmaturity deposits suggests that depositors will increasingly seek alternative investments once interest rates rise above a certain threshold. Thus, holding down costs on nonmaturity deposits may not always be the best asset/liability management strategy to control for interest rate risk. Results also suggest that short-term exposure to higher rates has risen significantly, and the duration of the exposure has increased as well, particularly for those institutions with high concentrations in long-term assets.

Chicago Regional Perspectives

The Region's banks and thrifts reported record earnings and generally healthy conditions at year-end 1999. However, the range of profitability as measured by return on assets has widened over the past two years and is trending downward for the more poorly performing institutions. The number of established[1] insured financial institutions that were unprofitable increased to 59, or 3 percent of the Region's institutions, at December 31, 1999, compared with 35, or 1.7 percent, a year earlier.

The Region's labor market reflects the economy's health and constraints. High employment is supporting moderate household income growth. The buoyancy of domestic demand is being supplemented by a revival in demand from abroad. Yet job growth in the Region lags the nation, and tight labor markets are tempering the capacity of the Region's economy to expand rapidly.

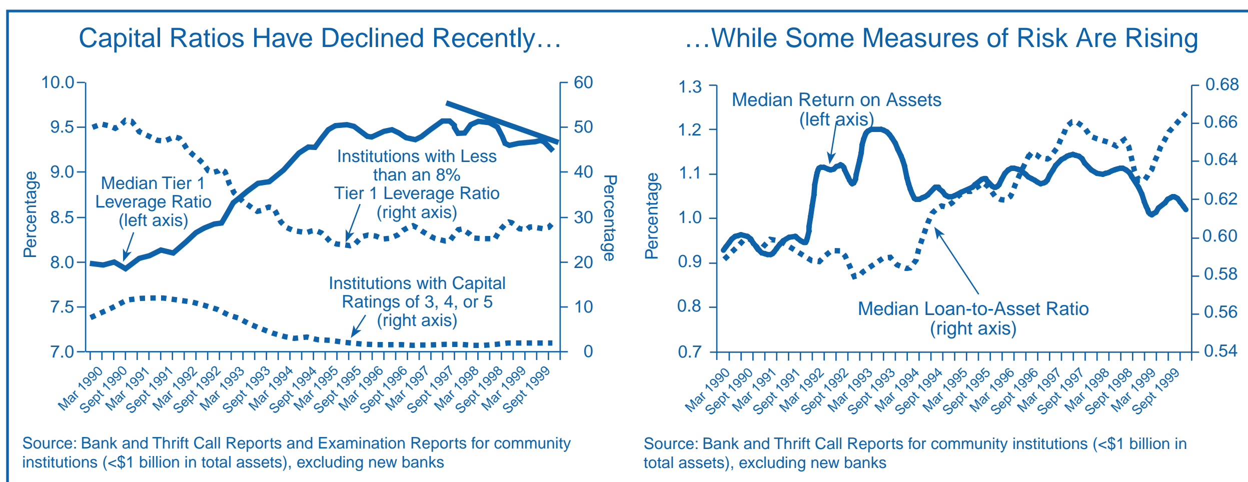
Agricultural bankers shared views on current conditions and outlook. On March 30, 2000, the FDIC hosted an agricultural bankers' roundtable in **Springfield, Illinois,** to discuss the effect that prolonged depressed commodity prices are having on small farmers and rural agricultural banks. The roundtable participants also addressed the long-term structural changes occurring in the agricultural industry and in rural communities.

Going into the 2000 planting season, bankers voiced some concerns. First, dry soil conditions have increased the potential for drought this summer. In addition, rising fuel costs and interest rates will increase farm expenditures. Bankers also indicated that operating lines are increasing, an indication that cash reserves may be declining. Younger farmers with higher leverage and lower cash reserves appear to be most vulnerable to the consequences of sustained low commodity prices.

Although the median Tier 1 leverage ratio remains high, the recent downward trend is not consistent with increased risk shown in some measurements. After rising dramatically in the early 1990s, the median Tier 1 leverage ratio has declined modestly during the past few years (see Chart 1). Also during this time, the Region's median loan-to-asset ratio is rising and profitability is declining (see Chart 2).

Strong growth primarily in commercial and commercial real estate loan portfolios has driven the increase in the loan-to-asset ratio. Traditionally, these two segments have been the higher-yielding, higher-risk portions of the loan portfolio. Yet profitability levels have not improved as a result of this loan growth. Other factors, such as increased competition, which may suppress loan yields, and growth in noncore funding, which raises funding costs, are dampening profitability. These factors constrain the ability of the Region's institutions to strengthen capital positions. In addition, the financial flexibility afforded by some noncore funding sources may be tempting more institutions to operate at lower capital levels.

CHARTS 1 AND 2



Source: Bank and Thrift Call Reports and Examination Reports for community institutions (<$1 billion in total assets), excluding new banks

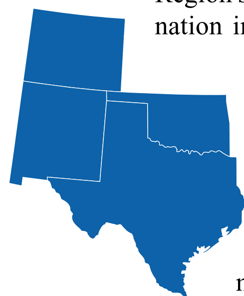
Source: Bank and Thrift Call Reports for community institutions (<$1 billion in total assets), excluding new banks

[1] Established insured institutions exclude any banks and thrifts less than three years old.

Dallas Regional Perspectives

Dallas Region average annual employment outpaced other regions as the decade ended. The Dallas Region has exceeded the nation in employment growth for 11 consecutive years. The Dallas Region reported an annual average growth rate of 3 percent during the 1990s, outpacing other areas of the country. However, during 1999, problems in the energy, manufacturing, and agricultural sectors resulted in a growth rate of 2.5 percent, the Region's slowest since 1992. Concerns about rising interest rates, higher inflation, stock market volatility, possible economic shocks from abroad, and rising business and living costs within the Region could constrain the U.S. expansion and regional economic growth.

Banks and thrifts in the Dallas Region continued to report strong earnings and solid credit quality. The Region's insured institutions tracked the nation in return on assets (ROA), leverage, and past-due ratios. The Region's banks tend to have a slightly higher net interest margin (NIM), but lower noninterest income. These figures reflect the Region's large number of small banks that are more reliant on income from loans and investments.



Colorado banks and thrifts continued to post impressive gains, as evidenced by an ROA of 1.60 percent and return on equity over 21 percent. A robust economy contributed to strong earnings and lower past-due ratios. However, in support of the state's healthy construction sector, real estate loans represented 64 percent of total loans at year-end 1999, up dramatically from 51 percent three years ago. This rapid increase in real estate lending may be cause for concern should the economy slow.

Maturities for securities, most notably for the Region's holdings of mortgage-backed securities (MBS), remained extended. MBS with maturities in excess of 15 years, as of year-end 1999, stood at 63 percent of total MBS portfolios, up from 40 percent two years ago. Price volatility and interest rate movements affected the value of securities held by banks during 1998.

In addition, insured institutions in the Dallas Region experienced a fair market value decline for securities investments. As of December 31, 1999, the account used to track unrealized gains or losses from securities available for sale was a negative $1.3 billion, a $1.6 billion decline from year-end 1998. While the decline represents only a fraction of total assets, it accounts for 6 percent of equity capital. Moreover, securities classified as held to maturity (representing 22.5 percent and 18.5 percent of all securities in the Region and nation, respectively) are carried on the balance sheet at book value without adjustments for changes in value. If interest rates continue to rise, the income from these securities will be lower than market rates. This adverse effect on interest income would likely result in a decline in the overall NIM.

Thus far, increases in Treasury interest rates have not translated into lower NIMs in the Region; however, Dallas Region institutions remain vulnerable to rising rates. Asset yields may be exposed because of the large portion of the Region's assets invested in long-term fixed-rate securities. As rates increase, the values of the fixed-rate securities decline, and the income received is less than the prevailing market rate.

On the interest expense side, the Region's funding advantages—strong core deposit levels and a high volume of non-interest-bearing deposits—may become more vulnerable in a rising interest rate environment. Although core deposits have historically been stable sources of funding and may be less price sensitive than other funding sources, at some point in a rising interest rate environment the majority of these deposits can be rate sensitive and may pressure interest expense. In addition, pending legislation to allow banks to pay interest on business checking accounts, if enacted, could raise banks' costs.

Kansas City Regional Perspectives

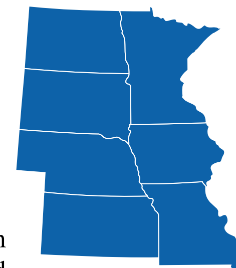
Agricultural conditions remain depressed, with little improvement expected in 2000. The cumulative effects of four consecutive years of bumper crops in major agricultural-producing countries continue to depress prices for the major field crops. Prices for corn, wheat, and soybeans have declined dramatically since 1996. A long run of unusually favorable weather, both at home and abroad, led to the increasing accumulation of stocks, which is the most important determinant of field crop prices.

The outlook for livestock prices is more optimistic. Pork industry analysts expect prices to rise above the $40 per hundredweight level for 2000. Similarly, cattle prices appear headed for improvement this year.

The U.S. Department of Agriculture (USDA) forecasts that U.S. net farm income will decline from $48.1 billion in 1999 to $40.4 billion in 2000. Much of the decline is based on assumptions of lower government payments in 2000. The USDA forecast for 2000 does not assume additional emergency aid in 2000, but emergency aid cannot be ruled out in an election year as congressional candidates from agricultural-dependent areas of the country try to appeal to their constituents.

Reported farm bank results remain positive. In the aggregate, as of year-end 1999, the Region's 1,279 farm banks continued to report sound conditions. Earnings remained strong, as seen by the aggregate 1.18 percent return on assets ratio, contributing to adequate reported capital levels. Funding is a concern as farm banks continue to have difficulty increasing core deposits and are turning instead to noncore funds to support asset growth. Such funds typically are more expensive and volatile than core deposits. As a result, increased interest expenses, coupled with more intense competition for loans, have put moderate pressure on net interest margins. Farm banks in the Region reported an aggregate net interest margin of 4.09 percent in 1999, down from 4.15 percent in 1998 and 4.25 percent in 1997.

The St. Louis office market is heating up. Office vacancy rates increased from 8.8 percent at the end of 1998 to 12.1 percent during the first half of 1999, prompting concern about whether this increase is a temporary distortion or the beginning of a long-run buildup in surplus office space. Presently, office vacancy rates differ greatly among building classes and submarkets. Not surprisingly, the suburban office submarkets in St. Louis appear much stronger than the downtown submarket. What may be of concern, however, is that the amount of actual and planned office space construction appears inconsistent with population and employment trends for the metropolitan area. Overbuilding in office space this late into an economic expansion may exert downward pressure on rents and property values.



Because the office supply cycle is thought to be more closely tied to its own supply cycle than to market demand, there is a risk of periodic "boom-to-bust" cycles. Competitive pressure to build may result in an oversupply of office space. Office construction starts, planned construction, and aggressive revitalization efforts all point to an increase in future office space during a time when office absorption is slowing.

Torto Wheaton Research predicts that, along with a rise in vacancy rates, rents will peak during 1999 and begin a long period of decline as newly completed office space comes on line. Furthermore, it expects office vacancies downtown and in the suburbs to converge in the double-digit range, which is a significant increase from the present.

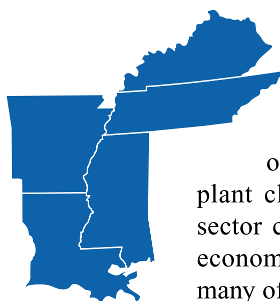
Smaller commercial banks in the St. Louis metropolitan area reported that nearly three-fourths of total loans were secured by real estate, compared with about one-half of total loans for banks in **Kansas City** and **Minneapolis.** Moreover, commercial banks in St. Louis have increased holdings of commercial real estate loans to a greater degree than banks in the comparison metropolitan areas.

The implications of an overbuilt office market to commercial banks are clear. Higher office vacancies could result in projects that generate less net operating income, which translates into less cash available to service debt. In addition, expectations of slower rental rate increases or declining rents will depress the market value of office buildings that serve as collateral. Importantly, because of lending limitations, smaller commercial banks are more likely to fund class B and C buildings, and these types of properties appear to be experiencing the greatest competitive pressure.

Memphis Regional Perspectives

The Memphis Region experienced generally favorable economic conditions during 1999, although employment growth lagged the nation and some sectors outperformed others. The service and retail trade sectors, driven by robust consumer spending, contributed significantly to annual employment growth of 1.5 percent. By contrast, the Region's manufacturing sector lost jobs in 1999, continuing a longer-term trend.

The strength in urban-concentrated service employment compared with weaknesses in rural-based manufacturing is contributing to a growing economic disparity between urban and rural areas. Many people in the rural labor force remain dependent on manufacturing because of the lower skill level required. Recent plant closures, particularly in the apparel and textile industry, resulted in an increasing number of layoffs in rural areas. Continued plant closures and job losses in the sector could exacerbate already poor economic conditions in rural areas, many of which also face weak agricultural conditions.



A third consecutive year of sustained low commodity prices will further stress farm financial conditions. The U.S. Department of Agriculture (USDA) projects net cash income for the farm sector in 2000 to fall to its lowest level since 1986. Farmers in the Memphis Region are expected to be among the most severely affected. Specifically, the USDA projects that

- The Mississippi Delta will experience the largest drop in average net cash income in the nation over the next two years, with expected declines of 39 percent in 2000 and an additional 30 percent in 2001.

- The Mississippi Delta will report the largest increase in the nation in the number of farms with negative cash flows.

- Twenty percent of farm businesses in the Mississippi Delta will experience debt repayment difficulties in 2000, which would represent a substantial increase from prior years and the highest level in the nation.

Agricultural loan problems could worsen in 2000 and 2001 as farm conditions in the Region deteriorate. Agricultural production loan past-due ratios and loan loss rates increased during 1998 and 1999, as did carryover debt levels. Underwriting standards will take on added importance as lenders receive an increasing number of loan applications from less creditworthy borrowers. Also, credit administration and loan review functions may require additional attention as existing loan portfolios experience rising delinquencies.

Lenders in many Mississippi Delta communities also face additional economic and demographic hurdles. With off-farm employment opportunities a major factor in the continuing economic viability of many smaller farms, weaknesses in manufacturing sector employment may further stress many farmers. Also, the Mississippi Delta is losing population as people exit to more economically vibrant areas of the nation. These trends could eventually have significant structural implications for many Mississippi Delta communities and the financial institutions serving them.

Tobacco farmers in Kentucky and Tennessee also face a bleak outlook for 2000. The amount of annual domestic tobacco production is down sharply because of reduced U.S. cigarette consumption, lower export levels, and increased use of imported tobacco in domestic production. As a result, earlier this year the USDA announced the largest reduction in the amount of tobacco allowed to be sold in the history of the tobacco program (the program strives to maintain stable prices by controlling production levels). A cumulative 60 percent reduction in tobacco production for 1999 and 2000 equates directly to a similar decline in farm income for burley tobacco farmers in Kentucky and Tennessee.

Potential challenges for banks operating in tobacco-dependent areas include elevated credit quality concerns, declining overall loan demand, and additional funding pressures. The uncertain outlook for tobacco farming will require considerable effort by institution officers and directors to properly manage current risks and plan for future growth.

New York Regional Perspectives

Although the Region's economic growth rate lagged the nation's in 1999, this gap narrowed because of the strong stock market and a growing concentration of new high value-added jobs. Forecasts by ***Regional Financial Associates*** call for the Region's economic growth to continue in 2000 but at a slower pace than the nation's. The strong economy has increased demand for commercial real estate, particularly in the large urban areas. In third quarter 1999, vacancy rates in **New York City, Washington, D.C.,** and **Wilmington, Delaware,** were almost half the nation's average. Vacancy rate trends in the Region's major metropolitan areas differ from those reported prior to the recession of the early 1990s. While vacancy rates for many metro areas were lower than the national average during that time, vacancies had started to rise in some areas. This economic downturn hit the Region's real estate markets harder than those in other parts of the nation, in part because a significant amount of new office construction was being completed just as the Region's economy was contracting and demand for space was declining.

The Region's banks benefited from increased noninterest income, stable credit quality, and a steeper yield curve in the fourth quarter of 1999. In the latter half of 1999, the average net interest margin rose as the yield curve steepened following increases in the Federal Funds rate. The ratio of loans to deposits also rose during the year, but the Region's banks faced competition for core deposits, which declined marginally as a percentage of assets.

Lower charge-off rates reported by the Region's credit card specialists partially offset the effect of competitive pressures on margins. Although returns on credit card lending continue to exceed returns earned by most of the banking industry, and credit quality measures improved in 1999, the outlook for credit card banks is mixed. As interest rates declined from 1997 through the first half of 1999, some consumers paid off credit debt with proceeds from refinanced mortgage loans. Refinancings have declined, however, as interest rates have risen, and a potentially slower economy could have implications for consumer credit quality. In addition, although average credit card delinquency and charge-off rates have improved, in 1999 the consumer debt service burden reached its highest level in ten years.

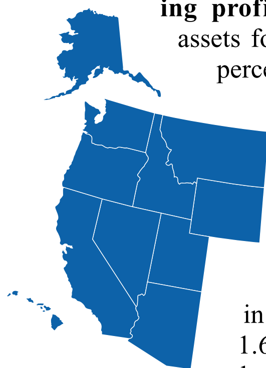
The rise in interest rates could affect interest margins earned by the Region's banks, particularly those that specialize in mortgage lending. The Region could be more sensitive to rising interest rates and changes in mortgage preferences than the nation because almost one-third of the Region's banks are mortgage specialists, compared with 11 percent of banks elsewhere in the nation. Mortgage specialists' net interest margins could be constrained if interest rates continue to rise because the maturity distribution of mortgage portfolios has lengthened, reflecting consumers' preference for longer-term mortgages. Concurrently, the proportion of volatile liabilities at these banks has risen as reliance on shorter-term, noncore funding has increased, reflecting stiffer competition for core deposits. Higher interest rates could squeeze earnings if the mismatch between the maturity and pricing intervals of loan portfolios relative to a bank's liabilities is significant. Faced with margin compression, some banks may be tempted to invest in higher-yielding, traditionally higher-risk securities to supplement income.

Higher interest rates also could affect the valuation of bank securities portfolios. Mortgage specialists may be more vulnerable to securities depreciation caused by rising interest rates because this group holds a larger percentage of assets in securities and a higher proportion of long-term securities than the rest of the Region's banks. Because longer-term securities are more sensitive to interest rate changes than shorter-term securities, the Region's mortgage specialists could be at greater risk in a rising interest rate environment.

San Francisco Regional Perspectives

The San Francisco Region's economy grew more rapidly than the nation's as measured by increases in nonfarm payroll employment, driven primarily by strength in the services, trade, and construction sectors. Employment growth rates in **Nevada, Arizona, Idaho, California,** and **Utah** exceeded that of the nation in 1999. However, the Region's manufacturing sector employment contracted, and weakness persisted in the agricultural and mining sectors. Consequently, because **Montana, Wyoming,** and **Washington** depend greatly on these industries, these states reported job growth for 1999 about equal to the nation, while **Oregon, Alaska,** and **Hawaii** lagged the U.S. average. Per capita personal income growth and housing price appreciation were robust for most of the Region during 1999.

The majority of the Region's insured financial institutions reported sound conditions as of year-end 1999, the third consecutive year of increasing profits. Combined return on average assets for year-end 1999 improved to 1.37 percent from 1.30 percent a year ago, on a merger-adjusted basis. Strong growth in fee income and declining provision expenses offset declining net interest margins (NIMs). A lower level of provision expenses is attributed to continued improvements in reported asset quality. The year-end 1.69 percent past-due loan ratio was the lowest year-end level in the decade.



Rising interest rates during the latter half of 1999 could adversely affect profitability of the Region's insured institutions going forward. Increasing interest rate sensitivity is most pronounced among the Region's mortgage lenders. These institutions reported the fifth consecutive quarter of declining NIMs at year-end 1999. The Region's larger commercial lenders also have increased levels of interest-sensitive liabilities and are experiencing vulnerability to rising interest rates. However, these lenders have not yet experienced earnings declines because of sufficient increases in noninterest income. Smaller commercial lenders, which primarily hold variable-rate portfolios, have benefited in the short term from increases in interest rates. These lenders, however, could face heightened risk of asset quality deterioration if interest rates rise sharply, since variable-rate loans increase borrower debt service requirements when rates rise.

Commercial lenders in most of the Region's states experienced rapid growth and increased concentrations in traditionally higher-risk loan types—construction, commercial real estate (CRE), and commercial and industrial (C&I) loans—during the current economic expansion. Commercial lenders in Arizona, Nevada, Utah, and Washington have exceeded the nation's median loan growth rate significantly since 1992. In addition, commercial lenders in these states generally experienced a more rapid loan growth rate than the nation's in construction, CRE, and C&I loans since 1992. This situation could be cause for concern when viewed with the results of examiner surveys indicating that the Region's insured financial institutions may be engaging in moderately higher-risk underwriting practices than institutions in other parts of the country.

Publicly available data indicate certain positive trends in the allowance for loan and lease losses (ALLL). The Region's commercial lenders reported higher median ALLL levels than the national average as of year-end 1999. In addition, ALLL levels declined more slowly than reductions in net charge-off rates in recent years, and coverage of nonperforming loans is at its highest point in 15 years. Most of the Region's states report median ALLL levels above those that preceded each state's previous economic downturn or banking crisis.

Some commercial lenders in fast-growing states, however, maintain ALLL levels at or below the national level despite rapid growth and increasing concentrations in potentially higher-risk loan types. For example, insured financial institutions operating in Arizona, Nevada, Washington, and Oregon share these rapid growth and concentration characteristics. However, in Arizona and Nevada these trends could be mitigated by the fact that many lenders in these states are subsidiaries of out-of-state, multibank holding companies that, if necessary, may be able to provide financial support and management expertise. In contrast, institutions in Washington and Oregon generally do not have the benefit of geographic diversification at the holding company level. Generally low historical net charge-off experience and relatively strong reported capital levels, however, may moderate some risk at Pacific Northwest institutions. Nevertheless, because of recent slowing in the economies of these two states, now may be a good time to consider the effects of rapid growth and increasing concentrations in higher-risk loan types on lending strategies and existing portfolios.

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