Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1999

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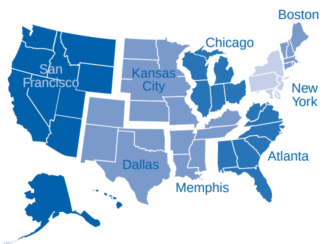

DIVISION OF INSURANCE

In Focus This Quarter

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

- ***Indicators of Industry Performance*—The reported financial condition of insured banks and thrifts is strong. However, despite projected growth in earnings, bank and thrift stocks underperformed the broader market through October 1999. *See page 3.***
- ***Economic Conditions*—The economy remains generally strong, and the outlook calls for continued growth. Growth is likely to slow, however, in order to correct financial imbalances that have developed as a result of a rapid creation of household and commercial credit and borrowing from abroad. There is a threat that the adjustment process could be a volatile one. *See page 4.***
- ***Emerging Risks in Banking*—Rising indebtedness on the part of businesses and households raises concerns about future loan performance. Industry responses to intense competition have created greater credit, market, and operational risks. *See page 8.***

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

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

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

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

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

By the Analysis Branch Staff

Regional Perspectives

◆ ***Atlanta*—Increased reliance on more volatile noncore funding by banks in the Region may require higher levels of asset-side liquidity. *See page 18.***

◆ ***Boston*—Commercial lending levels have increased. Small-business lending has grown faster than in previous years at the Region's small institutions. *See page 19.***

◆ ***Chicago*—Despite some weakness in the manufacturing sector, economic and banking conditions remained healthy. Recently chartered banks may need to be particularly vigilant about the potential for a reversal of strong economic conditions. *See page 20.***

◆ ***Dallas*—Insured financial institutions hold a higher percentage of securities than do institutions in other areas of the country. This asset mix may reduce credit risk, but it could expose institutions to higher levels of interest rate and market risks. *See page 21.***

◆ ***Kansas City*—Low agricultural commodity prices remain a concern. Entry by large commercial companies with existing thrift charters or financial services conglomerates could increase the level of competition for small, rural community banks. *See page 22.***

◆ ***Memphis*—Favorable banking and economic conditions have led to considerable new bank activity, but the performance of these institutions is declining. *See page 23.***

◆ ***New York*—The Region has experienced an increase in new bank activity over the past three years, particularly in New Jersey and Pennsylvania. *See page 24.***

◆ ***San Francisco*—Weakness was evident in the aerospace, manufacturing, energy, and agricultural sectors. Depressed commodity prices for some products and declining farm income in certain states caused deterioration in the Region's agricultural banks. *See page 25.***

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation institutions and financial institution regulators. It is produced for the following eight geographic regions:

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Economic Conditions and Emerging Risks in Banking

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

- *Households' and businesses' debt levels are on the rise.* Spending by households and businesses is growing faster than cash income, resulting in rapidly increasing indebtedness. Consumer spending has been driven, in part, by large increases in the net worth associated with stock holdings and home equity. Businesses are restructuring and investing in new technologies to raise productivity and cut costs. Both consumer and business spending has been assisted by ready access to financing. Rising interest rates or slower economic growth could make debt service more difficult for borrowers.

- *Intense competition in banking is driving business strategies.* Competitive pressures have affected nearly every facet of the banking business. These pressures are evident in net interest margins, which have suffered from tighter loan pricing and higher funding costs. To maintain profits, some institutions are lending to less creditworthy borrowers, expanding into new or higher-yielding activities, creating more complex balance sheet structures, or cutting costs. These strategies may lead to greater credit, market, and operational risks.

- *The currently benign economic environment is vulnerable to rapid deterioration in the event of financial market instability.* During the 1990s, we have witnessed recurring, and perhaps more frequent, episodes of financial market turbulence. Recent episodes have arisen mainly overseas and have had little adverse effect on U.S. economic activity. However, the current economic expansion is closely tied to the ready availability of market-based financing for households and businesses and to wealth generated with the help of rising stock prices and falling interest rates. For this reason, the currently strong economic outlook may be subject to sudden deterioration in the event of market shocks that sharply raise interest rates or lower stock prices.

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

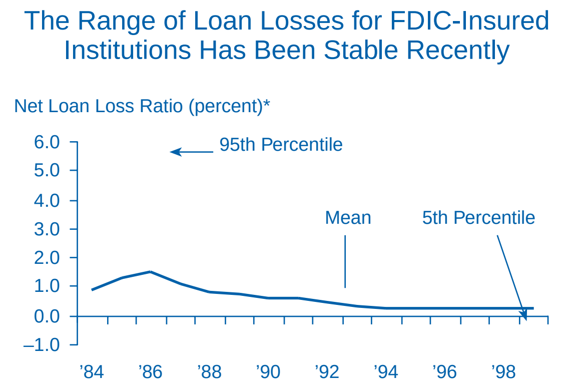
Indicators of Industry Performance

Industry Financial Performance Is Strong

According to reported financial information, the banking and thrift industries are performing well. As summarized in the ***FDIC Quarterly Banking Profile,*** second quarter 1999, both the commercial banking and thrift industries report near-record earnings, strong capital levels, and manageable volumes of problem assets and loan losses. Return on assets (ROA) for all insured institutions in the second quarter was 1.21 percent and return on equity (ROE) was 14.07 percent. ROA and ROE were down slightly from the first quarter despite improvement in the industry net interest margin (NIM) and a decline in provision expense. However, the majority of the decline in net earnings resulted from a $1.5 billion loss posted by one large bank.

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

CHART 1



* For institutions with at least 10 percent of assets invested in loans.
Source: FDIC Bank and Thrift Call Reports (Research Information System)

Bank Stocks Underperform Despite Projected Earnings Growth

Analysts expect continued earnings growth for banks and thrifts in 1999 and 2000. Median growth in earnings per share is projected to be 16.9 percent for publicly traded banks and 19.4 percent for publicly traded thrifts for 1999.[1] Ratings agencies also view the industry positively. The ratio of upgrades to downgrades for ratings issued by ***Moody's Investors Service*** improved in the second quarter, with nine companies receiving upgrades versus four receiving downgrades.

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

Economic Conditions

Overview

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

Commodity Industries Have Faced Pricing Pressures

One disadvantage of low inflation during this expansion has been that firms in certain commodity industries have suffered from falling prices. Profit margins have declined in agriculture, mining, and some manufacturing sectors because of weak or negative revenue growth during 1997 and 1998.[2] Firms operating in these industries have aggressively cut costs to preserve profit margins. Nonetheless, profit growth has been flat or negative for a large proportion of ***S&P 500*** firms in the mining, textiles, chemicals, iron and steel, and oil and gas sectors since 1997. In response, some firms in these industries have chosen to consolidate through mergers. According to ***Mergerstat,*** the dollar volume of merger and acquisition transactions involving U.S. firms was a record $1.2 trillion in 1998, more than 80 percent above 1997 levels.

Business Investment Is Outpacing Cash Flow

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

[1] Based on estimates as of November 4, 1999, for 98 commercial banks and 33 thrifts that have at least five analyst estimates.
[2] Richard A. Brown and Alan Deaton, "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality," ***Regional Outlook,*** Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

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

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

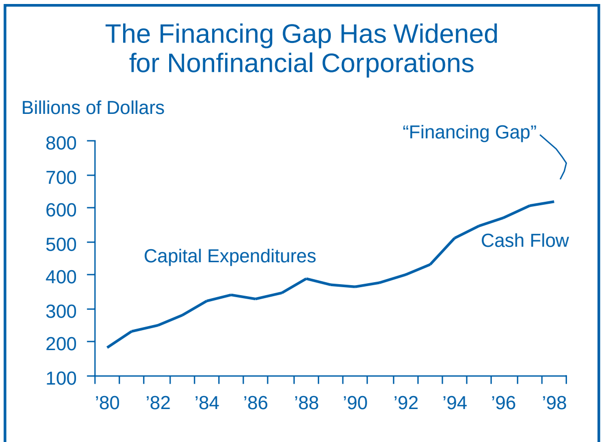
A widening financing gap and increasing debt levels could pose future problems if there are adverse changes in the financial environment. For example, a sharp rise in interest rates would increase the debt burden of businesses, hurt their profitability, and impair their creditworthiness. Under such a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

Consumer Spending Continues to Grow

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

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

Chart 2



Source: Federal Reserve Board (Haver Analytics)

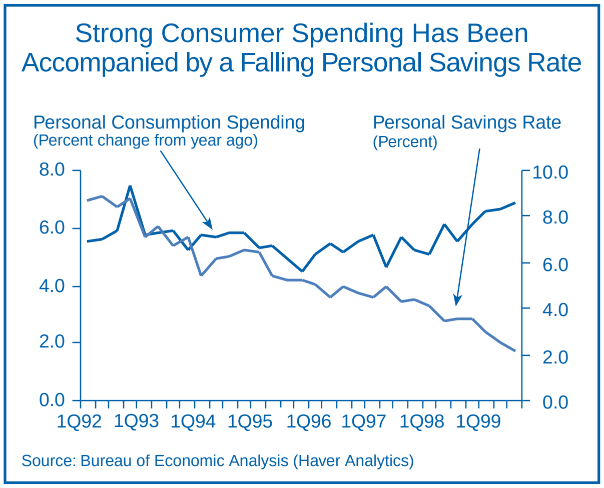
Rapid growth in consumer spending also warrants attention. Despite the highest rates of real income growth in nine years, consumer spending has grown more quickly than disposable personal income. The divergence in growth has resulted in a falling personal savings rate, which reached a record low in 1999.[4] The recent decline in the personal savings rate continues a trend that has been under way for more than a decade (see Chart 3, next page).[5]

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

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

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

CHART 3



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

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

The Growing Private Deficit Raises Concerns

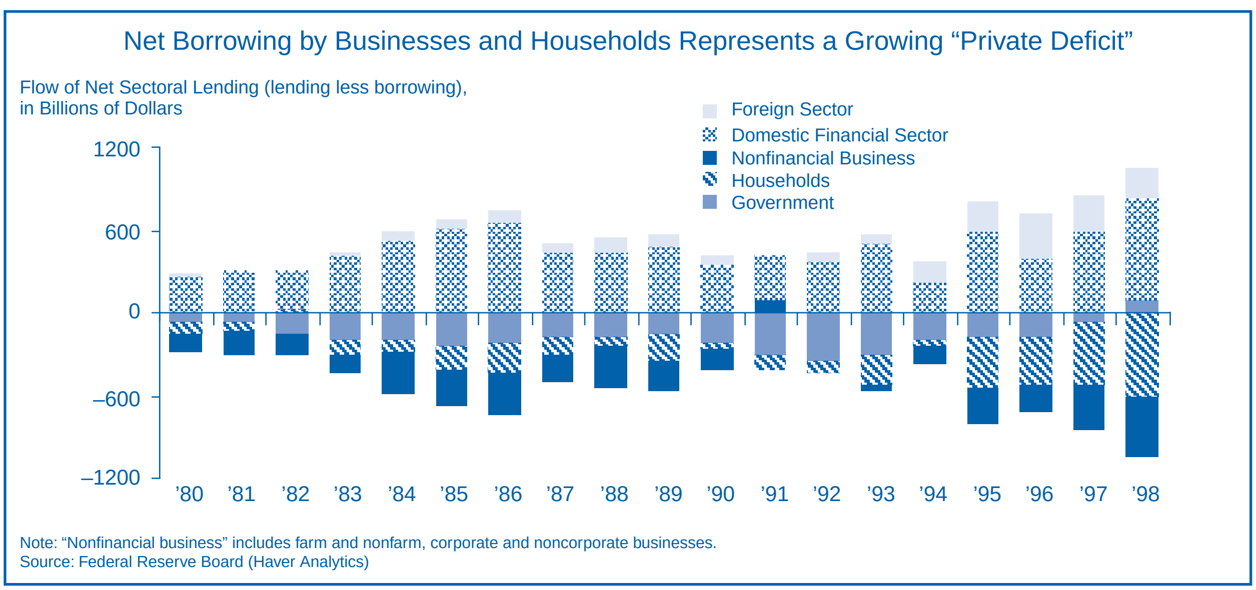
Taken together, the sum of annual net borrowing by businesses and households has been referred to as the "private deficit." During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it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

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

Recovery Abroad Is Changing the Terms of Trade

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

CHART 4



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

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

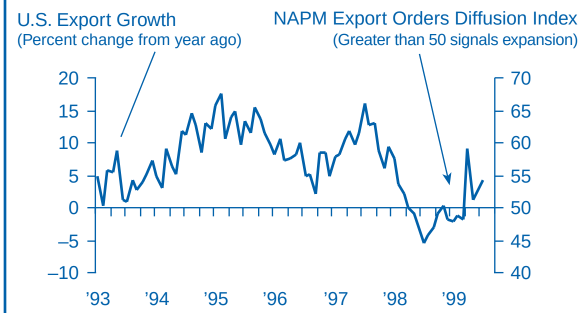
A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent in 2000.[6] Foreign investors, in anticipation of stronger growth and greater investment opportunities abroad, have started to convert excess dollar holdings to other currencies, including the yen and euro. This change in investment strategy has put downward pressure on the value of the dollar. Between July and September 1999, the dollar lost approximately 10 percent of its value against the yen.

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

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

CHART 5

U.S. Exports Fell in 1998, but Rising Orders Point to Growth in 1999



Source: Bureau of the Census; National Association of Purchasing Managers (NAPM) (Haver Analytics)

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

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

The Economic Outlook Calls for Continued Growth

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

The ***Blue Chip Economic Indicators*** consensus outlook for the U.S. economy calls for a "soft landing." Gross domestic product is projected to grow at a rate of 3.8 percent in 1999 with somewhat slower growth of 2.8 percent in 2000.[7] Rising wage pressures, reflecting tight

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

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

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

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

Emerging Risks in Banking

Overview

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

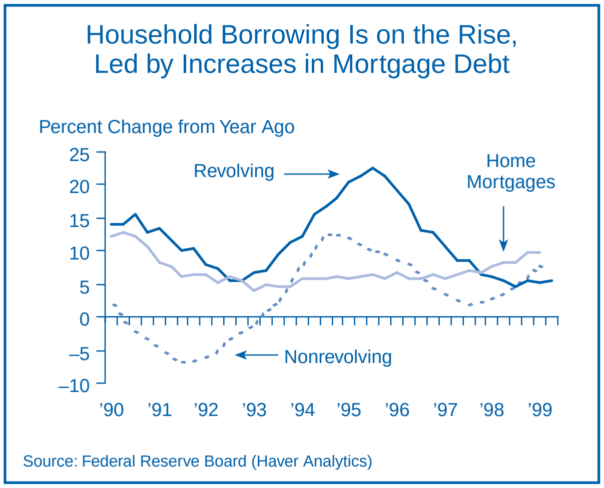
Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured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

Consumer Lending

Household Borrowing Is on the Rise

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

CHART 6



A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

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

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

Credit Card Lenders Face Declining Returns

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

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

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

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

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

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

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

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

Subprime Lenders Have Riskier Characteristics than the Industry

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

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

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

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

Rising Losses May Be Attributable to Loose Underwriting

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

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

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

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

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

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

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

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

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

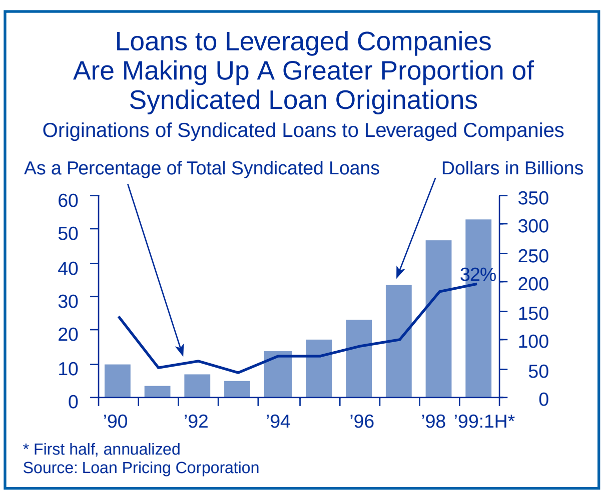
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank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

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

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

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

CHART 7



Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

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

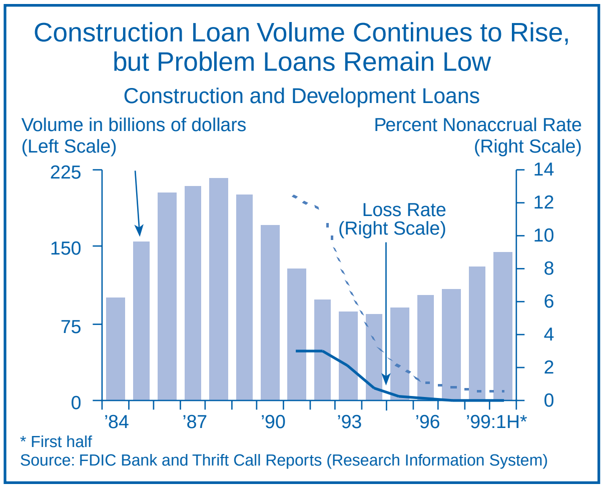
Office Vacancy Rates Are Rising in Many Top Markets

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

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

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

CHART 8



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

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

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

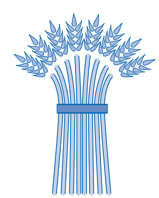
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to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

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

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

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



Farm Banks Continue to Perform Well Overall

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

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

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

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

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

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

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

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

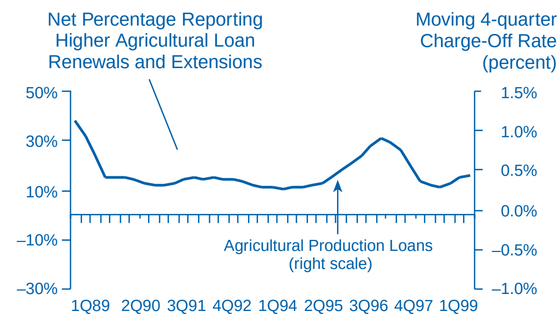
[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported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

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

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

CHART 9

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



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

Funding and Interest Rate Risk

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

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

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

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

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

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

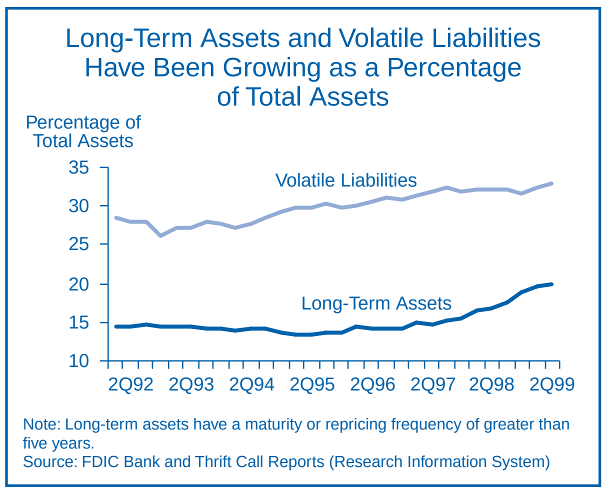
The securitization market competes to originate loans that could be made by insured institutions. This competition may tend to erode underwriting standards if securitizers ease terms to maintain sufficient volume to support lending pipelines. Recent trends indicate that this competition has intensified.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

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

Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

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

CHART 10



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

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

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

Operational Risks

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

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

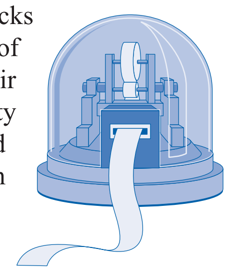
Implications

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

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

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

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



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

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

Maureen E. Sweeney, Associate Director

Paul C. Bishop, Senior Financial Economist
Richard A. Brown, Chief, Economic and Market Trends Section
Steven K. Burton, Senior Banking Analyst
Steven E. Cunningham, Chief, Financial Institutions Section
Alan Deaton, Economic Analyst
Diane Ellis, Senior Financial Analyst
Brian Kenner, Financial Analyst
Allen Puwalski, Senior Financial Analyst
Arlinda Sothoron, Senior Financial Analyst
Jack Taylor, Senior Financial Analyst

Atlanta Regional Perspectives

The Atlanta Region's economic growth exceeded that of the nation, although job growth moderated during the first half of 1999. Recently, however, some rural areas have experienced declines in the mining, manufacturing, and agricultural sectors.

Growth remains very strong in metropolitan markets, but could be constrained by tight labor markets. Urban areas have experienced exceptionally low levels of unemployment, high rates of in-migration and corporate expansion and relocation, and strong real estate construction activity. However, the strong growth has led to rising labor shortages, particularly among less-skilled workers. In addition, between 1995 and 1998, total compensation growth has trended upward. Inability to pass on these higher costs in highly competitive markets could affect businesses' profit margins. High levels of construction activity have resulted in above-average and increasing construction and development lending exposure in several metropolitan areas.

Gains in rural counties have not been as pronounced as in urban areas. Declining agricultural commodity prices, widespread drought, and destruction caused by recent hurricanes have hurt many farmers, particularly those who began 1999 in a weakened financial state. Many rural areas also have seen losses in the textile and apparel and coal mining industries. Increasing economic stress in rural areas can adversely affect credit quality as struggling businesses and displaced workers encounter difficulties servicing their debt.

Insured institution performance reflects the differences between the Region's urban and rural areas. Favorable growth and earnings among institutions in metropolitan areas have resulted in heavy *de novo* activity in high-growth markets, while asset quality in some rural institutions has weakened because of pressures in the agriculture, textiles and apparel, steel, and coal industries.

Geographically diverse financial institutions may be better positioned to weather economic slowdowns. In contrast, smaller financial institutions may be more at risk to local economic volatility. Already, small banks in **Alabama** and **West Virginia,** states experiencing declining manufacturing sectors, report loan delinquencies above the Atlanta Region average.

An increase in noncore funding emphasizes the importance of asset-side liquidity. Atlanta Region banks are relying increasingly on borrowings and noncore deposits to fund asset growth. The potential volatility of these types of funds raises the question of whether liquidity needs, particularly on the asset side, have grown more acute. This question is particularly important because off-balance-sheet lending commitments are at the highest levels in a decade. The shift in funding composition also has earnings and interest rate risk implications, as the potentially higher interest cost of noncore funding might lead some banks to sacrifice liquidity, either by extending maturities or by assuming more credit risk, in search of higher asset yields.

The mix within loan and investment portfolios at Atlanta Region banks has changed substantively over the past decade. However, allocations among broad asset categories, such as cash, securities, and loans, have not changed significantly. For example, banks have been moving out of U.S. Treasury securities and into agency- and mortgage-backed securities (MBS), thus extending portfolio maturities and increasing banks' sensitivity to interest rate fluctuations. However, the typical loan portfolio maturity structure is longer now than a decade ago, as residential mortgages have increased relative to shorter-term consumer and commercial and industrial loans. The shift has allowed Atlanta Region banks to earn higher yields over Treasuries, however, and given the size and transaction volume of the MBS market, the liquidity trade-off likely has been modest.

Balance sheet structures continue to evolve, and asset/liability management becomes more complex as new interest rate and market sensitivities are introduced. Liquidity sources have increased on both sides of the balance sheet with expanded secondary loan markets and expanded bank borrowing opportunities. However, the stability of these sources has not been tested in a protracted down market. The challenge for bank managers going forward is to maintain an asset allocation that balances liquidity needs with an acceptable and stable return.

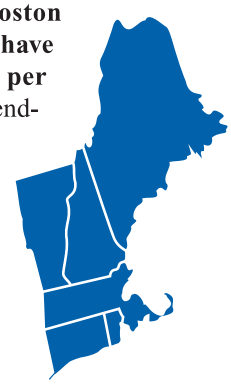
Boston Regional Perspectives

The Boston Region had a more marked deceleration in job growth than the nation during the first eight months of 1999. As in 1998, job growth was stronger in the northern three states than in **Connecticut, Massachusetts,** and **Rhode Island.** Across sectors, only manufacturing payrolls declined during the first eight months. Job growth trailed the nation's rate in all sectors except construction, where the New England states generally experienced gains that exceeded the nation's. Home prices rose, but sales and building activity slowed in 1999.

The Boston Region's insured institutions performed well through June 1999, but several key indicators show signs of deterioration. Asset quality remained favorable and net charge-offs, though still low, increased slightly. Noninterest income helped to support earnings as net interest income declined. Profitability measures compared favorably with national levels but were below prior-year averages. Aggregate earnings numbers were driven largely by subsidiaries of the Region's three largest banking organizations, which accounted for 52 percent of the Region's total assets.

Commercial office markets remained healthy throughout the Region in the first half of 1999. Office markets performed well throughout the Region as vacancy rates continued to fall, especially in **Boston's** central business district. Office vacancy rates also fell in **Stamford, New Haven,** and southern **New Hampshire,** while **Hartford's** rates remained steady. Although office markets performed well, retail and industrial markets experienced mixed results. Construction and development and commercial real estate loan activity has been increasing in institutions with assets less than $1 billion over the past few years; however, concentration levels to Tier One capital remain low compared with peak levels reached in the late 1980s.

Commercial lending has grown considerably in the Region's insured institutions. Commercial loans increased about 14 percent per year for each of the past three years, the highest growth rate of any loan type except credit card loans. From a low in June 1993, commercial loan concentration levels have been rising steadily toward high levels reached in the mid-1980s. Should earnings soften or interest rates rise, borrowers with high levels of commercial debt will face higher debt service burdens, which may increase commercial loan delinquency levels.



Small-business loans in Boston Region insured institutions have increased almost 3.5 percent per year since 1993. This type of lending does not appear to have kept pace with overall asset and loan growth. Institutions with assets over $1 billion have experienced the most rapid growth during the past year in this loan category, with a growth rate of 19 percent. However, accurately measuring small-business loan growth is difficult because borrowers obtain financing from a variety of sources. Community Reinvestment Act data provided by the Federal Financial Institutions Examination Council for 1998 show that 19 percent of the total small-business loans made by FDIC-insured institutions to borrowers in the Region were made by lenders headquartered elsewhere in the country. These out-of-Region lenders are most active in the category of loans less than $100,000 and generate 57 percent of the total number of loans of that size but only 30 percent of the total dollars. These statistics show that these lenders are pursuing the smaller dollar loans in this category more aggressively.

Chicago Regional Perspectives

Economic conditions are generally healthy; however, some sectors are beginning to show signs of a slowdown. The Region's low unemployment rate—4.1 percent or less since late 1997—shows that labor markets are tight. Slower domestic demand growth, weak demand from abroad, and the loss of some customers to foreign producers are accompanying this labor shortage and contributing to the slowdown of the Region's industrial output growth.

High activity in commercial real estate markets is partially cushioning the impact of slower gains in the industrial sector. While scattered pockets of "hot" construction activity have been reported in a few metropolitan statistical areas (MSAs), overall vacancy rates in large MSAs have not risen noticeably, suggesting that supply and demand are balanced.

Rapid appreciation in asset values is another distinguishing feature of this expansion. Without the wealth effect generated by their rising net worth, households' spending growth likely would have moderated noticeably by now. The risk ahead is that a sudden drop in asset values, should one occur, could trigger a sharp, swift decline in households' discretionary spending. A sharp drop in stock prices also could limit businesses' access to capital markets. The potential impacts on insured institutions include reduced collateral values and increased use of unsecured lines of credit.

An unusually low inflation rate is contributing to interest rates that, although rising, at midyear were still near the lowest levels of the expansion. Low interest rates have contributed to strong real estate markets and wealth creation.

At insured institutions, growth in commercial and industrial loans is outpacing the growth in total loan portfolios, which is typical of a mature expansion. This trend partly reflects the fact that businesses are relying more heavily on external sources of financing than earlier in the expansion.

Profitability among banks and thrifts remained solid during the first half of 1999. The stability in earnings performance reported by commercial banks was heavily dependent on increases in noninterest income (NONII). The growing use of NONII by the Region's commercial institutions has helped to sustain overall profitability despite lower margins and rising noninterest expenses. For thrifts, earnings performance remained stable, in part because of a shift in asset mix. The declining interest rate environment has led to a migration from lower-yielding residential mortgages toward higher-yielding consumer loans and commercial and industrial obligations.

Agricultural weakness continues. Abundant supply, sagging demand, and increased competition from abroad led to depressed crop prices, and as a result, farm cash receipts and farmland values have declined. A significant portion of the Region's agricultural loans is held by small institutions whose reported asset quality measures are showing some signs of deterioration. The declining coverage ratio suggests that commercial banks may not have made sufficient provisions for loan losses, which may affect the quality of future earnings.

Several factors have contributed to an increase in new bank formation. The record profitability of the banking industry has led to an average of 17 new bank openings annually since 1990, with the majority in established urban areas. The strength and longevity of the current economic expansion and a strong stock market have also helped drive new bank creation in the Region. In addition, industry consolidation has contributed to the formation of new banks as displaced banking executives and other entrepreneurs look to provide small-business financing and personal banking to the local community.

The significant growth in new institution formation taking place this late in an economic expansion may be cause for concern. Higher levels of commercial lending, increased use of noncore funding, and declining earnings could excessively strain new banks during an economic downturn. Many of these new banks are untested during a recession.

Dallas Regional Perspectives

The Dallas Region's economy continued to moderate during the second quarter. The Region's states, with the exception of **New Mexico,** experienced slower, more sustainable growth rates in the past year compared with robust levels in the mid-1990s. All states in the Region, however, experienced falling unemployment rates for the 12 months ending August 1999. Declines in unemployment continue to reflect tight labor markets.

Despite mortgage interest rates rising to the highest level in two years, new and existing home sales as well as home building continued to post strong numbers through the summer. Issuance of single-family building permits for the first seven months of 1999 exceeded last year's pace by 5 percent, reflecting the strong demand in the Dallas Region for new homes. The Region's hot housing market, however, is expected to cool by year-end. Slower job growth and higher mortgage rates and home prices are expected to constrain home sales and home-building activity in 2000.

Financial institutions continue to report healthy conditions. The Dallas Region's average return on assets (ROA) was 1.34 percent for second-quarter 1999, 13 basis points higher than the nation's ROA and 23 basis points higher than the Region's first-quarter ROA. The Region's average charge-off and past-due rates showed improvement over the prior quarter and compare favorably with national averages.

Oklahoma agricultural banks, however, are beginning to show signs of stress. The overall past-due ratio for these institutions was 3.43 percent, as of June 30, 1999, significantly higher than the 2.63 percent for all other agricultural banks in the nation and the 1.98 percent for all banks in the nation. The deterioration in credit quality is attributable, in part, to weather-related problems and, more recently, low commodity prices. Continued low commodity prices will place additional pressure on agricultural producers, rural economies, and banks in agriculturally concentrated areas.

The Small Business and Job Protection Act of 1996 created the S corporation tax-advantaged status. Since enactment of this legislation, 313 banks and thrifts in the Dallas Region have elected sub S status. These institutions represent 24 percent of all sub S banks nationwide. An S corporation is treated as a pass-through entity similar to a partnership and is not subject to federal income tax at the corporate level. The overall tax burden is usually reduced for a bank and its shareholders.

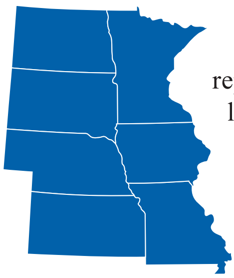
While sub S status offers tangible benefits to bank shareholders, there are downsides. Safety and soundness issues may arise if an institution needs additional capital or is prohibited from issuing dividends to pay shareholder tax liability. In addition, the conversion of a significant number of small institutions to sub S status makes performance comparisons over time more difficult and may mask earnings deterioration in non-sub S banks.

The Dallas Region has a higher percentage of securities on its balance sheet than any other Region. As of June 30, 1999, financial institutions in the Dallas Region had invested 27 percent of total assets in securities, compared with 19 percent for the rest of the nation. A lower cost of funding and a conservative mind-set rooted in the 1980s real estate and oil crisis help explain why the Region's commercial banks maintain competitive profitability levels despite a relatively low loan-to-asset ratio. The higher allocation of securities may indicate a conscious choice to reduce credit risk; however, the potential exists for increased levels of interest rate risk and market risk.

Mortgage-backed securities (MBS) with lengthening maturities expose the Region's balance sheet to rising interest rates. MBS represented over half the Region's total securities portfolio as of June 30, 1999. While MBS maturities lengthened for the nation and the Region, 62 percent of the Region's MBS have maturities in excess of 15 years, significantly longer than the national average. As emphasized in previous articles, the unique asset mix of financial institutions in the Dallas Region may reduce levels of credit risk; however, holding a greater percentage of securities may also expose many institutions to higher levels of interest rate risk and market risk.

Kansas City Regional Perspectives

The Region's economy remained strong through the summer months. Average nonfarm employment through July increased from year-ago levels, and unemployment remained significantly below the national average. The agricultural sector continued to experience stress, as the U.S. Department of Agriculture forecasts low prices for major commodities through 2000. In the aggregate, as of June 30, 1999, the Region's farm banks continued to report strong earnings, capital, and loan loss reserve levels, as well as moderate levels of delinquent loans. However, continued low commodity prices could signal higher levels of problem loans in the near term.



Despite steadily increasing competition in recent years from nonbanks (such as mutual fund companies, credit unions, Internet banking alternatives, and the Farm Credit System), community banks have performed well in the 1990s. Reported capital levels are strong, delinquent loan levels have remained moderate, and loan loss reserve levels appear adequate.

Many of the Region's rural community banks, however, have experienced less direct competition from large institutions than from metropolitan community banks. This phenomenon is largely a result of four factors: rural areas' smaller population bases; the vast geography of the Region, which could make large rural branch structures unworkable; past restrictions on interstate banking and branching; and rural banks' strong personal relationships with their customers, which large banks may perceive as difficult to penetrate. This situation, however, may be changing.

Existing unitary thrift holding companies, with a significant presence in the Region, could intensify competition in rural areas. An exemption in financial services law that allows commercial companies to purchase or charter thrifts has presented significant opportunities for nonbanking companies, such as insurance companies, securities firms, and commercial entities, to enter the financial services arena. Since January 1, 1997, 81 nonbanking companies have filed applications with the Office of Thrift Supervision to establish a new thrift charter or purchase an existing thrift. However, provisions included in financial modernization legislation pending in Congress would eliminate this exemption and prohibit commercial companies from creating or purchasing unitary thrifts.

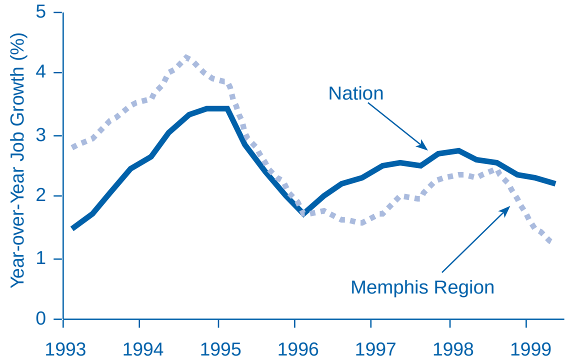
Financial reform legislation also would allow insurance companies, securities firms, and banks to affiliate, potentially creating large financial services conglomerates that could become significant competitors in the Region. Certain existing unitary thrifts, insurance companies, and brokerage firms already have significant operations in the Region's rural areas, and as these institutions expand their banking business, they could represent the first significant form of competition from large institutions for many of the Region's rural community banks.

The results of this increased competition could be seen on both sides of community banks' balance sheets, affecting net interest margins and funding strategies. Furthermore, increased competition could increase rural banks' level of credit risk, diminish loan portfolio diversification, and reduce opportunities to generate noninterest income.

Memphis Regional Perspectives

The Region's economy continues to underperform that of the nation. Nonagricultural payroll employment growth dropped sharply since mid-1998 (see chart below) because of slowdowns in manufacturing and energy sector job losses.

Regional Employment Growth Has Dropped Sharply since Midyear 1998



Source: Bureau of Labor Statistics, Payroll Establishment Survey

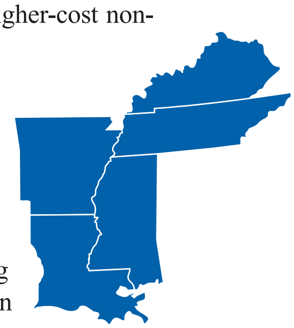
The outlook is unfavorable for much of the agricultural sector. Several factors are pressuring an already stressed farm economy, including a second year of adverse growing conditions in some areas, and continued low crop prices.

Earnings performance of the Region's agricultural lenders is being adversely affected by conditions in the sector. During the first six months of 1999, provisions for loan losses were 14 basis points higher than in the same period in 1998. The higher provision expense contributed to an overall 19-basis-point decline in reported return on assets (ROA). Agricultural lenders and their communities likely will continue to be adversely affected as high existing stocks will keep prices low in the near term, absent any supply shocks.

Overall banking conditions remain favorable, although earnings performance continues to decline. An average ROA of 0.99 was reported during the first six months of 1999, down 19 basis points from the same period in 1998. Increasing competition for loans and funding contributed to a sharp decline in net interest margins. Other financial ratios generally reflect improvement over the first six months of 1998, with higher leverage capital ratios and lower past-due loan ratios reported.

Recently established banks represent a higher portion of the Region's existing banks than at any other time in the previous 30 years. Almost 11 percent of all insured institutions in the Region have been established since 1991 and have not experienced an economic downturn. Several factors may be contributing to the rising level of new banks, including record industry profitability in the mid-1990s; strength and longevity of the current economic expansion; and significant industry consolidation in recent years.

New banks typically report operating losses followed by gradual improvement in profitability. Weak initial earnings performance is attributable to start-up costs, high overhead expense relative to a smaller earning assets base, and an initially heavy reliance on higher-cost noncore funding sources.



The rate of new institutions' initial earnings improvement appears to be slowing, suggesting that the climate for new bank performance has worsened since the middle of this decade. Nationally, the median ROA for new banks during their third year of operation declined in recent years from levels reported earlier in the expansion. Consistent with this trend, new banks in the Memphis Region are taking slightly longer to reach initial profitability than in prior periods.

New banks also are more susceptible to economic downturns, on the basis of a review of bank failures from 1980 to 1992, a period encompassing three recessions. Of Memphis Region banks established during or immediately before that time, 17.7 percent failed. This failure rate is more than double that of established banks during the period. Factors contributing to the higher failure rate include lower earnings levels that provide a more limited cushion to absorb credit losses; concentrations of higher risk assets; and loan portfolios encompassing disproportionately high numbers of unseasoned borrowers.

The significant growth in new banks late in an economic expansion may be cause for concern. The risk of failure for new banks is highest after the first few years of operation, when earnings are still relatively low, capital levels have declined, and asset growth remains high. Many banks will be entering this higher risk stage during the next few years. With earning performance of new banks already weakening, these institutions may need to respond quickly to changes in economic conditions.

New York Regional Perspectives

Employment levels and incomes in the Region continue to rise, and joblessness remains low. In the second quarter of 1999, the Region's employment level rose by 1.4 percent. Wage and salary levels in the Region have been increasing faster than the rate of inflation since 1995, implying real gains for the Region's workforce.

The Region's commercial real estate markets continue to benefit from the healthy economy. Office market vacancy rates in many of the Region's largest cities continue to tighten and are at their lowest levels in the 1990s. Office vacancy rates have declined to about 5 percent in **New York City, Washington, D.C.,** and **Wilmington, Delaware.** New office building construction has been reported in the **Albany, New York,** and northern and central **New Jersey** office markets. Most real estate observers, however, believe that the buildup of space is temporary and will be filled if the economy continues to grow.

The Region's banks and thrifts reported generally healthy financial performance in second-quarter 1999. The Region's average return on assets (ROA) was 0.89 percent, compared with 1.03 percent a year ago, largely reflecting a decline in the average net interest margin. Aggregate past-due ratios continued to decline, reflecting an improvement in almost all loan categories, with the exception of commercial and industrial (C&I) loans, which experienced a modest rise. Past-dues on credit card loans were stable. Credit card charge-offs were 3.46 percent in the second quarter of 1999, significantly lower than the near 5.0 percent level reported during much of the past three years. The Region's savings institutions continued to report lower average ROA numbers than commercial banks. In the second quarter of 1999, savings institutions reported an average ROA of 0.75 percent, compared with 0.97 percent for commercial banks.

C&I loan portfolio concentrations have been increasing steadily over the past four years, even though the total loan-to-asset ratio has declined in the past two years. Small-business lending (C&I loans under $1 million), traditionally the main niche of smaller financial institutions, is becoming particularly competitive. Although reported C&I loan asset quality indicators remain favorable, aggregate past-due and charged-off C&I loan levels have risen since midyear 1997.

The New York Region has experienced an increase in new bank activity over the past three years. Sixty banks opened in the New York Region between June 30, 1996, and June 30, 1999. Indeed, 1999 is shaping up to be a record year as 19 banks opened in the first half of the year, compared with 21 banks in all of 1998. **Pennsylvania** and New Jersey have experienced the highest levels of new bank activity in the Region. Clusters of new bank formation seem to be associated with improving economic and demographic conditions as well as industry consolidation.

Higher interest rates may curtail the Region's economic expansion. In 1994, higher interest rates resulted in slower housing activity and reduced capital gains in the subsequent year. A higher volatility of capital gains in the Region underscored the strong link between the stock market and the Region's economy relative to the rest of the nation. If interest rates continue to rise, however, it is uncertain whether the Region's economy will react as it did in 1995.

San Francisco Regional Perspectives

The San Francisco Region's economy is generally healthy, despite a slowing since last year. Jobs were added at a 2.9 percent year-over-year pace during the first seven months of 1999. Strength in the services and construction sectors offset softness in the manufacturing, aerospace, energy, and agricultural sectors.

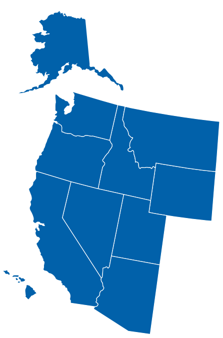
Job growth rates in the Region differed widely during the first seven months of 1999. The services and construction sectors drove growth in the Region's best performing states — **Nevada, Arizona, Idaho, California,** and **Utah. Washington** and **Oregon** experienced some weakening as a result of dependence on the depressed manufacturing and agricultural sectors. **Alaska, Montana,** and **Wyoming** trailed the nation's rate of job growth because of low commodity prices. **Hawaii** remained weak because of declining eastbound tourist volume.

The Region's insured financial institutions generally reported strong earnings as of June 30, 1999. Insured institutions posted 1.33 percent aggregate return on average assets (ROA) through second-quarter 1999, unchanged from the level reported one year ago. While net interest margins (NIMs) have continued to fall from a year ago, ongoing reductions in overhead and provision expenses have offset the effect of declining margins. Strong and improving asset quality in most of the Region's institutions has reduced provision expenses. Reported past-due loans, currently at a low 1.59 percent of total loans for the Region's insured institutions, remained below the 1.98 percent reported for the nation.

Although the Region's insured institutions performed well through midyear 1999, pockets of weakness were identified. Banks in Hawaii and Montana underperformed peer institutions in the Region and the nation, likely as a result of poor economic conditions in these states. Macroeconomic trends also have negatively affected the financial performance of some institutions concentrating in mortgages. The Region's 57 mortgage lenders reported declines in NIMs and lower gains on securities and loan sales, attributed in part to the increase in interest rates and a steepening yield curve. The Region's commercial lenders, which account for over 31 percent of the Region's assets, increased higher-yielding, traditionally higher-risk assets such as commercial real estate, construction, and multifamily residential loans. Finally, stress in the agricultural sector has weakened conditions for the Region's 93 agricultural banks, primarily located in California, Montana, Washington, and Wyoming.

Low commodity prices, which have persisted since 1997 for some of the Region's agricultural products, have adversely affected the Region's farm sector. In addition, farm incomes from operations have declined, and conditions at agricultural banks have deteriorated. Distress in the agricultural industry is a concern because the Region's agricultural cash receipts represent over 20 percent of the nation's total, and over 50 percent of the Region's 852 insured institutions have agricultural loans in their portfolios.

Although the San Francisco Region produces a variety of agricultural products, the commodity groups that have recently experienced price declines are wheat, cattle, and vegetables and fruits (primarily apples). Domestic overproduction as a result of improved technology, farmers' response to enactment of the 1996 Federal Agriculture Improvement and Reform Act, low incidence of crop diseases, and a strong U.S. dollar have contributed to low agricultural commodity prices.



In 1998, low commodity prices resulted in declining farm incomes, particularly in California, Montana, and Washington. However, in many states, weakness in crop or livestock revenue has been masked by large increases in government payments to farmers, particularly in 1998.

While earnings and capital levels declined slightly through the second quarter of 1999, asset quality at the Region's 93 agricultural banks has noticeably deteriorated compared with previous years. Insured institutions in Montana experienced the most severe past-due agricultural loan problems in the Region during the first half of 1999. As a result, the total past-due loan ratio for agricultural loans in the state was one of the highest in the nation. While government programs guarantee some loans, many loans are not guaranteed, leaving lenders at risk of default if commodity prices continue to fall.

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