Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 2000

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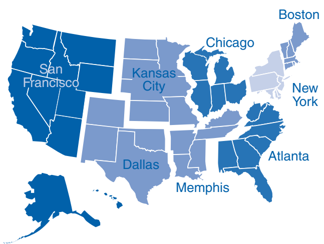

DIVISION OF
INSURANCE

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion***—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions. *See page 3.*

By the Division of Insurance Staff

Regional Perspectives

◆ ***Atlanta***—Interest rate risk may be rising among Atlanta Region community banks because of an increase in the net duration of assets, the timing of interest rate changes, and a lag in the repricing of liabilities. *See page 12.*

◆ ***Boston***—Slow core deposit growth in the Region has caused institutions to seek alternative funding sources. Increased noncore funding may limit liquidity and increase levels of interest-rate and credit risk. *See page 13.*

◆ ***Chicago***—Recent evidence suggests that new banks are exhibiting an increasingly higher risk profile than established banks. Challenges in the auto industry suggest that the industry's strong performance may slow. *See page 14.*

◆ ***Dallas***—Many insured institutions in the Region are expanding loan exposure and are migrating into traditionally higher-risk assets when the economy could be slowing, potentially increasing the level of credit risk. *See page 15.*

◆ ***Kansas City***—Despite record-high loan-to-asset ratios, the Region's community banks have experienced net interest margin (NIM) compression during the 1990s. Long-term competitive pressures on both sides of the balance sheet have contributed to this NIM compression. *See page 16.*

◆ ***Memphis***—With increasing competition compressing net interest margins, many banks are accepting greater levels of credit risk to improve asset yields, which could heighten the vulnerability of the Region's banks to any deterioration in economic conditions. *See page 17.*

◆ ***New York***—While housing prices have increased sharply in areas near some of the Region's larger cities, straining home affordability, the strength and duration of the current housing boom have been more modest than the 1980s experience. *See page 18.*

◆ ***San Francisco***—Rapid growth in commercial real estate development has occurred in five metropolitan statistical areas; should demand weaken, the potential for overbuilding could exist. Community banks in these areas have experienced rapid loan growth and increased concentrations in commercial real estate and construction and development loans. *See page 19.*

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

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REVISION:

The article "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" in the Third Quarter 2000 issue of the ***Regional Outlook*** has been revised to correct a data-related error. The revision affects Chart 4 and Chart 11 of the report. Please see www.fdic.gov/bank/analytical/regional/ro20003q/correction.html for revised versions of Chart 4 and Chart 11, along with an additional explanation of how the revision affects the article.

Emerging Risks in an Aging Economic Expansion

- **The economy and the banking and thrift industries are reporting generally healthy conditions. However, the economic expansion is aging, and it is unlikely that the vigor experienced during the first half of 2000 can be sustained.**

- **Likewise, record banking and thrift industry profits, healthy capital cushions, and good asset quality of recent years may not be sustainable. Declining net interest margins, rising commercial loan losses, tighter liquidity, and riskier asset composition are among the warning signs that industry performance may have peaked for this business cycle.**

- **Specific areas of concern include growing reliance on noncore funding; heightened interest rate risk; increased exposure to market-sensitive revenues; deteriorating credit quality; rising leverage among businesses and households; and signs of imbalance in some residential and commercial real estate markets.**

Although no readily apparent situations or imbalances suggest that a recession or widespread banking problems will develop in the near term, warning signs are present. A highly competitive banking industry shapes the environment in which pressures on insured institutions are unfolding. The presence of a large share of newly chartered banks in some areas appears to be raising the risk profile among all institutions in certain markets. Publicly owned companies remain under intense pressure to grow earnings and increase shareholder value. In addition, local banking environments exist in which a confluence of risks is generating heightened vulnerability for all participants, even during healthy economic times. Complacency in these environments may have negative repercussions for many insured institutions going forward.

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

The performance of the U.S. economy contributes to the opportunities and risks financial institutions face. The current cyclical expansion, now nine and one-half years old, is displaying signs of aging while setting a record for longevity. A consensus forecast calls for moderate real gross domestic product (GDP) growth through 2001, following robust gains in the first half of 2000. Current conditions might be called a "soft landing," in which real GDP growth slows to a sustainable noninflationary rate of 2.5 to 3.5 percent, and unemployment hovers around recent rates.

Although the current macroeconomic environment might appear to be the best of all possible worlds, areas of concern exist. One is that sustained prosperity tends to foster higher levels of risk taking, overconfidence, and complacency. For example, the turmoil in world foreign exchange and financial markets during 1997 and 1998 illustrates how dramatic imbalances can develop and trigger disruptive adjustments even during healthy economic times.

Currently, no specific situation or imbalance seems to threaten the viability of the expansion. However, as detailed below, several likely will contribute to slower economic growth. Situations that warrant monitoring include the following:

- The repercussions from higher energy prices are unfolding. Historically, oil price shocks have weakened several other long-lived economic expansions.

- Short-term interest rates rose over the past year while longer-term rates declined, resulting in a modest inversion of the yield curve. This relationship may inhibit the profitability of some lenders' practice of borrowing short term and lending longer term and also complicate the interest rate risk management process for some insured institutions.

- Continuing low unemployment suggests that demand for additional workers will go unfilled, thus limiting economic growth or triggering bidding wars that increase workers' compensation and, potentially, inflation.

- Stock market sentiment is no longer strongly bullish. A pullback from high valuations and optimism could trigger negative repercussions on consumers' net worth and spending as well as on the level of business investment.

- A large international trade deficit and strong U.S. dollar may be an unsustainable combination over the long run. Meanwhile, repatriated profits of U.S. corporations are being trimmed by the dollar's strength relative to the euro and other currencies.

- Household debt burdens are historically high, with leverage rising the most in recent years among low- and middle-income households. These households' access to credit has increased as lenders competed more fiercely for customers.

- Corporations are more highly leveraged, and potential default risk rose in the past year across a range of industries. Meanwhile, downgrades of publicly traded corporate debt issues are exceeding upgrades by a 2 to 1 ratio.

- In some metropolitan areas, overheated housing markets are developing, in which home prices are rising dramatically and exceeding gains in median incomes.

- Potential signs of excess commercial real estate construction are appearing in several urban areas where banks' construction loan growth also is strong.

Economic indicators of what lies ahead are not clear-cut, and each possible scenario contains a set of potential challenges for insured institutions and regulators. Should economic growth slow considerably, current vulnerabilities, such as highly leveraged borrowers' debt loads and overheated housing markets, could worsen significantly. As evidenced by the rash of bank failures during the 1980s, it doesn't always take a national recession for problems to develop. Alternatively, sustained rapid growth might foster new vulnerabilities and allow current imbalances to intensify or build up. For example, speculative construction could accelerate, stock market volatility could increase, or ballooning trade deficits could generate turmoil in foreign exchange markets.

Signs of Strain Are Also Appearing amid Healthy Banking and Thrift Industries

With the long economic expansion as a backdrop, insured institutions in the aggregate are performing very well. However, the record profits attained in recent years may not be sustainable. The losses posted recently by several large institutions are striking examples of increased appetite for risk resulting in significant financial loss during a period of strong economic growth. While these are isolated instances, they are indicative of the increasingly competitive environment facing the financial services industry.

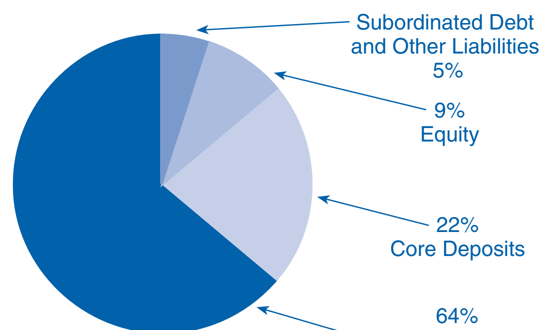
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting that recent increases in interest rates and energy costs not only are affecting businesses but also are taking a toll on some consumers. Other signs suggesting that aggregate risk within the system has risen include the growing reliance on noncore funding to support asset growth, heightened interest rate risk at many institutions, growing concentrations in traditionally higher-risk loan classes, and a shift in institutions' overall asset mix toward higher-risk categories. A brief discussion of these risks follows.

Funding Patterns Heighten Liquidity Concerns

Lackluster core deposit growth is placing pressure on bank earnings and contributing to rising liquidity risk in the banking system. During the past five years, the compounded annual rate of core deposit growth for all insured institutions was just 2.8 percent. Assets over this time grew at a 6.6 percent rate. Accordingly, a significant portion of the industry's growth has been funded by noncore sources (see Chart 1). The higher cost and rate sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

CHART 1

Most of $2 Trillion of Asset Growth since 1995 Was Funded with Noncore Funds



Source: Bank and Thrift Call Reports, June 2000 and June 1995

To compensate for higher funding costs, the industry has pursued growth in higher-yielding asset classes that are traditionally both riskier and less liquid. For example, almost 37 percent of the asset growth in the past five years has come from nonresidential real estate and commercial and industrial loans.

For institutions that fund illiquid assets with wholesale sources, any adverse events that trigger a lack of confidence in the institution may result in higher funding costs, thus placing further pressure on margins. In efforts to obtain funding, an institution also may pledge a greater portion of its best quality assets as collateral, further reducing liquidity. Finally, in instances where funding needs have exceeded available liquidity, the forced sale of illiquid assets to meet funding outflows could result in losses if market conditions are unfavorable. Presumably, the FDIC, as insurer, would suffer greater losses if such an institution failed, because it would be relying on proceeds from the liquidation of less liquid, and potentially lower-quality, assets to satisfy the claims of insured depositors.

Subprime lenders, in particular, tend to rely heavily on noncore funding to pursue aggressive growth strategies. Chart 2 illustrates the extent to which noncore funding exceeds the level of liquid assets for this group. The chart suggests the difficulty these institutions may encounter if forced to convert assets to meet funding outflows. Although subprime lenders may use noncore sources to fund riskier assets to a greater extent than the industry at large, this illustration exemplifies a systemic trend that is raising liquidity risk industrywide and is increasing risk to the insurance funds.

Increasing Levels of Interest Rate Risk Challenge Some Institutions

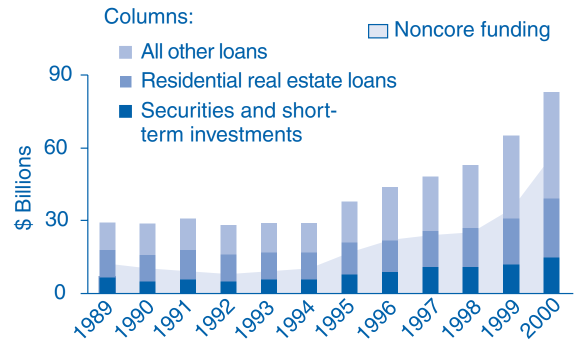
The refinancing boom of the late 1990s spurred a significant shift into longer-maturity assets for many insured institutions. During this period, a vast majority of mortgage borrowers opted for longer-term, fixed-rate loans, which they obtained at historically low rates. A great deal of the higher-rate or adjustable-rate loans that borrowers refinanced were held in the portfolios of insured institutions, which contributed to a general lengthening of the maturity of assets held at insured institutions.

The trend toward longer-term, fixed-rate assets has been particularly pronounced among mortgage lenders. For example, state-chartered savings banks, which are traditionally mortgage lenders, have experienced a dramatic increase in long-term assets. As of June 30, 2000, almost 45 percent of the median savings bank's earning assets were not scheduled to reprice for five years or longer (see Chart 3).

Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts and savings banks, therefore, have significant exposure to rising rates from low-yielding long-term assets.

CHART 2

Subprime Lenders' Growing Dependence on Noncore Funding Strains Liquidity

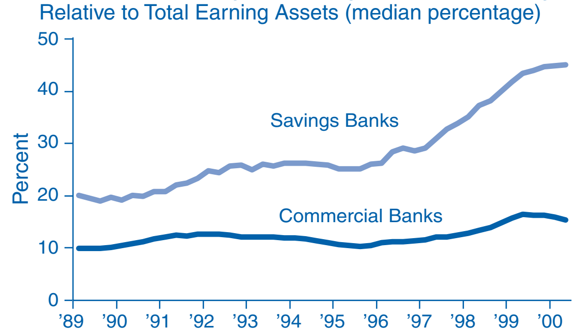


Source: FDIC Division of Supervision and Bank and Thrift Call Reports (data are merger adjusted)

CHART 3

Growing Concentration in Long-Term Assets Elevates Interest Rate Risk

Share of Assets Maturing or Repricing in Five Years or Longer Relative to Total Earning Assets (median percentage)



Source: Bank Call Reports, excluding Thrift Financial Report filers

While most commercial banks do not have as high exposure to rising rates as savings banks, some may have taken on significant risk. The median savings bank has a ratio of long-term assets to earning assets that corresponds to the ratio level for the 93rd percentile of commercial banks. Although the 93rd percentile is in the tail of the commercial bank distribution, almost 600 commercial banks have a concentration in long-term assets that exceeds that of the median savings bank. These institutions may be exposed to significant interest rate risk as well.

While assets have lengthened considerably for many institutions, there has not been a corresponding extension of liabilities. To the contrary, funding pressures are tending to make bank liabilities more rate sensitive. These diverging trends generate concern, especially in a rising interest rate environment. That is, rate increases drive up the cost of funds more rapidly than earning asset yields at institutions with liability-sensitive interest rate risk postures. In a significantly higher interest rate environment, many institutions' current postures likely would cause heavy margin erosion.

Most institutions that have high concentrations in long-term assets also have strong capital and an asset mix that contains lower credit risk than that of many other institutions. Among savings banks, interest rate risk primarily arises from significant concentrations in residential mortgage loans, whereas the typical commercial bank's exposure is more likely to arise from large holdings of long-term securities. However, some institutions with concentrations in long-term assets also may have lower capital levels, a higher-risk asset mix, or poor earnings. Rising rates could weaken these institutions and make it more difficult for them to weather adverse economic or other developments.

Dependence on Market-Sensitive Revenues Increases Earnings Volatility for Some Institutions

During the recent generally favorable conditions in financial markets, the share of revenue earned from business lines susceptible to financial market volatility has increased substantially for some of the industry's largest institutions. Among these revenue sources are fees and gains from asset management, brokerage, investment banking, venture capital, and trading activities. The 19 institutions most active in these lines of business earned over 26 percent of their net operating income from such sources in the second quarter of 2000. Other large institutions also have reported a growing dependence on these volatile sources of revenue.

Turbulence in the financial markets has led to greater earnings volatility for some of these institutions. Stress in the financial markets could weaken the demand for underwriting services or significantly reduce trading revenues or venture capital gains. Furthermore, the same factors that are causing volatility in the financial markets could hamper loan growth and lead to slower revenue growth from core business lines. Should increased earnings volatility from exposure to market-sensitive revenues combine with slower revenue growth from core business lines, some institutions could face significant earnings challenges.

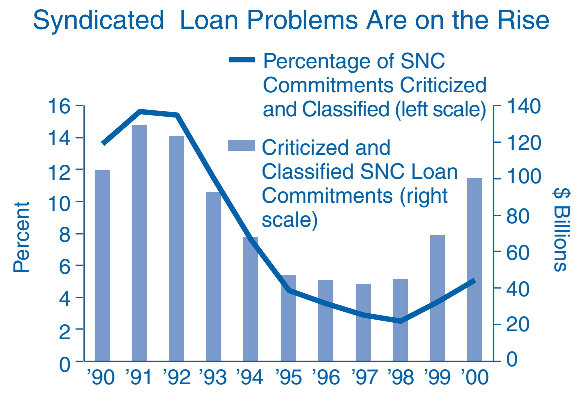
The Rising Level of Problem Business Loans Is Centered in Large Banks

Second quarter 2000 commercial and industrial (C&I) credit quality indicators at banks deteriorated for the eighth consecutive quarter. Noncurrent C&I loans—those on nonaccrual status plus those 90 days or more past-due—rose 13 percent over first quarter 2000 levels to $14.5 billion, or 1.4 percent of total C&I loans. Noncurrent loan levels for the period ending June 2000 were 40 percent higher than the year-earlier level. Net C&I loan loss rates also continue to edge higher but remain well below those experienced by banks in the late 1980s and early 1990s.[1]

Large banks, particularly those active in syndicated lending, are bearing the brunt of deteriorating C&I loan quality. Recent increases in criticized and classified shared national credits (SNCs), which are loans exceeding $20 million that are shared among three or more lending institutions, are illustrated in Chart 4. In the 2000 SNC review, criticized and classified credits increased 44 percent over 1999 levels to 5.1 percent of total SNC commitments. Furthermore, the bulk of the increase was in the more severe *classified* categories, which now comprise 64 percent of total criticized and classified credits, compared with 54 percent at the year-earlier review.

[1] During second quarter 2000, banks posted an annualized net C&I loss rate of 0.67 percent, up from 0.55 percent for second quarter 1999. For comparison purposes, net quarterly annualized C&I loss rates averaged 1.11 percent from fourth quarter 1991 to fourth quarter 1993.

CHART 4



Note: C&I = commercial and industrial; SNC = shared national credit
Source: Shared National Credit Program

C&I loan quality indicators continue to deteriorate despite generally favorable economic conditions. Three factors explain much of this deterioration: certain weak industries, rising corporate debt burdens, and the seasoning of syndicated loans underwritten from 1997 to 1998, when many banks significantly eased business lending standards.

Industry Sector Weaknesses

The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account for the full extent of the increase in noncurrent loans and problem SNC loans. Both of these sectors are within the broader services sector, which experienced a $4.6 billion increase in criticized and classified credits from the 1999 to the 2000 SNC review. However, this increase accounts for only 15 percent of the $30.8 billion increase in criticized and classified SNCs overall.[2] The expected default probabilities evident in market-based information can be used to identify other industry sectors experiencing financial stress. ***KMV LLC*** has developed a model that uses publicly available information to estimate the likelihood of default of individual firms.[3]

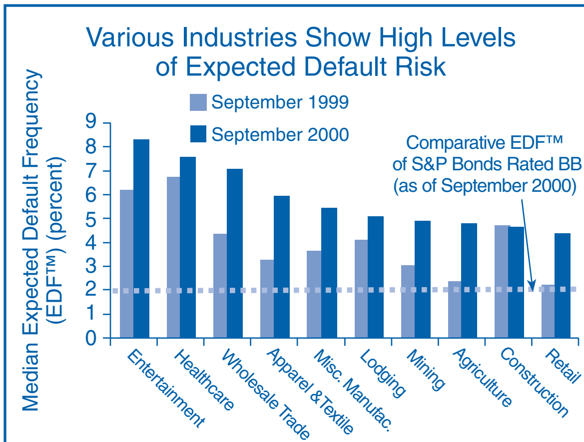
KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

Sectors that include a high proportion of firms with high default probabilities (median one-year default probabilities exceeding 4 percent) are shown in Chart 5. Using entertainment as an example, the bars in the chart show that in September 2000, one-half of publicly held entertainment firms had greater than an 8 percent chance of defaulting on their obligations within one year. In September 1999, this same proportion of entertainment companies had a substantially smaller (6 percent) chance of defaulting within a 12-month period. The median likelihood of default for all the industries shown in the chart far exceeds that of ***Standard & Poor's***-rated, BB-grade (sub-investment-grade) obligors as of September 2000, as indicated by the dotted line in the chart.

Rising Corporate Debt Burdens

U.S. corporate debt burdens, as measured by the debt-to-net-worth ratio for nonfarm, nonfinancial businesses, continue to increase. This ratio reached 83 percent in the second quarter of 2000, up from 72 percent as of year-end 1996. Although debt burdens remain below the 1988–1992 average of almost 87 percent, U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability.

CHART 5



Source: Credit Monitor™ ©2000, KMV LLC, all rights reserved

[2] See the interagency release of SNC results at www.occ.treas.gov/ftp/release/2000-78a.pdf.

[3] KMV Credit Monitor® uses information from a firm's equity prices and financial statements to derive KMV's Expected Default Frequency (EDF™), which is the probability of the firm defaulting within a one-year period. The main determinants of a firm's likelihood of default: the firm's asset value, the volatility of the firm's asset value, and the degree of financial leverage.

Seasoning of 1997–1998 Vintage Loans

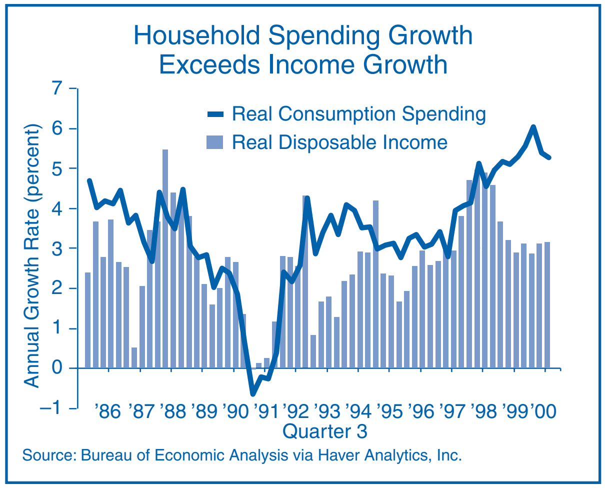
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] Not coincidentally, the period between 1995 and 1998 saw a sharp rise in the proportion of lower-graded, higher-risk credits categorized as leveraged transactions by ***Loan Pricing Corporation.*** Leveraged loan originations—those priced at 150 basis points or more over the London Inter-Bank Offer Rate (LIBOR)—rose from 12 percent of total syndicated loan originations in 1995 to 31 percent in 1999. According to a recent ***Standard and Poor's*** commentary, many banks have acknowledged that 1997 and 1998 vintage credits are beginning to produce higher problem loan levels.[5]

Household Sector's Leverage Is High, and Imbalances Are Appearing

Consumers are enjoying the benefits of the economic expansion, as jobs are plentiful, home ownership remains generally affordable, and credit seems to be readily available for financing motor vehicles and other major purchases. These conditions contributed to record high sales of cars and light trucks during the first nine months of 2000, helping sustain the consumer spending growth shown in Chart 6. One corollary of high vehicle sales, however, is softening prices for used vehicles. Consequently, some lessors—including banks—are realizing lower-than-expected residual values on leased vehicles, which, in turn, are triggering losses in their lease portfolios. This situation illustrates one problem that lenders can encounter even in good economic times.

Spending growth remained robust in recent quarters even as gains in disposable income slowed. The gap between income and spending growth is "financed" as households draw down savings, tap capital gains, refinance mortgages, assume more debt, or undertake some combination of these measures.

CHART 6



From 1995 through 1998, and likely since then, the increase in both leverage and debt servicing burdens has been concentrated among low- and middle-income households. Among families holding debt in 1998, debt payments exceeded 40 percent of disposable income for nearly 20 percent in the $10,000 to $24,999 income group and nearly 14 percent in the $25,000 to $49,999 group.[6] One concern is that these debt-laden families may have inadequate financial resources to make payments should adverse conditions or job loss occur. In such instances, lenders could be doubly affected if households draw on their credit card and home equity lines of credit, further compromising their repayment ability, in order to sustain spending in excess of income. The recent rise in credit card losses in banks' card portfolios and rising losses in the portfolios of subprime lending specialists may indicate that strains among some households are spilling over to lenders. ***Moody's Investors Service*** expects credit card losses to rise through 2001, according to a recent analysis of prospects for the U.S. credit card industry.

Overheated residential real estate markets in several metropolitan statistical areas (MSAs) may be another warning of economic imbalances. Dramatic gains in home resale prices in San Francisco stand out (see Chart 7), but this market is not alone in experiencing appreciation considerably higher than income growth. In some markets, where financial-services or information-technology workers are concentrated, bidding wars for properties may reflect the fact that affordability is

[4] See Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices for May and August 2000* and Surveys of Credit Underwriting Practices for 1999 and 2000 from the Office of the Comptroller of the Currency.

[5] "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." July 20, 2000. *Standard and Poor's Commentary*.

[6] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. January 2000. "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin.* Vol. 86, 1–29.

enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real estate lenders arises because pockets of speculative construction under way in some markets may produce units that become increasingly difficult to sell at anticipated asking prices.

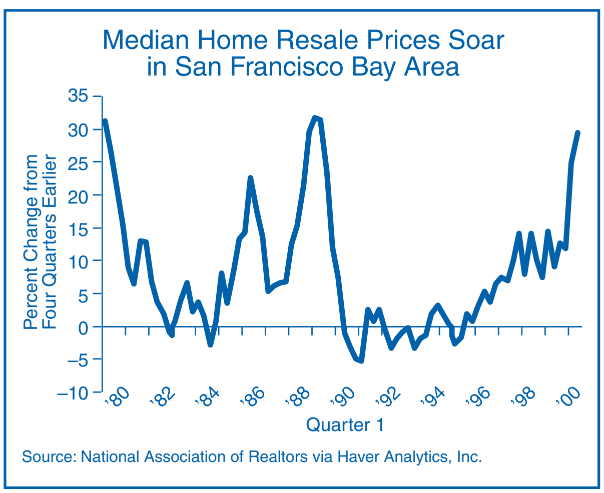
Construction and Development Loan Growth Is Accelerating

Commercial real estate (CRE) construction across all property sectors has grown during this expansion, with office construction particularly active. The amount of office space completed in mid-2000 was the largest since 1989 and is projected by ***Torto Wheaton Research*** to continue rising. Not surprisingly, construction and development (C&D) loan volume, growth rates, and concentrations are trending upward rapidly. While total private real estate spending grew about 6.5 percent over the four quarters ending midyear 2000, C&D loans at insured institutions rose by 26 percent. C&D loan growth has remained above 20 percent since 1997, and the aggregate volume of C&D loans is the highest since 1989.

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

Nine of the 16 markets highlighted in Table 1 not only have a relatively high percentage of C&D loan exposure but also appear vulnerable to overbuilding in two or more property types.[8] While these markets show no clear signs of emerging economic stress, lenders there clearly may be at greater risk should economic or real estate conditions sour. Other concerns regarding CRE lending arise from a recent ***Office of the Comptroller of the Currency*** survey, which reports heightened credit risk in CRE portfolios and predicts it will increase through 2001. In addition, respondents to a midyear 2000 FDIC survey of examiners reported more frequent comments about excess office and retail space.

CHART 7



Increasing Share of De Novo Institutions Raises the Stakes in Some Markets

A common element among the metropolitan markets listed in Table 1 (next page) is the presence of newer institutions. In 10 of the 16 markets, at least 20 percent of the nonspecialized community institutions are less than three years old. The drive to build market share among these institutions, particularly if they are publicly traded entities, is increasing the competitive pressure on banks and thrifts in these markets. In some instances, the aggregate cost of deposits within the MSAs has risen faster than in the nation as a whole, risk

[7] The term "nonspecialized community bank" refers to institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.

[8] See "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," *Regional Outlook,* third quarter 2000, which identifies markets where new construction is high relative to existing stocks of space.

TABLE 1

High C&D Loan Exposure Appears in Various MSAs		
MSAs with 15 or More Nonspecialized Community Institutions*	Share (%) of Institutions* with C&D Concentrations > or = 100% of Tier 1 Capital	Aggregate C&D Loans Relative to Aggregate Tier 1 Capital (as %) in This MSA*
Atlanta, GA	**65**	**156**
Phoenix–Mesa, AZ	**56**	**131**
Memphis, TN–AR–MS	52	154
Portland–Vancouver, OR–WA	**47**	**146**
Oakland, CA	47	163
Nashville, TN	44	103
Riverside–San Bernardino, CA	42	110
San Diego, CA	41	90
Grand Rapids–Muskegon–Holland, MI	40	81
Seattle–Bellevue–Everett, WA	**39**	**98**
Salt Lake City–Ogden, UT	**38**	**56**
Fort Worth–Arlington, TX	**38**	**110**
Dallas, TX	**36**	**95**
Las Vegas, NV–AZ	**35**	**119**
Lexington, KY	34	80
Denver, CO	**33**	**113**

*Sample includes institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.
Note: Boldface indicates major MSAs identified at risk for excess commercial real estate construction in Regional Outlook, third quarter 2000.
C&D = construction and development, MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports for June 30, 2000

profiles are being elevated, and aggregate leverage ratios are falling, despite the influx of capital from the new institutions. Highly competitive environments have the potential to increase risk taking by negatively affecting underwriting standards and balance sheet composition.

Farm Sector Challenges Continue

Much of the agricultural industry is experiencing stress because of low commodity prices, compounded in some areas by low yields resulting from weather- or disease-related problems. Strong global competition and high worldwide production during the past several years have resulted in large crop inventories, depressed prices, and limited prospects for a price turnaround in the near term. In the aggregate, record levels of government payments have helped the nation's farms maintain a generally stable financial condition but have not eliminated the stress in this sector. In fact, the ***U.S. Department of Agriculture*** projects that at least one in four farm businesses in several regions[9] will not cover net cash expenses in 2000, suggesting that the viability of highly leveraged farmers may be in question.

Fortunately, the aggregate condition of nearly 2,100 insured agricultural banks—institutions with 25 percent or more of loan portfolios in agricultural credits—remains healthy. Generally, agricultural banks continue to report favorable asset quality, earnings, and capital positions. However, they are experiencing somewhat elevated levels of noncurrent loans compared with nonagricultural institutions. Agricultural banks are disproportionately represented among the weakest 25 percent of institutions nationwide in terms of noncurrent

[9] These are USDA's Basin and Range, Mississippi Portal, Fruitful Rim, and Southern Seaboard regions. See www.ers.usda.gov/briefing/farmincome/fore/regional/regional.htm.

loan levels. In addition, rising levels of carryover debt at farm banks may translate into higher losses in the future if commodity prices remain low.

The strains in the farm sector also have implications for nonfarm banks in agricultural areas. In several agriculture-dependent states, such as Montana and the Dakotas, for example, where farmers' earnings are depressed and the economies not well diversified, nonagricultural banks are reporting higher noncurrent levels than insured institutions elsewhere in the nation.

Summary

The long-lived economic expansion has contributed to the banking and thrift industries' record levels of profitability and asset quality. However, as the expansion has matured, both consumer and corporate leverage has risen considerably. Bank liquidity is becoming increasingly strained by lackluster core deposit growth, which has been insufficient to fund strong loan demand. This trend has resulted in a decided shift into higher-risk asset classes to mitigate margin pressures arising from the greater reliance on noncore-funding sources. Furthermore, interest rate risk has risen significantly for many institutions, and after nearly a decade of improving asset quality, the level of problem loans is increasing.

Clearly, high levels of profitability in recent years have been achieved, in part, by an increased appetite for risk. Concern arises because insured institutions' current profitability is being negatively affected by some recent trends, despite the sustained economic expansion. And, while capital levels have remained fairly stable, the amount of risk being leveraged on the industry's capital base is on the rise. Just as a rising tide is said to float all boats, a strong economy can mask potential problems that will become evident should the economic tide turn, particularly in institutions or markets where above-average risk is concentrated. Insured institutions' safety and soundness may be most vulnerable in situations where banks and thrifts are exposed to multiple challenges, whether because of strategic decisions or because of repercussions from economic and banking forces beyond their control.

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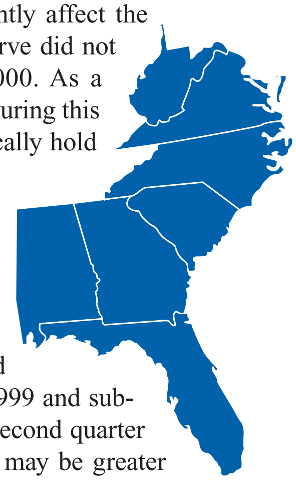
Atlanta Regional Perspectives

The interest rate environment faced by commercial banks has varied significantly during the past two years. Actions by the Federal Reserve Board and the U.S. Treasury have significantly affected the nation's interest rate environment and led to a virtually flat yield curve. A prolonged flat or inverted yield curve typically is not considered the most conducive market for financial intermediaries, as they traditionally earn a positive spread by borrowing at the short end of the curve and lending or investing at the long end.

As discussed in ***Atlanta Regional Outlook,*** second quarter 1998, rate/volume analysis is "...one effective *ex post* approach to measuring interest rate risk." Changes in interest income and interest expense can be determined through a rate/volume analysis, which isolates these components' effects on net interest income (NII) over two time intervals. For Atlanta Region community banks,[1] a rate/volume analysis suggests a minimal amount of interest rate risk (IRR) arising from changes in the yield curve during the past year. The analysis was applied to two four-quarter trailing periods ending second quarter 2000 and second quarter 1999. This group, on average, experienced an increase in NII, and the net interest spread expanded from 3.73 percent to 3.83 percent. Asset yields rose faster than funding costs, in part because of the influence of rates. Conversely, total funding costs remained almost the same; however, notable differences exist among the various funding categories. The cost of historically rate-sensitive or noncore categories—large time deposits, borrowed funds, and Federal Funds purchased—remained virtually unchanged. Core funding that normally is assumed to be less rate sensitive—small time deposits, savings, demand and money market accounts—experienced a decline in cost except for money market accounts. Despite the lower cost of most funding sources, total funding costs increased nominally because of rapid growth in noncore funding. These noncore funding sources increased 25 percent while total interest-bearing funds grew only 11.7 percent. As a result, noncore funding now represents a substantial and growing share of interest-bearing funding sources for community banks in the Atlanta Region.

In order to maintain or grow interest income, some community banks in the Atlanta Region may be assuming more credit risk. The greatest contributor to the growth in interest income was a significant increase in the volume of real estate and commercial and industrial loans. At community banks in the Region, income from real estate lending occurred at lower marginal rates as the yield declined by 8 basis points to 9.0 percent while most other asset yields were increasing. Construction and development lending, traditionally considered a higher-risk form of lending, is growing much faster among the Region's community banks compared with their national peers. As a result, the decline in yield may suggest that lenders are not being adequately compensated on a risk-adjusted basis.

Although this analysis does not identify a significant amount of IRR, an increase in the net duration of assets, the timing of changes in the yield curve, and a lag in repricing could mask the degree of IRR. Community banks appear more susceptible to IRR as the net duration of assets and liabilities has extended. The timing of interest rate changes in tandem with the repricing structure of the assets and liabilities can significantly affect the level of IRR. Specifically, the yield curve did not shift upward and twist until early 2000. As a result, we expect the spread to expand during this period, because community banks typically hold significantly larger volumes of immediately repriceable assets than of liabilities. As liabilities reprice, we expect the net interest spread to narrow, given the interest rate environment. A quarterly rate/volume analysis, in fact, supports the lag effect, as the spread peaked at 4.08 percent during fourth quarter 1999 and subsequently declined to 3.99 percent by second quarter 2000. Therefore, the level of IRR risk may be greater than the long-term rate/volume analysis suggests.



While the rate/volume analysis has yet to show a material variation in NII, the full effect of changes in the yield curve probably has not manifested because of repricing lags. If the current yield curve remains constant, net interest spreads are likely to narrow over time. The substantial growth in longer-duration assets and shorter-duration liabilities may be beneficial if short-term rates fall and the yield curve becomes positively sloped. However, there is no guarantee that this will happen. In short, as is often the case, it is not clear which way interest rates will move; as a result, extending long-term assets and shortening liabilities is a wager that could easily have a heavy cost.

[1] Includes Atlanta Region commercial banks with assets between $25 million and $1 billion. The data set contains 763 banks and excludes de novos (banks in operation at least three years), specialty banks, and banks involved in merger and acquisition activity.

Boston Regional Perspectives

Through late summer 2000, the Region's economic growth cooled from its heated pace of recent years. While August 2000 year-to-date total nonfarm job growth in the Region essentially matched its 1999 pace and continued to trail the nation by a modest margin, some sectors exhibited decelerating growth. The Region's rate of decline in factory sector payrolls in 2000 was less than one-half that seen in 1999 but about double the national rate. Seasonally adjusted unemployment rates in August 2000 were well below the national rate in all the Region's states except **Rhode Island,** and most also were at or below year-end 1999 levels. Per capita income growth during first quarter 2000 generally remained well above the national rate, continuing the five-year trend.

The Region's housing markets also showed some signs of cooling, as August year-to-date permit issuance was down about 7 percent from the previous year, versus a 4 percent drop nationally. Meanwhile, commercial real estate markets generally remained strong in the Boston Region. The Region's office vacancy rates continued to decline compared with one year ago because of lack of construction and rising demand. Rents continued to rise. However, the scarcity of office and certain kinds of industrial space, particularly around greater **Boston,** may be cause for concern. Tenants are leasing space when it is available, even if it is not then needed, in anticipation of future demand. Such practices not only inflate rents but may prove troublesome if market conditions falter, leaving tenants with high-rate rental contracts for space that will not be occupied.

The Region's insured institutions continued to report stable conditions. Excluding credit card specialists, the aggregate return on assets for the Region was 1.28 percent as of June 30, 2000—little changed from the same period in 1999. Some signs of weakening have emerged, principally in the commercial and industrial portfolios of the Region's largest institutions. However, the past-due ratio continued to fall in the Region's other institutions and remains low in aggregate compared with the nation. Consumer and commercial loan growth outside the Region's largest institutions remained strong, while the largest institutions saw no growth partly because of sales of loans associated with merger-related divestitures.

Core deposits alone have not been sufficient to fund loan and asset growth. To compensate, insured institutions have increasingly turned to alternative funding sources. For the most part, the Region's loss in core deposits has been offset with borrowings, primarily in the form of Federal Home Loan Bank (FHLB) advances. Borrowings are a more expensive and potentially volatile source of funds. As a percentage of assets, borrowings are at a recent all-time high, both in the Boston Region and nationally. Increased exposure to borrowings may elevate regulatory risk (e.g., if FHLB lending capacity is modified), liquidity risk (by tapping out credit sources and leaving little reserve borrowing capacity), interest rate risk (because of noncore funds' higher sensitivity to market rates), and credit risk (as banks reach for asset yield to compensate for higher funding costs). Also, a larger share of secured borrowings might lead to greater losses to the insurance fund, as secured lenders would be made whole first in the event of bank failure, and the FDIC would presumably have lower-quality assets available for sale to satisfy its obligations to insured depositors.

In addition to borrowings and core deposits, funds can also be obtained from asset sales. Typically, the most liquid assets have the least embedded credit risk, and their sale can raise the risk profile of an institution. Over the past decade, securitization has positively affected liquidity levels by allowing insured institutions to sell virtually any loan. However, the marketability of the loan depends on its quality. If loan quality declines, marketability may also decline. Moreover, the highest-quality loans may be sold first, which leaves the institution with higher-risk assets.

Aggregate data for all categories of institutions in the Region show declines in historically lower-risk assets, such as residential loans, and increases in higher-risk assets, such as commercial loans. Provided the economy remains strong, higher-risk assets generally offer higher returns. These higher returns may offset funding cost increases in the short term but may exacerbate earnings problems if the economy turns down. Economic problems would also magnify the growing liquidity risk that accompanies an increasingly higher-risk asset mix funded with potentially volatile sources.

Chicago Regional Perspectives

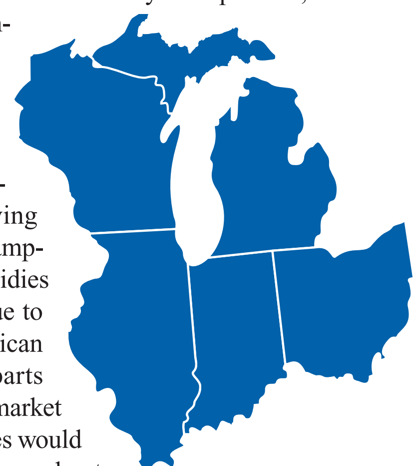
Aggregate performance stumbles in the second quarter. In the aggregate, the Region's insured institutions reported narrowing margins and lower profitability as of June 30, 2000. Aggregate earnings were hampered by an increase in provision expenses and securities losses at the Region's largest commercial banks. While overall credit quality is strong in general, the largest commercial banks reported a higher level of noncurrent loans. Analysts expect problem loans to rise over the coming quarters, particularly among the largest commercial banks involved in syndicated and leveraged lending.

New bank formation increases the Region's risk profile. The current rate of new bank formation in the Region is high compared with the 1980s and is centered in the Region's larger metropolitan areas. New banks historically have exhibited inherently riskier profiles than more established institutions. However, recent evidence suggests that this gap between new and established institutions in the Region is widening. This is particularly apparent when analyzing the income statement. New banks report higher levels of both interest income and interest expense compared with established institutions. A wider interest income spread may indicate a more aggressive loan posture and potential credit risk. In fact, the loan-to-asset ratio among new banks has increased significantly, and new bank loan portfolios are more heavily weighted toward commercial and industrial and commercial real estate loans when compared with established institutions. Both new and established banks report higher funding costs. This trend is primarily associated with the increased use of noncore funding and a highly competitive environment. However, the increase in new bank funding costs exceeds that reported by established institutions and may indicate just how aggressively new banks price deposits. In addition, new banks report a heightened reliance on more expensive noncore funding.

In markets where new bank formation has been active, institutions may be particularly vulnerable to margin compression as new banks attempt to gain market share through competitive loan and deposit pricing. As new banks compete for deposits, interest rate risk concerns may arise, because deposits attracted through competitive pricing may be highly sensitive to interest rates. While a more aggressive loan posture may augment new bank income, the shift in loan mix could increase exposure to credit risk.

Strong auto sector faces challenges. The auto industry plays an important role in the Region's economy, providing about 3 percent of all jobs in the five-state Region. The auto industry's importance to the Region is compounded by its highly cyclical nature. In addition, the direction of the industry's business cycle can shift quickly in a changing economic environment.

The auto industry is in the midst of a two-year expansion, but evidence of some potential weaknesses in the industry is emerging. A general uneasiness about the economy, rising interest rates, fluctuating gasoline prices, and growing foreign competition may dampen future sales. While subsidies and other efforts to continue to bolster sales of new American vehicles insulate the parts manufacturers from some market pressure, any decline in sales would have a strong ripple effect throughout the auto supply chain. Auto parts manufacturers operate in a competitive environment and have little pricing power with auto manufacturers. As a result, auto parts manufacturers often are in a weaker financial position.



The risk profile of auto leasing portfolios remains high. Leasing portfolios have experienced problems over the past few years, and underwriting trends indicate that this segment may continue to experience weak performance. Lessors are facing losses on the sale of leased vehicles, write-offs on the carrying value of lease residuals, and higher remarketing costs and other expenses.

Dallas Regional Perspectives

The competitive advantages enjoyed by the Dallas Region, such as lower housing costs and strong job growth, contributed to the Region's booming economy of the 1990s. These competitive advantages, however, have eroded over time and threaten to constrain future growth in some areas. In particular, the rapid increase in housing prices in the metropolitan areas of **Denver, Boulder, Colorado Springs,** and **Austin** is creating concern among local officials and residents about how housing affordability and economic growth could be affected.

These metropolitan statistical areas (MSAs) were among the fastest-growing areas in the United States during the 1990s. The Austin–**San Marcos** MSA added nearly 300,000 new residents during the 1990s, and the combined MSAs of Denver, Boulder–**Longmont,** and Colorado Springs added over half a million residents. Net domestic in-migration accounted for much of this population growth, which strengthened demand for short-term housing. The combination of a strong demand for housing and an inadequate supply has caused housing prices to accelerate. The chart below shows the positive relationship between employment growth—a proxy for housing demand—and home price appreciation in selected MSAs in the Region.

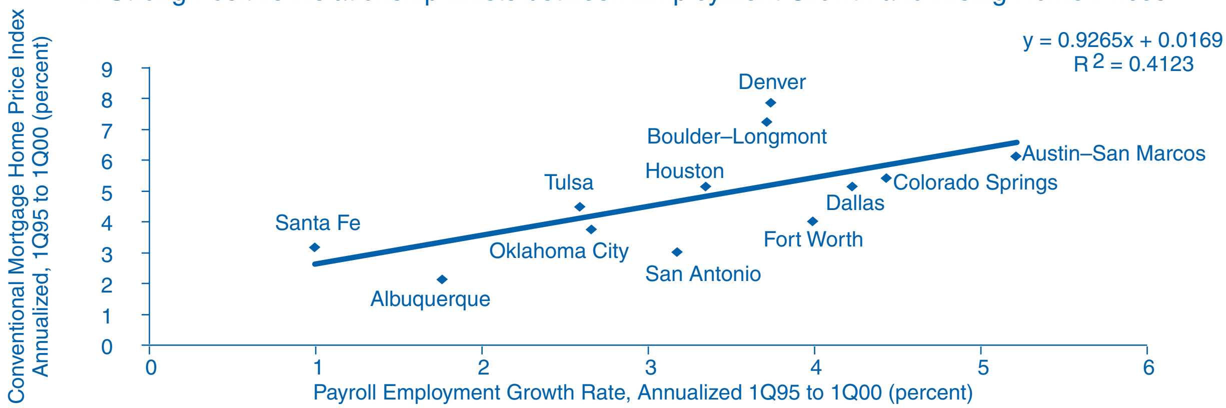
Insured financial institutions in the Dallas Region have increased loan volume as a share of total assets to the highest level in the past 14 years. Moreover, this loan growth has risen rapidly over the most recent 2½-year period. Emerging risks include the potential for increasing levels of credit risk; expanding loan exposure at a time when the economy could be slowing; and an allowance for loan and lease losses (ALLL) that has lagged the Region's rapid level of loan growth.

Factors contributing to the increase in loan levels by Dallas Region banks and thrifts include relatively low loan-to-asset levels and a strong demand for loans generated by the robust Dallas Region economy. In an environment in which loan demand is strong and a strategy of holding a large share of securities is less effective because of rising interest rates, many insured institutions have begun increasing loan levels to maintain profitability. Insured institutions are shifting asset compositions from securities into loans.

Moreover, the types of loans showing the greatest increases include real estate construction (95 percent), commercial real estate (54 percent), and commercial and industrial (33 percent), all considered historically to exhibit higher levels of risk than many other categories of loans. Insured institutions in the Dallas Region continue to report the lowest ALLL-to-total loans ratio of any FDIC Region. Moreover, the Region's banks and thrifts exhibiting the most rapid loan growth report an ALLL ratio that has been declining and is lower than that of other insured institutions in the Region. Should the economy weaken and loans deteriorate, many institutions may find themselves without adequate buffers against future losses.

CHART 1

A Strong Positive Relationship Exists between Employment Growth and Rising Home Prices



Sources: Bureau of Labor Statistics (Haver Analytics); Federal Home Loan Mortgage Corporation

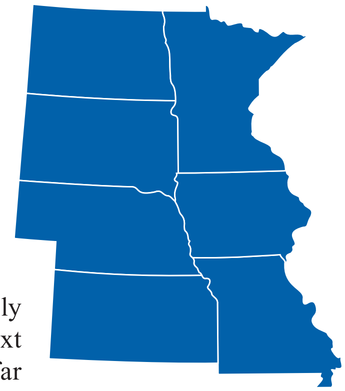
Kansas City Regional Perspectives

Compressing net interest margins (NIMs) are widespread among the Region's community banks, with 73 percent of all community banks reporting a decline in NIMs since 1992. Concern about the declining NIM trend and its effect on net income is particularly important for the Kansas City Region, because the Region is dominated by smaller banks, which typically rely more heavily than larger institutions on the NIM to generate revenue.

Legislative, demographic, technological, and other changes have increased competition for community banks and have contributed significantly to the declining NIMs. Increasing competition for loans occurred during the 1990s and has contributed to an ongoing decline in loan yields since 1995. On the liability side of the balance sheet, competitive pressures for retail deposits have hindered community banks' ability to continue to maintain high levels of core deposits.

Although competitive trends on both sides of the balance sheet have contributed to a narrowing of NIMs, community banks have balanced much of this pressure by increasing loan-to-asset (LTA) ratios to historically high levels. Community banks reported an increase in the aggregate LTA ratio from 48.7 percent in 1990 to 62.4 percent in 1999, the highest level ever reported. Although increasing LTA ratios helped support NIMs against further decline, this is a departure from previous periods, when rising LTA ratios actually boosted NIMs (see Chart 1).

Competitive forces not only are stronger now but cannot be expected to dissipate should the economy weaken. Therefore, the 1990s could evidence a new relationship between LTA ratios and the NIM; rising LTA ratios would not boost NIMs to the high levels previously experienced. Conversely, NIMs could decline to even lower levels should a recession occur.

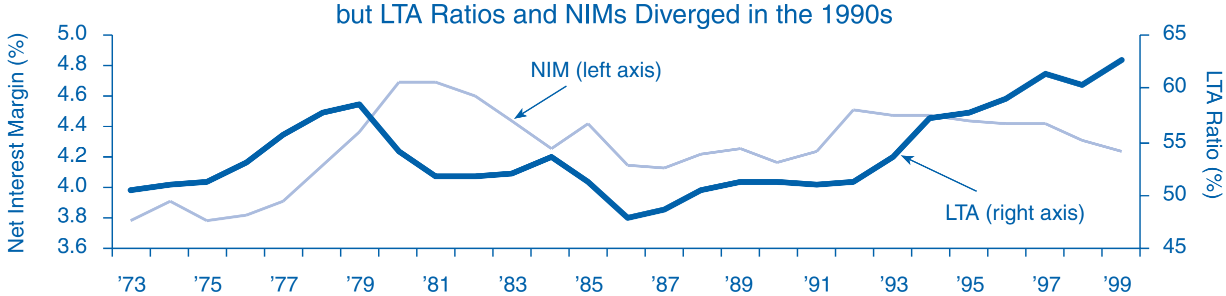


If LTAs decline to historically "normal" levels during the next economic downturn, how far could NIMs fall? To answer this question, we conducted two analyses, both of which determined that community bank NIMs would be significantly lower now had LTA ratios not risen so dramatically since 1992. This fact suggests that NIMs could decline substantially should LTA ratios moderate.

To compensate for the competitive factors that are compressing NIMs, community banks have increased levels of credit risk and interest rate risk. These significant changes have helped mitigate NIM compression. However, at this stage of the economic expansion, asset quality could be affected should the economy falter. The next recession will show whether community banks in the Kansas City Region have managed risk wisely and whether earnings performance throughout the expansion was commensurate compensation for taking on additional risk.

Chart 1

Increasing LTA Ratios Contributed to Higher NIMs during Prior Expansions, but LTA Ratios and NIMs Diverged in the 1990s



Note: This chart was assembled using commercial banks with less than $250 million in assets and excludes de novo banks for their first three years of existence and credit card banks. In addition, banks that were involved in a push-down merger were excluded for the year when the merger occurred. Community banks, as defined in this article, differ slightly from this definition. This difference was necessary to build the chart back to 1973, because community banks were paired only back to 1990. Numerical differences between reported results of community banks and the set of banks used for this analysis are minimal.
LTA = loan to asset; NIM = net interest margin
Source: Bank Call Reports

Memphis Regional Perspectives

Management at many banks nationwide faces pressure from stockholders to maintain or improve earnings performance. The duration and continuing strength of the economic expansion have provided a positive environment for banks and other financial institutions, leading to the emergence of considerable competition from many newly established banks and nonbanks. Resulting pricing pressures for loans and funding have adversely affected banks' net interest margins (NIMs). Return on assets and NIMs contracted at most banks in the Memphis Region during the late 1990s, following a period of exceptionally strong earnings.

In an effort to maintain NIMs, many banks are accepting greater credit risk to improve asset yields. Accommodated by strong loan demand, many banks responded to declining margins by increasing loan-to-asset (LTA) ratios to historically high levels. The sharp rise over the past 18 months equals the cumulative growth in LTA levels over the preceding six years. Recent growth has been concentrated in higher-yielding, and traditionally higher-risk, loan types, such as commercial real estate and construction and development lending, which has also contributed to heightened levels of credit risk.

During the first half of 2000, rising loan levels contributed to higher NIMs, which may be difficult to sustain. Reported NIMs as of June 30, 2000, were somewhat higher than those reported one year earlier. While many factors played a part, higher LTA ratios appeared to be critical to banks' improved NIMs. Increasing competition, however, could lead to further reductions in interest rates charged on loans (relative to other interest rates) and lower loan fees, particularly if loan demand softens. The cost of funding loan growth also could continue to escalate. During the early and mid-1990s, loan growth was funded largely through a combination of core deposit growth and the liquidation of securities portfolios. However, now institutions are relying increasingly on typically higher-cost noncore funding sources to support higher loan levels.

Growing exposure to credit risk may increase the vulnerability of the Region's banks to any deterioration in economic conditions. Experiences during the banking crises of the 1980s and early 1990s suggest that increases in LTA ratios heighten banks' vulnerability to changing economic conditions. A 1997 study conducted by the Federal Deposit Insurance Corporation's Division of Research and Statistics[1] found that banks that failed during economic downturns reported higher LTA ratios and CRE loan exposure than did surviving banks. This study also found that during periods of economic expansion preceding regional or sectoral downturns, many banks pursued a strategy of aggressive loan growth in response to strong credit demand, leading to rising LTA ratios at these institutions. Strong growth in the economy and in the banking industry experienced in the Memphis Region throughout much of the past decade is reminiscent of growth experienced by several states in the early 1980s that later fell victim to regional or sectoral downturns.

Reported asset quality remains sound at community banks, but repayment difficulties for most loans are unlikely to surface until economic conditions erode. Should the economy turn down, the severity of credit quality deterioration will likely be heavily influenced by the current risk selections of banks.

Capital levels are declining. Some institutions report higher capital levels and allowances for loan and lease losses in line with risk selections. Other banks, however, appear content to rely on continuing economic strength to minimize potential long-term credit concerns while emphasizing short-term profitability.

With increasing credit exposure and declining capital levels, risk management is assuming greater importance. There is nothing inherently inappropriate about a strategy of accepting additional credit risk; banks are in the business of accepting and managing credit risk. In fact, such a strategy may be more necessary to preserve earnings in today's competitive banking environment. However, with exposure to credit risk rising and capital levels declining, strong risk management becomes increasingly critical. While economic conditions remain favorable, bank management may want to consider acceptable risk tolerance levels in reviewing overall credit exposure and take steps to correct any specific underwriting laxity.

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[1] Federal Deposit Insurance Corporation. 1997. *History of the Eighties—Lessons for the Future. Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s,* p. 27.

New York Regional Perspectives

The Region's insured institutions[1] reported relatively stable profitability during the first half of 2000. However, higher interest rates compared with a year ago pressured net interest margins as funding costs increased for banks of all sizes. Intense competition for core deposits over the past several years has also contributed to margin compression. Erosion of banks' core deposit base has resulted in increased reliance on noncore funding sources, which are generally more expensive than traditional bank deposits. Furthermore, noncore funding sources typically are more interest rate sensitive. As a result, banks' liquidity and interest rate risk management could be challenged, particularly during periods of rising interest rates or unstable financial markets, when access to liquidity sources may become more difficult.

Credit quality in most loan categories remained favorable, except for C&I loans held by the Region's large banks. During second quarter 2000, the commercial and industrial loan (C&I) charge-off ratio for the Region's large banks reached its highest level since 1993 but was below the rate experienced during the recession of the early 1990s. Recent underwriting surveys indicate tighter C&I underwriting by banks nationwide; however, an increased number of criticized Shared National Credits, higher corporate bond defaults, and widening spreads on high-risk loans indicate that C&I credit problems may not be over.

The Region's commercial banks have reported loan growth centered in traditionally higher-risk categories. During the past four years, the Region's commercial banks experienced the greatest annual growth rates in commercial (including C&I and commercial real estate) loans. In fact, commercial loans accounted for more than half the Region's total loan growth during this time.[2] Furthermore, although residential loans continue to account for the largest percentage of the Region's loans, the current level almost equals the share of commercial loans.

The growth in commercial loan volume reflects a shift by banks into higher-yielding, potentially higher-risk credits as lenders attempt to maintain earnings in the face of increasing competition and margin pressure. Higher operating costs and increased provisions, however, have constrained the earnings benefit that typically accrues to lenders that assume greater credit risk. Banks with riskier credit profiles and lower capital ratios may be more vulnerable if commercial credit quality problems persist.

During the past several years, significant employment gains and high consumer optimism have stimulated demand for housing around the Region. Recently, communities surrounding the Region's larger urban areas, primarily **New York City, Baltimore,** and **Washington, D.C.,** where job growth has been strong, reported the most significant price appreciation. Home prices in many of these areas increased at double-digit rates during the first six months of 2000, far exceeding the average price increase for homes nationally. Housing prices in some of these areas have benefited from strong Wall Street conditions and may be vulnerable to weakening in the financial markets. Nevertheless, the Region's current housing boom has been more modest than the 1980s experience.

As a result of limited supply and strong demand, home prices in some of the Region's major markets have been rising three to four times the rate of increase in household incomes over the past year.[3] One consequence of rising home prices, particularly if they are increasing substantially faster than household income, is that it may place additional financial stress on prospective homeowners, who may be faced with higher debt servicing costs. According to the ***Federal Reserve Board,*** in first quarter 2000, the debt service burden for the nation—the ratio of consumer debt payments to disposable personal income—reached the highest level since first quarter 1988. Consumer debt service burdens also have increased in many of the Region's states, raising concern about consumer credit quality, particularly if the economy weakens.

[1] Excludes institutions in operation less than three years and credit card banks. The banking analysis uses median figures.

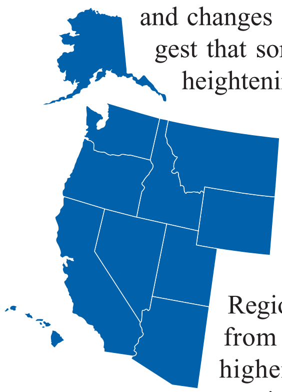
[2] Loan growth was computed as the difference in total loans from June 30, 1996, to June 30, 2000, for the Region's commercial banks, adjusted for mergers.

[3] Household income data are from the Bureau of the Census. Economy.com develops quarterly estimates. Amounts include all wages but not income from capital gains.

San Francisco Regional Perspectives

The San Francisco Region continued to experience robust economic conditions through midyear 2000. Arizona, Nevada, Idaho, and **California** reported the highest levels of employment growth among the states in the Region, while job growth in **Hawaii** and **Oregon** lagged the national average. The construction and service sectors added jobs; however, employment in the mining and manufacturing industries declined. The rise in oil prices has not stimulated exploration and production in **Wyoming** and **Alaska,** where oil and gas output is important.

Insured institutions reported healthy financial results as of June 30, 2000, but overall risk profiles may be increasing. Earnings, leverage capital, and delinquent loans were reported at acceptable levels at midyear 2000. However, loan growth rates and changes in portfolio composition suggest that some of the Region's banks are heightening their risk profiles. Insured institutions continued to grow loan portfolios more rapidly than deposits, resulting in an increasing reliance on noncore funding. In addition, a sizable portion of the Region's loan growth has resulted from increases in traditionally higher-risk, higher-yielding commercial real estate (CRE) and construction and development (C&D) loans. High loan growth rates also may be forestalling increases in delinquent loan levels. However, as loan portfolios season, this trend could reverse. In fact, commercial and industrial loan delinquencies are rising at some of the Region's larger institutions.



Several of the San Francisco Region's metropolitan statistical areas (MSAs) have recently experienced a rapid increase in construction activity. High rates of CRE construction activity may not be a problem if absorption of space continues. However, as discussed in ***Regional Outlook,*** third quarter 2000, should demand weaken, the potential for overbuilding could exist.

This article looks at five of these MSAs—Las Vegas, Phoenix, Seattle, Salt Lake City, and Portland—focusing on the economic drivers of the growth in CRE activity and on the levels of CRE and C&D lending at community banks in these areas. However, as was the case with the analysis presented in ***Regional Outlook,*** third quarter 2000, rising vacancies in the at-risk markets are not being predicted. Rather, the purpose is to raise awareness about substantial growth in real estate development and the corresponding increases in risk exposure to insured financial institutions.

These five MSAs exhibited substantial increases in real personal income between 1993 and 1998. During this time, real personal income growth outpaced the national average. The FDIC study, ***History of the Eighties—Lessons for the Future***, found that "boom and bust" economic activity (in part measured by fluctuations in real personal income growth) was correlated with an increase in bank failures.

Growth in the high-tech sector has significantly contributed to the Region's current economic expansion and to CRE development in several of the Region's MSAs. The **Phoenix, Seattle,** and **Portland** MSAs are identified as "high-tech MSAs" (see ***San Francisco Regional Outlook,*** third quarter 2000) and as areas vulnerable to CRE overbuilding. Employment in the high-tech sector has historically been volatile. This sector also has been traditionally dependent on the availability of venture capital, which ties the high-tech sector more closely to the stock market. As a result, a downturn in the high-tech sector or a prolonged decline in the stock market could adversely affect local economies in these MSAs.

Insured institutions in these MSAs have played an important role in financing the increased levels of CRE activity. As a result, rising CRE and C&D loan exposures at community banks in these MSAs could heighten these institutions' vulnerability in an economic downturn. As of June 30, 2000, concentrations of CRE and C&D loans at insured institutions in the five MSAs exceeded the median for all other MSAs in the nation. In addition, new chartering activity has been strong in these MSAs, and the number of unseasoned institutions (in operation less than eight years) has grown significantly. Elevated CRE and C&D loan concentrations and an increase in new bank formation could be a concern, given that insured institutions sharing these characteristics experienced higher failure rates during the last recession.

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