Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FOURTH QUARTER 2000

FDIC
CHICAGO
REGION

DIVISION OF INSURANCE

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Regional Perspectives

◆ ***Bank Performance Stumbles in the Second Quarter*—In the aggregate, the Region's insured institutions reported narrowing margins and lower profitability. 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, 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.** *See page 3.*

◆ ***New Bank Formation Increases the Region's Risk Profile*—New banks are forming at a rapid rate, particularly in the Region's larger metropolitan areas, and are contributing to an already competitive banking environment. The risk profile of new banks appears to be higher compared with established community banks because of higher exposure to commercial and industrial loans and commercial real estate lending and greater reliance on noncore funding.** *See page 4.*

◆ ***Some Challenges to the Auto Industry Are Emerging*—The auto industry is in the midst of a two-year expansion, but some evidence of potential weaknesses in the industry's strong current performance is emerging. Because of the industry's importance to the Region's employment picture and its highly cyclical nature, continued attention is warranted as these challenges unfold.** *See page 7.*

◆ ***Underwriting Trends in Auto Leasing Point to Continued Weakness*—Generous residual values, longer lease terms, higher mileage allowances, and the capitalization of origination charges indicate that this segment may continue to experience weak performance. Lessors are facing losses on the sale of leased vehicles, write-downs on the carrying value of lease residuals, and higher remarketing costs and other expenses.** *See page 9.*

By the Chicago Region Staff

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 11.*

By the Division of Insurance Staff

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Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
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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.

Regional Perspectives

- **Narrowing margins and lower noninterest income at the Region's largest commercial banks combined with higher provision expenses and securities losses, reduced aggregate net income through second quarter 2000.**

- **New bank formation in the Region remains at a high level. Recent evidence suggests that new banks are exhibiting an increasingly higher-risk profile than established banks.**

- **The auto industry, which plays an important role in the Region's economy, is in the midst of a two-year expansion. However, some significant challenges suggest that the industry's strong performance may slow.**

- **Auto leasing portfolios have exhibited some weakness in recent years, and some aspects of lease underwriting appear to be growing riskier.**

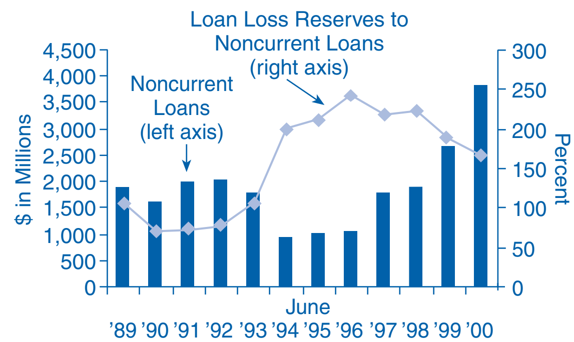
Region's Economic and Banking Conditions

Aggregate Performance Stumbles in the Second Quarter

In the aggregate, the Region's insured institutions reported narrowing margins and lower profitability. Margin compression continues as the cost of funding earning assets increases faster than the yield on earning assets. In past quarters, rising noninterest income bolstered aggregate net income. However, in second quarter 2000, noninterest income to average assets fell to 1.70 percent from 1.91 percent a year ago. Aggregate earnings also were hampered by an increase in provision expenses and securities losses at the Region's largest commercial banks,[1] resulting in a 10 percent decline in aggregate net income from a year ago.

CHART 1

Reserve Coverage of Noncurrent Loans Declines at the Region's Largest Commercial Banks



Source: Call Reports for commercial banks with total assets greater than $10 billion

While overall credit quality is strong in general, the largest commercial banks reported higher delinquencies. At the Region's largest banks, noncurrent loans[2] increased nearly 43 percent from the prior year to $3.8 million as of June 30, 2000. The ratio of noncurrent loans to Tier 1 capital for this group is 8.86 percent, its highest point since 1993. Provision expenses more than doubled from the same period a year ago, yet the reserve coverage on noncurrent loans continued to decline (see Chart 1). Pointing to a general easing of credit through the mid-1990s, analysts expect problem loans to rise over the coming quarters, particularly among the largest banks involved in syndicated and leveraged lending.[3] However, regulatory surveys indicate that banks responded to the market turmoil in fall 1998 by tightening loan terms, and this trend appears to be continuing.[4] As a result, while analysts expect credit quality to weaken in the near term, they do not predict significant deterioration, but a return to more normal, historical levels.[5]

Meanwhile, the Region's community-insured institutions[6] reported modestly wider margins and stable profitability.

[1] Commercial banks headquartered in the Chicago Region with total assets greater than $10 billion.

[2] Noncurrent loans are loans past due 90+ days and nonaccrual loans.

[3] KPMG Analysis Commercial Loan Portfolios: The Worst May Be Yet to Come. July 18, 2000.

[4] Senior Loan Officer Opinion Survey on Bank Lending Practices. August 2000. Federal Reserve Board of Governors.

[5] Commercial Lending Update. April 2000. Commercial Credit Risk Rises Despite Strong Economic Conditions. Federal Deposit Insurance Corporation.

[6] Community-insured institutions hold less than $1 billion in total assets.

An increase in the median yield on earning assets outpaced an increase in the cost of funding earning assets over the 12 months ending June 30, 2000. Improved margins may reflect the moderately strong loan growth experienced by community institutions. Median net loan growth of 11.71 percent boosted the median loan-to-asset ratio to 67.6 percent at June 30, 2000, up from 64.4 percent recorded in each of the past two years.

While overall community bank performance was solid, signs of modest deterioration were apparent.

- The number of community institutions rated 3, 4, or 5 was 104, or 6 percent of total community institutions in the Region as of June 30, 2000, up from 77, or 4 percent, a year ago.
- While still low, the median level of adverse classifications to capital rose modestly to 8 percent as of June 30, 2000, from 6 percent as of June 30, 1998.
- The number of unprofitable established community institutions[7] has doubled in the past two years to 3 percent of established community institutions.

[7] Established community-insured institutions hold less than $1 billion in total assets and have been in operation longer than three years.

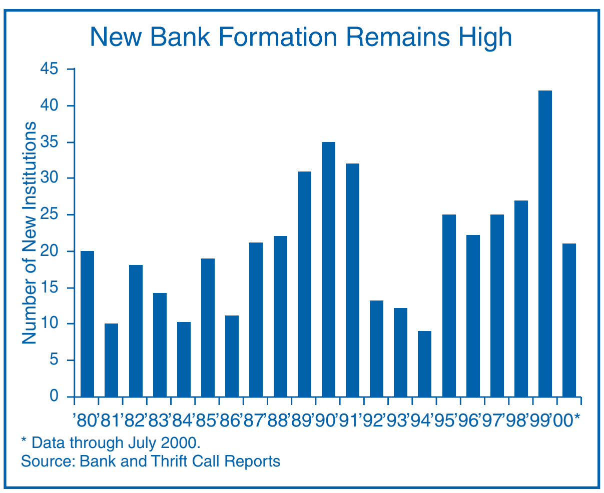
New Bank Formation Increases the Region's Risk Profile

Fueled by a strong economy, new bank[8] formation in the Region is high compared with the 1980s, and exceeds the last cycle's peak, which occurred in 1990 (see Chart 2). New banks represented more than 5 percent of insured institutions in the Region as of June 30, 2000, up from less than 2 percent in the early 1990s.

Most new bank activity has been centered in the Region's larger markets, particularly Chicago, Detroit, and Grand Rapids (see Map 1). As of June 2000, most new banks were located in Illinois (41) and Michigan (24). In fact, Illinois ranks third among all 50 states in the number of new banks. Looking ahead, a review of new bank applications[9] revealed that while the rate of new bank formation may moderate, formations will remain centered in Illinois and Michigan.

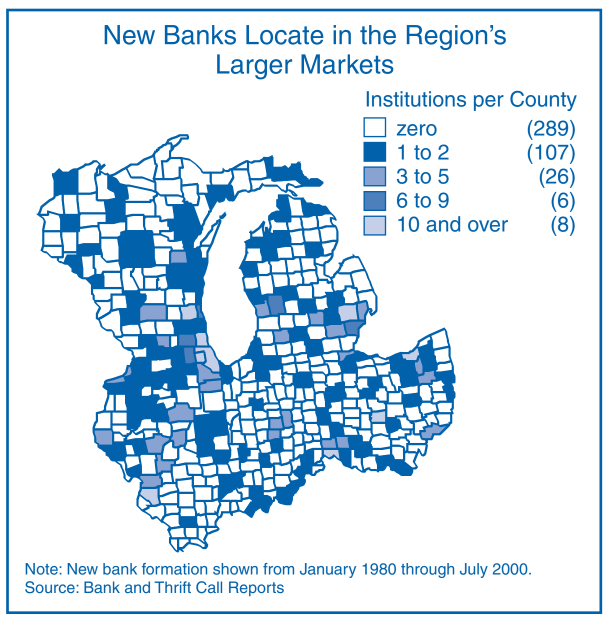
In general, new banks historically have had inherently riskier profiles than more established banks. Anticipated losses during the start-up period, rapid asset and loan

Chart 2



* Data through July 2000.
Source: Bank and Thrift Call Reports

Map 1



Note: New bank formation shown from January 1980 through July 2000.
Source: Bank and Thrift Call Reports

[8] New banks are defined as insured institutions established within the past three years.

[9] As of August 24, 2000, there were 15 new bank applications pending in the Region, five in Illinois and four in Michigan.

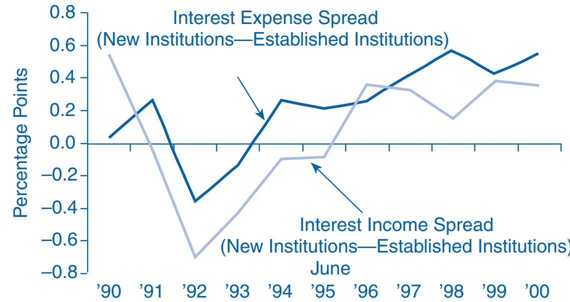
growth, and the lack of a stable customer base may elevate new banks' risk levels. Recent evidence suggests that new banks are exhibiting a higher risk profile than established banks in the Region.

Interest income trends among new banks may point to increasing levels of risk relative to established institutions. This trend also raises questions about future net interest margins. New banks report higher levels of interest income than established institutions in the Region (see Chart 3). A wider interest income spread indicates that new banks may be operating more aggressively than in the past. Increased exposure to traditionally riskier, higher-yielding loan products, such as commercial real estate and commercial and industrial loans, is evidence of this more aggressive posture. Not only has the loan mix shifted at new banks, but aggregate loan-to-asset levels have increased significantly since 1995.

Both new and established banks report higher funding costs. This trend is primarily associated with increased use of noncore funding and a highly competitive environment. However, the increase in new bank funding costs exceeds that reported by established banks and may indicate how aggressively new banks price deposits. In addition, new banks report a heightened reliance on more expensive noncore funding. While some established institutions have mitigated the effect of declining margins through increased noninterest income, newer institutions have reported a decline in the median ratio of noninterest income to average earning assets.

CHART 3

New Banks Report Higher Interest Income and Interest Expense Compared with Established Institutions



Note: Spreads are based on median values and are relative to average earning assets. Only new institutions in their second or third year of operation are included.
Source: Bank and Thrift Call Reports

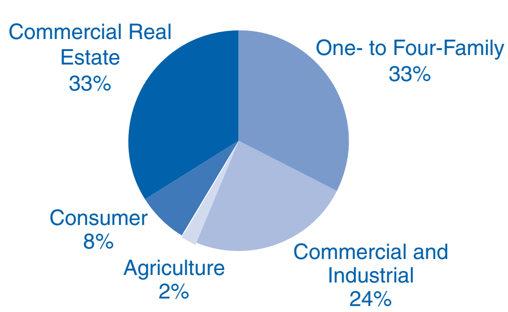
As stated above, interest income levels among the Region's new banks are higher than among established banks, in part because of a shift toward commercial lending. As of June 30, 2000, new bank loan portfolios were more heavily weighted toward commercial real estate and commercial and industrial lending than those of other small banks in the Region (see Charts 4 and 5).

This has not always been the case. New banks have steadily increased their exposure to commercial and commercial real estate lending to a level that is now three times higher than in June 1990 (see Chart 6, next page). A subset of commercial real estate lending—construction and development lending—has increased to 10 percent of aggregate loans for new banks. In contrast, established community banks have increased

New Bank Loan Portfolios Are Heavily Weighted Toward Commercial Lending

CHART 4

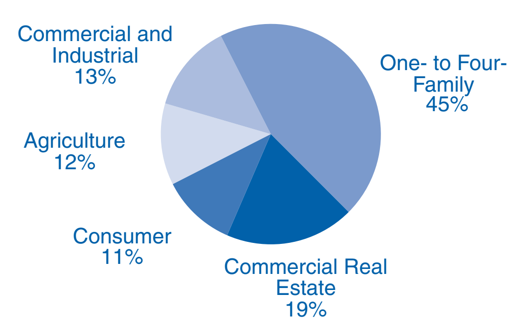
New Banks' Average Loan Composition



Note: Institutions in their second or third year of operation.
Source: Bank and Thrift Call Reports, June 30, 2000

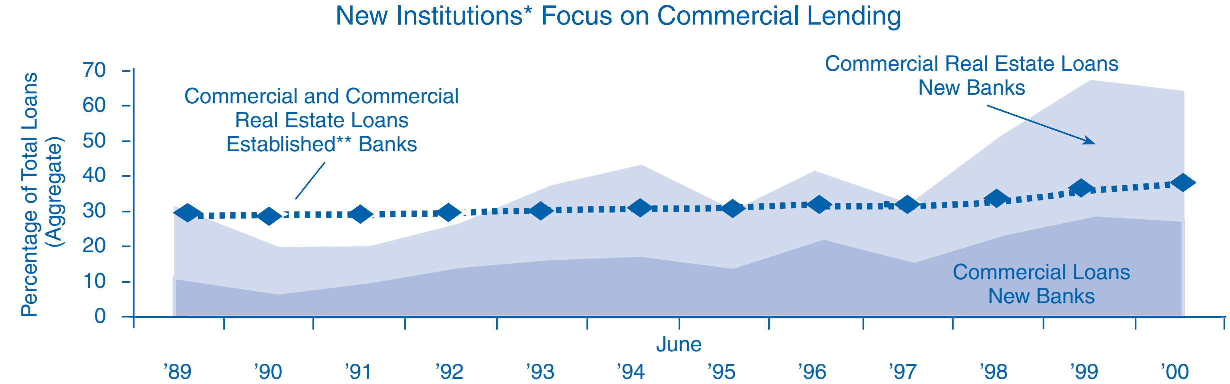
CHART 5

Established Banks' Average Loan Composition



Note: Institutions with less than $1 billion in assets as of June 30, 2000, excludingnew banks.
Source: Bank and Thrift Call Reports, June 30, 2000

Chart 6



* New institutions shown are in their second or third year of operation.
** Established institutions are community banks and thrifts (<$1 billion in assets) in the Chicago Region as of June 30, 2000.
Source: Bank and Thrift Call Reports

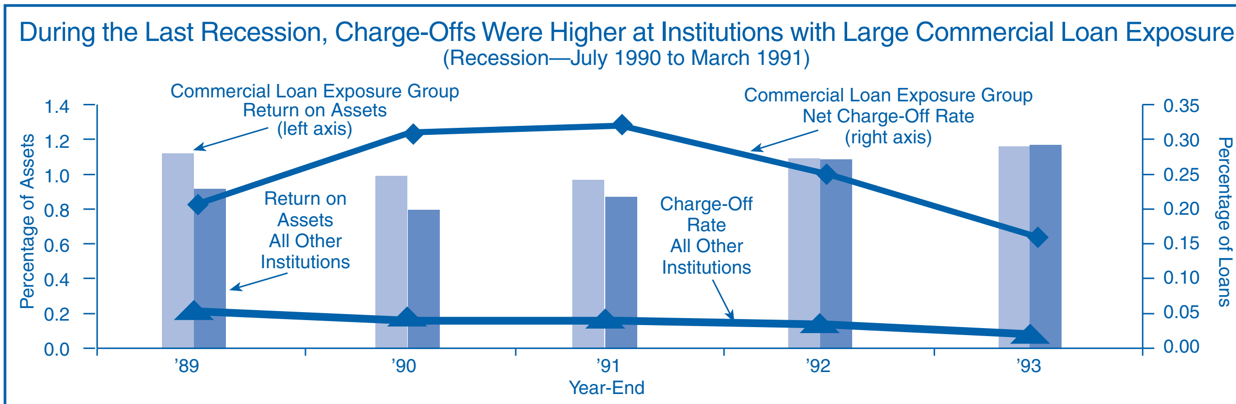
aggregate commercial and commercial real estate levels only modestly during the past decade, indicating a more cautious profile.

While a more aggressive loan posture may augment new bank income, the shift in loan mix could increase exposure to credit risk. For example, established institutions heavily engaged in commercial lending experienced higher net charge-off rates during the last recession (see Chart 7). Therefore, while commercial and commercial real estate loans historically have been higher yielding, these portfolios also have been more sensitive to economic downturns. The Federal Reserve has raised interest rates over the past year, and some economic indicators show that the economy is slowing. An abrupt or sustained economic slowdown could disproportionately affect new banks with exposure to commercial loans.

Many institutions in the Region, including both new and established banks, are relying on noncore funding as core deposits become more difficult to attain. Although new banks traditionally have held relatively higher levels of noncore funding, the more substantial growth in noncore funding at new banks has contributed to their divergence in interest expense from established banks. As of June 30, 2000, the ratio of noncore funding to assets was 39.6 percent for new banks, compared with 23.0 percent for established community banks.

Increases in noncore funding at new banks exhibit a different pattern from that of established banks, however. Other borrowings, such as Federal Home Loan Bank advances, have been the primary growth area in funding at established banks. In contrast, newer institutions rely on large time deposits and brokered deposits (see Chart 8, next page).

Chart 7



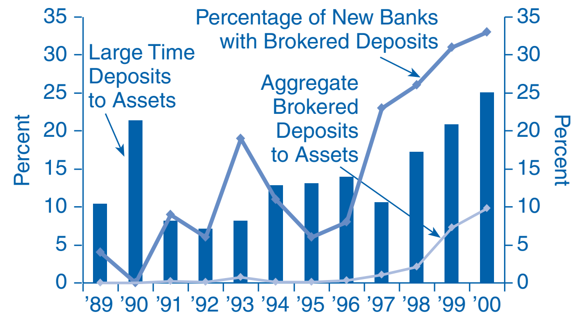
Note: Commercial Loan Exposure Group Criteria—must have a 50 percent loan-to-asset ratio and the sum of commercial and commercial real estate lending must be greater than 50 percent of loans. Median values shown.
Source: Bank and Thrift Call Reports

To the extent that new banks are willing to pay high rates to attract local market deposits, they may well be attracting the most interest rate–sensitive deposits in the area. This situation may raise interest rate risk concerns at new banks and further increase competition for deposits among all insured institutions in a local market.

The recent rapid rate of new bank formation, and the rising risk profile of new banks, has heightened the Region's risk profile. In the markets where new bank formation has been active, institutions may be particularly subject to margin compression as new banks attempt to gain market share through competitive loan and deposit pricing. Deposits attracted through competitive pricing may be highly sensitive to interest rates. Also, if credit quality concerns arise for smaller institutions, such as those recently experienced by large commercial banks, new banks may be disproportionately affected because of their significant exposure to commercial and commercial real estate lending.

CHART 8

Large Time Deposits and Brokered Funds Boost Noncore Funding Levels Higher at New Banks*



* Institutions in their second or third year of operation, excluding those with total assets greater than $1 billion in assets.
Source: Bank and Thrift Call Reports, June 30

Strong Auto Sector Faces Challenges

The auto industry plays an important role in the Region's economy. According to the 1997 Economic Census,[10] the industry provided 620,000 jobs, or 3 percent of all jobs in the five-state Region. Auto manufacturers employ about 27 percent of this total and are among the largest employers in Indiana, Ohio, and Michigan. Auto parts manufacturers represent the remaining 73 percent of jobs in this industry. In fact, auto parts manufacturers employ more people than auto manufacturers in every state in the Region. The auto industry's influence on 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-long expansion; however, some potential weaknesses in the industry's strong current performance are emerging. In 1999, light vehicle sales surged to 16.7 million units, surpassing the previous annual sales record and the average of 15.1 million logged in the mid-1990s. Participants at the Federal Reserve Bank of Chicago's seventh annual Auto Outlook Symposium held in June 2000 forecasted a new record in light vehicle sales of 17.3 million units for this year. Income growth, high consumer confidence, and demographic trends point to continued strength in the auto industry. However, a general uneasiness about the economy, rising interest rates, fluctuating gasoline prices, and growing foreign competition may dampen future sales, as indicated by the downward trend in the University of Michigan's index of car-buying conditions (see Chart 9, next page).

Recent increases in short-term interest rates have not affected new car sales substantially thus far, in part thanks to the actions of auto manufacturers' captive finance companies. These finance companies did not pass along increases in interest rates that occurred after November 1999. Instead, they subsidized loan rates and thereby insulated consumers from the uptick in interest rates (see Chart 10, next page). In fact, auto company–sponsored car loan rates actually declined through much of 2000 before edging up slightly during the summer.

Traditional incentives have increased as well. Retail promotion costs include rebates and discounts in addition to interest rate and lease subsidies. According to Autodata Corporation, retail promotion costs increased

[10] U.S. Census Bureau.

CHART 9

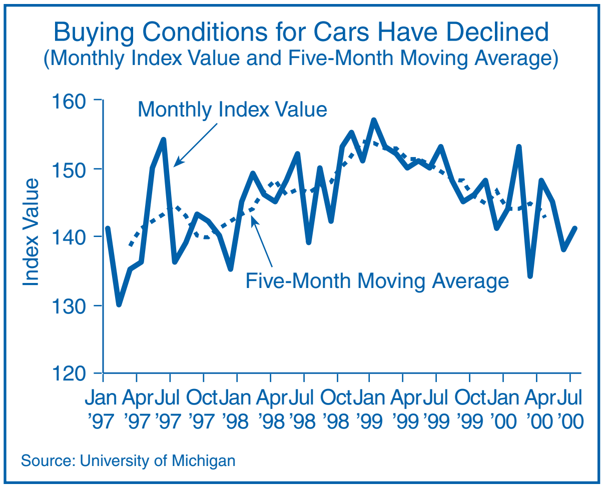
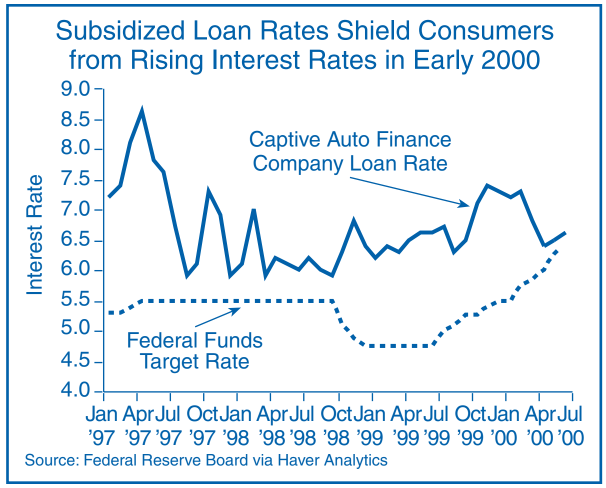


CHART 10



7 percent in July 2000 over the prior year. In fact, CNW Marketing Research reported that in late August incentives exceeded $4,000 per vehicle.

With U.S. crude oil supplies near a 24-year low, the prospect of continued high gasoline prices looms. Several industry analysts have made cautious predictions about the near-term prosperity of American auto manufacturers, because the most profitable vehicles also are the least fuel-efficient. Sales of these vehicles may be more susceptible to higher gasoline prices. Indeed, light truck sales declined 8 percent in second quarter 2000 from the prior quarter. However, new light truck sales remained up 2.2 percent from second quarter 1999.

Credit Monitor™, which was developed by KMV LLC®, is an analytical tool that measures credit risk. The application estimates the probability that a firm will default over a specified period of time. KMV's measure, called Expected Default Frequency™, or EDF™, expresses this probability. For example, an EDF of 2 indicates that a company has a 2 percent probability of default over the next 12 months. An EDF of 2 is equivalent to the median EDF over the past five years for a Standard & Poor's Credit Rating of "B." According to Standard & Poor's, an obligation rated "B" is more vulnerable to nonpayment, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

Finally, foreign competition, led by Japanese brands, has emerged as another challenge for domestic auto manufacturers this year. Japanese manufacturers gained 1.6 points of market share for a near-record 27.5 percent in July 2000. Korean and European manufacturers[11] also gained market share. Foreign auto manufacturers are making gains in both the small car market and the profitable light truck market.

Subsidies and other efforts to bolster sales of new American vehicles insulate parts manufacturers from some market pressure. However, the General Motors Corporation strike during summer 1998 showed the extent to which lean manufacturing production methods cause a strong ripple effect throughout the tightly linked auto supply chain. The 1998 strike at two General Motors Corporation–owned parts plants in Flint, Michigan, quickly shut down most of the company's North American assembly operation. In turn, it caused production adjustments at many of the company's independent suppliers.

Auto parts manufacturers operate in a competitive environment and exert little pricing power with auto manufacturers. As a result, auto parts manufacturers often are in a weaker financial position. This difference is apparent in Chart 11, which compares the median Expected Default Frequency™ (EDF™) credit measure reported by Credit Monitor™ of a group of auto parts manufacturers headquartered in North America with the EDF of both General Motors Corporation and Ford Motor Com-

[11] European manufacturers exclude Jaguar and Volvo, which are included in Ford Motor Company's results, and Saab, which is included in General Motor Corporation's results, but do include sales of DaimlerChrysler's Mercedes-Benz division.

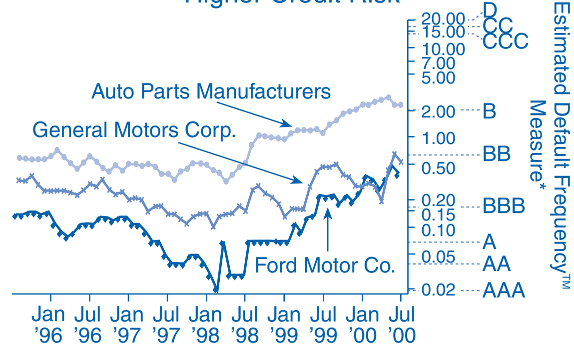
pany. The median EDF of auto parts manufacturers is nearly four times higher than that of the auto manufacturers themselves.

The comparatively weaker financial condition of auto parts manufacturers also was apparent in a survey reported in Dismal Sciences, Inc.'s *Précis:* METRO for Grand Rapids, Michigan. The survey indicated that only 20 percent of the area's auto parts manufacturers were thriving financially, and 60 percent were barely making enough money to survive. The remaining 20 percent likely will fail if revenues do not improve.

Therefore, while the U.S. auto industry appears poised to set a new sales record, a number of challenges are on the horizon. If these challenges result in reduced production by manufacturers, the Region's many auto parts manufacturers will feel the effect almost immediately and may face financial difficulty. Because of the industry's importance to the Region in terms of employment and its highly cyclical nature, continued attention is warranted as these challenges unfold.

CHART 11

Auto Parts Manufacturers Exhibit Higher Credit Risk



* Median EDF™ credit measure for auto parts manufacturers headquartered in North America.
Source: Credit Monitor™ KMV LLC®, all rights reserved

The Risk Profile of Auto Leasing Portfolios Remains High

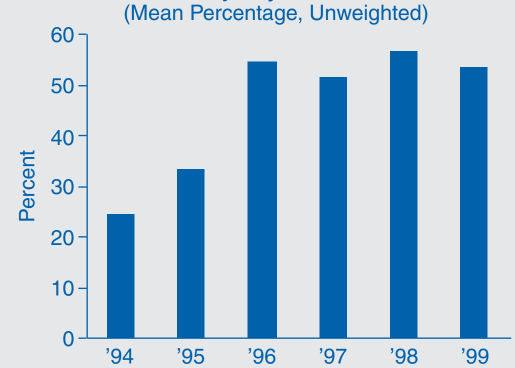
Leasing portfolios have exhibited some weakness over the past few years. The problems in leasing portfolios date back to 1994, when leasing activity began to grow and the used car market was strong. Lessors were recording lease income and, when the lease term expired, were selling returned vehicles for more than their residual value. Then, to build market share, lessors began to raise the estimate of residual value, effectively lowering the monthly lease payment for the consumer.

The 2000 Automobile Finance Study conducted by the Consumer Bankers Association showed that by 1999, the mean percentage of vehicles with a residual value greater than estimated by the *Auto Leasing Guide* was 53 percent, compared with 24 percent five years earlier (see Chart 12). When the residual value is higher than the current market value, consumers generally return the car at the end of the lease term instead of buying it. As a result, the used car market has become oversupplied. Lessors are facing losses on the sale of leased vehicles, write-downs on the carrying value of lease residuals, and higher remarketing costs and other expenses.

In addition to generous residual values, other aspects of lease underwriting appear to be riskier.

CHART 12

Residual Values Exceed Guidebook Limits for Majority of Leases
(Mean Percentage, Unweighted)



Source: 2000 Automobile Finance Study, Consumer Bankers Association

- The study showed that the percentage of lessors allowing dealers to approve leases without intervention continued to increase, from 50 percent in 1998 to 56 percent in 1999.

- New vehicle leasing terms lengthened in 1999, according to the study. The percentage of new vehicle leases originated with terms greater than 37 months was 67 percent, up from 52 percent in 1998.

continued on next page

Risk Profile of Auto Leasing Portfolios, continued

- Lessors increased the average permitted miles. In 1997, study respondents reported that 40 percent of new leases allowed fewer than 15,000 miles per year. Two years later, 53 percent of newly originated leases allowed 15,000 miles per year.

- The study showed that the capitalization of charges at origination, such as registration and license fees and warranty packages, has increased. In fact, 100 percent of survey respondents capitalized warranty packages.

These trends indicate that leasing portfolios may continue to experience weak performance. In 1999, 56 percent of vehicles reaching full term were returned to lessors, compared with 39 percent in 1998, according to the study. When vehicles are returned to lessors, losses occur frequently, and these losses have increased. Study respondents indicated that losses were recorded on 84 percent of all full-term vehicles returned to lessors in 1999, and the average loss increased to $1,920 from $1,185 in 1998. The large number of vehicles with residual values over *Auto Leasing Guide* values indicates that these losses may continue. There also is concern that the used vehicle market has a large supply of sports utility vehicles and pickups, the most popular vehicles in recent years, and that it may take years to work through a market glut.

The Chicago Region Staff

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 a 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.

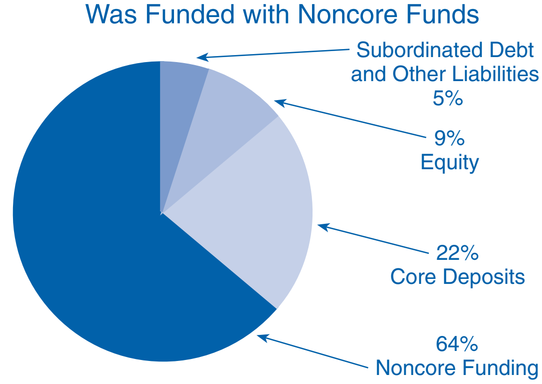
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting 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

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 sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

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.

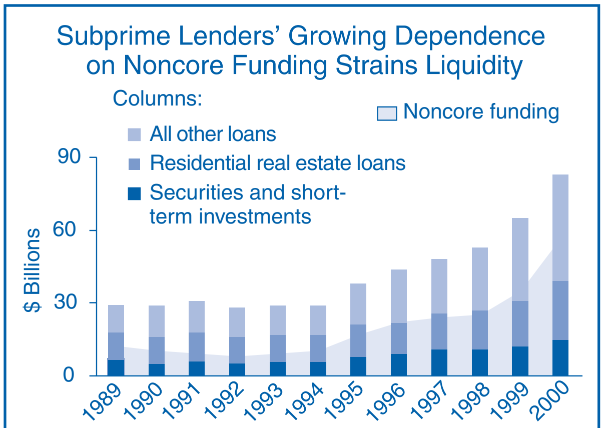
Increasing Levels of Interest Rate Risk Challenge Some Institutions

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).

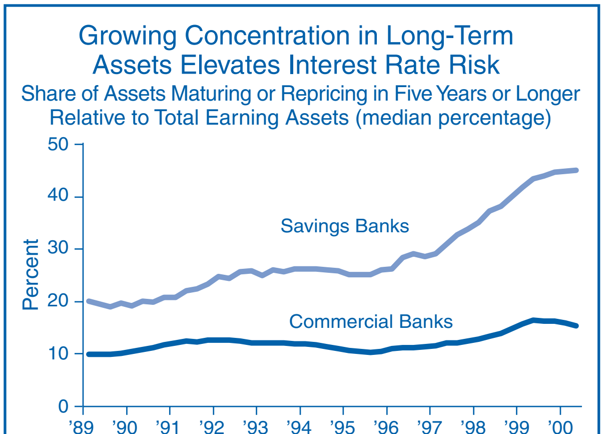
Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first-quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts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

CHART 2



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

CHART 3



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.

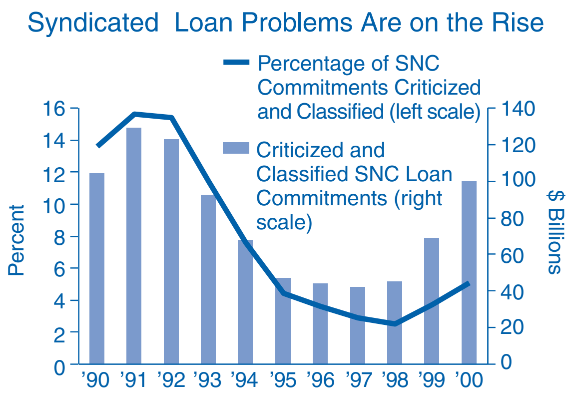
The Rising Level of Problem Business Loans Is Centered in Large Banks

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

[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

classified credits, compared with 54 percent at the year-earlier review.

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

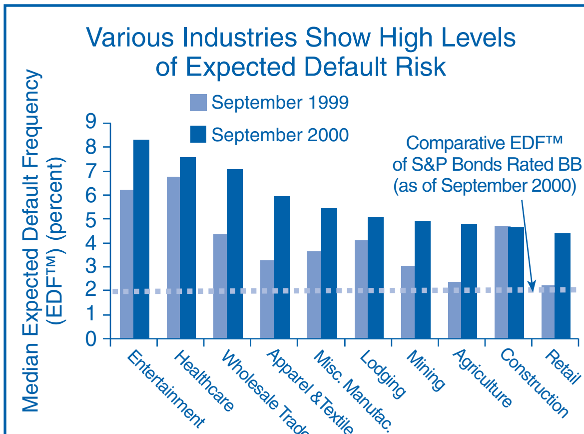
The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account 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

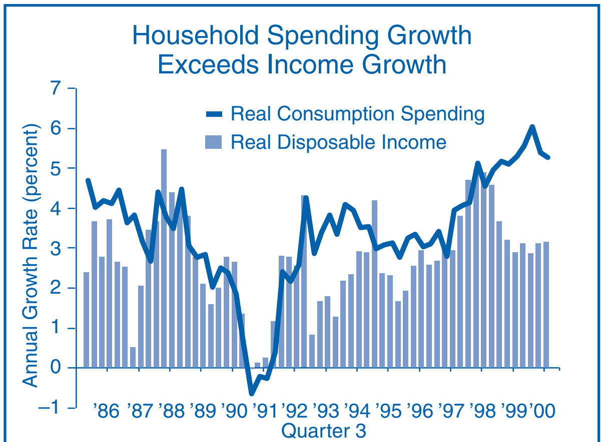
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] 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



Source: Bureau of Economic Analysis via Haver Analytics, Inc.

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, next page), 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

[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, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin.* Vol. 86. January 2000, 1–29.

that affordability is 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.

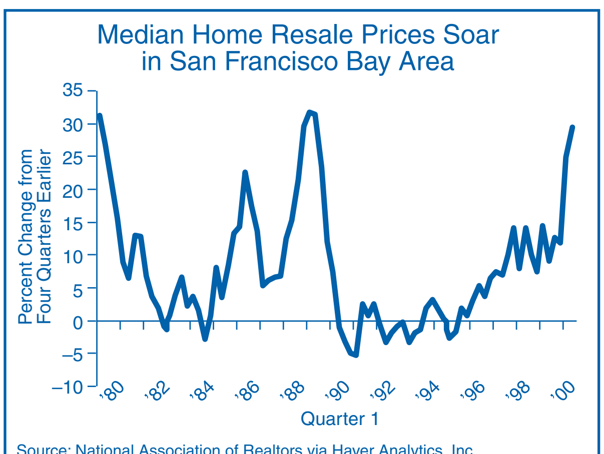
Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. 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.

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

CHART 7



Source: National Association of Realtors via Haver Analytics, Inc.

[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*** (USDA) 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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