Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999

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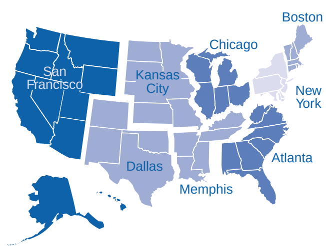

DIVISION OF INSURANCE

In Focus This Quarter

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

- ***Economic Developments*****—Low interest rates, dormant inflation, and rising stock markets have all contributed to a generally positive near-term outlook for the U.S. economy.** *See page 3.*
- ***Trends Affecting Banking Lines of Business*****—Although credit conditions appear strong, risks exist in the major banking lines of business.** *See page 7.*

  Consumer Lending**—Continued high consumer loan loss rates raise questions about how lenders will fare under less favorable economic circumstances.** *See page 8.*

  Commercial Lending**—Corporate loan growth accelerated in 1998 even as the corporate sector showed signs of stress.** *See page 9.*

  Commercial Real Estate and Construction Lending**—Selected metropolitan markets are experiencing rapid commercial development despite declining indicators of demand.** *See page 10.*

  Agricultural Lending**—Falling commodity prices threaten U.S. farm operators.** *See page 11.*

  Funding and Interest Rate Risk**—Intense competition and the changing term structure of interest rates have presented challenges for banks and thrifts.** *See page 12.*
- ***Indicators of Industry Performance*****—Weaknesses appear to be developing for banks with certain types of exposures, and the dispersion in performance among insured institutions is increasing.** *See page 13.*

By the Analysis Branch Staff

Regional Perspectives

◆ ***Atlanta*****—The Region's economic growth continued to outpace that of the nation while commercial bank and thrift returns remained strong in the fourth quarter, but earnings momentum may be slowing.** *See page 16.*

◆ ***Boston*****—The Region's economy steadily expanded in 1998, while financial institutions remained healthy. Some institutions increased their risk exposures to compensate for the effect on earnings caused by narrowing margins.** *See page 17.*

◆ ***Chicago*****—Because robust economic growth may be unsustainable and financial institutions saw a decline in performance during 1998, economic and financial sectors warrant careful monitoring in 1999.** *See page 18.*

◆ ***Dallas*****—The Region's states have benefited from long economic expansions strengthened by consumer spending, but slower growth is expected in 1999.** *See page 19.*

◆ ***Kansas City*****—The Region's 1,355 farm banks continued to report good financial results at year-end 1998, as the effects of a downturn in the farm economy are not yet widely evident in financial performance.** *See page 20.*

◆ ***Memphis*****—Slowing global economies have led to lower prices for many commodities that are important to the Region, particularly in the agricultural sector, as 1999 forecasts suggest a second consecutive year of declining farm income.** *See page 21.*

◆ ***New York*****—The Region's savings banks continue to underperform commercial banks, while credit card banks remain vulnerable to growing consumer debt levels and other industry trends.** *See page 22.*

◆ ***San Francisco*****—The Region's technology manufacturing slowdown presents challenges for communities with significant technology employment exposures.** *See page 23.*

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Economic Conditions and Emerging Risks in Banking

Periodically, the Division of Insurance assesses conditions in the economy and across the banking industry in an effort to evaluate the types of risks that could adversely affect the performance of insured depository institutions. The analysis that follows describes the salient aspects of this assessment by focusing on three areas: 1) developments and conditions in the U.S. and global economies; 2) trends affecting particular banking lines of business; and 3) selected indicators of bank performance.

In brief, the U.S. economy continues to provide a favorable environment for the banking industry. The industry as a whole has exhibited strong loan growth and minimal credit losses. Nevertheless, there are areas of concern, including subprime and high loan-to-value consumer lending, higher levels of leveraged commercial lending, localized overbuilding of commercial real estate, and the potential for credit quality problems among agricultural banks. Although it is uncertain when, or even if, these concerns will ultimately affect overall industry performance, the potential for stress among insured institutions is being monitored.

Economic Developments

Conditions Have Improved Markedly since Late 1998

The U.S. economy is now in its eighth year of expansion, the longest peacetime expansion during the post-World War II era. Although analysts raised concerns about the durability of the expansion amid the late-1998 financial market turmoil, the economic outlook since that time has improved for a number of reasons: 1) the 75 basis point reduction in short-term U.S. interest rates between September and November helped to support consumer spending and business investment; 2) following several quarters of decline, U.S. exports rose unexpectedly during the fourth quarter; 3) inflation remained dormant even though U.S. labor markets were extremely tight; and 4) equity valuations for large-cap stocks rebounded and erased most of the losses incurred during August and September.

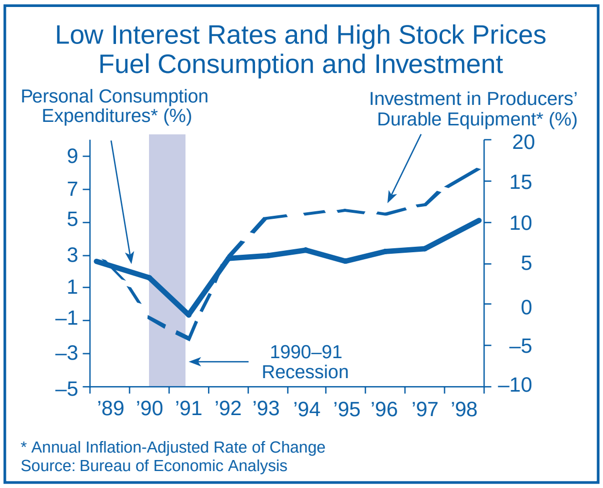
Consumer Spending and Business Investment Are Key to Economic Strength

Most of the standard indicators of health for the U.S. economy currently register values associated with the best macroeconomic conditions in our history. Growth in real gross domestic product (GDP) was 3.9 percent for all of 1998—the third consecutive year in which growth exceeded 3.5 percent. The U.S. economy added over 3.1 million jobs during 1998, while unemployment averaged just 4.5 percent, the lowest annual figure since 1969. Despite this robust economic activity, inflation was also the lowest in a generation. Consumer prices rose by just 1.6 percent in 1998, extending a seven-year streak during which prices have risen by less than 3 percent per year. At the same time, strong gains in the productivity of U.S. workers helped real hourly earnings rise by 2.7 percent—the best performance since 1972—while unit labor costs of businesses rose by only 1.9 percent.

Growth in business investment spending, which typically peaks in the early years of an economic expansion, has actually accelerated during the current expansion (Chart 1, next page). A number of factors appear to be responsible for this investment boom. One is the need for producers to invest in new technologies in order to cut costs and remain competitive. Also, rising stock prices, low interest rates, and low yield spreads during the past few years have helped keep the cost of capital relatively low. The result has been an economic expansion in which approximately 20 percent of net growth in real GDP has come from investment in producers' durable equipment, versus approximately 10 percent during the long expansions of the 1960s, 1970s, and 1980s. Bank commercial and industrial lending has expanded at an average annual rate of 10.6 percent over the past five years, largely on the strength of business investment spending.

The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted the ***Conference Board's*** consumer confi-

CHART 1



dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached 15.5 million in 1998, their best performance since 1986. Low interest rates also enabled a record number of homeowners to reduce their monthly interest expenses by refinancing their mortgages during 1998.[1]

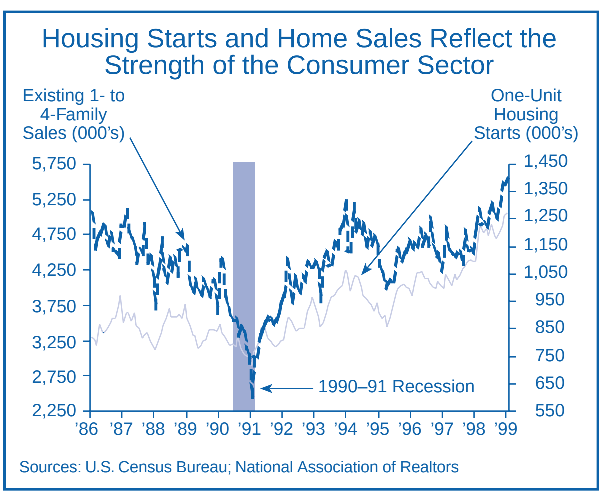
Although real disposable personal income grew by more than 3 percent during 1998, personal savings was essentially zero during the fourth quarter. This was the lowest rate of personal savings recorded in the United States since the Great Depression. The decline in personal savings has prompted much discussion of its causes and potential implications for the economy and for consumer credit quality. Most analysts have argued for the importance of a "wealth effect" from rising stock values on consumer spending.[2] They note that although consumers are saving little out of current income, household wealth continues to grow rapidly, driving consumer spending higher. The willingness of American consumers to spend has been a prime factor in prolonging the economic expansion for the United States and in supporting the economies of countries around the world that depend on exports to the United States. This high degree of reliance on the U.S. consumer has led analysts to voice concerns that the wealth effect might reverse itself, leading to a sharp drop in consumer spending if there is a sustained stock market decline.

Conditions Vary across Industry Sectors

While overall conditions in the U.S. economy are good, certain sectors have been undergoing significant strain because of low commodity prices and weak foreign demand.

Commodity price weakness extends across a wide range of items, from agricultural goods to industrial commodities to basic manufactured goods (Chart 3). Among agricultural commodities, grain prices have fallen substantially from their record-high levels of just three years ago, while prices for hogs and soybeans have also been under severe pressure. Industrial commodity prices have fallen sharply, with steel prices down by nearly 30 percent since January 1997. Certain manufactured goods show a similar pattern. The price of the industrial chemical benzene has fallen by 40 percent since January 1997, while the price of computer memory chips fell by more than 80 percent during that time. Oil prices decreased by nearly 50 percent between January 1997 and February 1999. Since mid-March, however, oil prices have increased as a result of agreements among oil producers to limit output. Analysts are uncer-

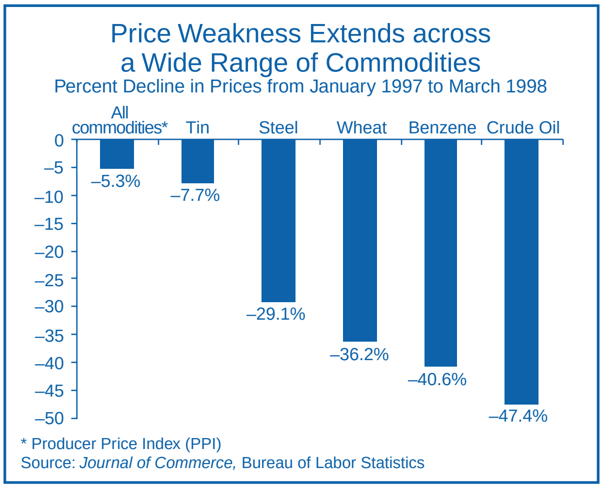
CHART 2



[1] The Refinancing Index of the ***Mortgage Bankers Association*** posted an all-time high of 4,389 in the second week of October 1998. The index is scaled to a level of 100 as of the third week of March 1990.

[2] Personal savings is measured as the difference between disposable personal income (personal income less tax payments) and total consumption outlays. Increasing household wealth may reduce personal savings either through a reduction in disposable income or through increased consumption outlays. Tax payments resulting from capital gains will reduce measured disposable personal income. Increasing household wealth may lead to higher consumption outlays by means of the wealth effect.

CHART 3



tain how long any reductions in output will be maintained or how much oil prices may increase during the next several months.

Three trends in the global economy appear to be responsible for weak commodity prices. First, sustained low inflation has taken root both in developed nations and in many emerging economies. Low inflation has eliminated much of the speculative demand for commodities that was evident during the 1970s. Low inflation has also made it difficult for manufacturing firms to raise prices, while at the same time encouraging the implementation of new technologies to cut costs. Second, large-scale investment in plant and equipment during the 1990s in both developed and emerging countries has added vast amounts of new global manufacturing capacity, making industrial overcapacity a source of price weakness in a number of industries. Third, successive currency crises and the resulting recessions that have taken place in Asia, Eastern Europe, and Latin America have reduced global demand for commodity goods. Moreover, U.S. firms find that their products are less price competitive abroad because of the relative strength of the dollar.

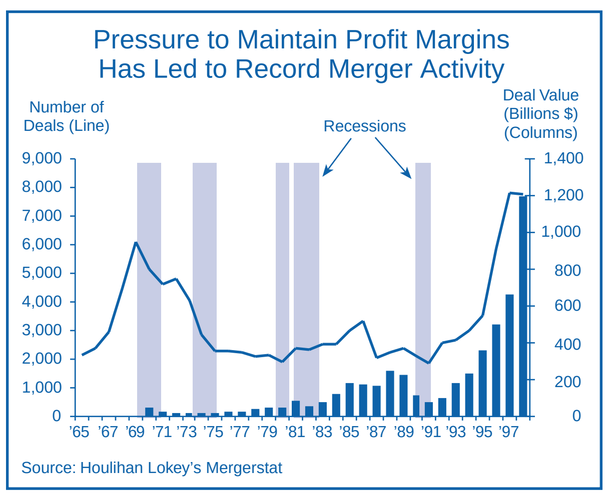
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record number and dollar value of merger deals announced during 1998. Mega-mergers involving Exxon-Mobil and Daimler Benz-Chrysler helped push the dollar volume of mergers announced in 1998 to almost $1.2 trillion—nearly double the level announced in 1997 and far greater than any year during the "merger mania" of the 1980s (Chart 4).

U.S. Foreign Trade Reflects Recent Turmoil in the Global Economy

The U.S. economy increasingly relies on exports to fuel its overall growth. Between 1994 and 1997, export growth contributed about 1 percentage point each year to total net growth in real GDP. However, with the onset of the Asian economic crisis in 1997, the export sector stalled and became a drag on overall U.S. economic activity. During the first three quarters of 1998, exports decreased at an annualized rate of 4.4 percent, led by declines in capital goods, industrial material and supplies, and food and agricultural products. Weakness in exports was not limited to Asia; in fact, Canada, Mexico, and South America were also weak markets for U.S. goods and services during most of 1998. Declining goods exports and rising imports combined to push the U.S. balance of trade to a record deficit of $169 billion during 1998—a 50 percent increase from the year before. The trade deficit continued to increase in early 1999. Data for January show an imbalance of nearly $17 billion, the largest monthly deficit ever recorded.

Despite the weakness in foreign demand that was observed during much of last year, U.S. exports rose sharply at the end of 1998. Total exports jumped by 19.7 percent during the fourth quarter, contributing 2.0 percent of the total 6.0 percent growth in GDP during the

CHART 4



quarter. This unexpected increase in U.S. exports involved nearly every region of the world except Eastern Europe. Export shipments increased across most product types, with the greatest increase in activity observed in capital goods.

The Outlook for the Global Economy Remains Uncertain

Developments during the past six months have resulted in an improved outlook for the global economy, but some key uncertainties remain. While the global financial system is more stable today than it was six months ago, some of the world's most important economies either remain in recession or are experiencing slower growth. In this environment, the potential remains for shocks to arise in the global economy that could adversely affect the performance of the U.S. economy and the credit quality of insured depository institutions.

Canada. The Canadian economy is healthier than at any time during the past several years. Canada's economy is expected to track overall growth in the United States, in part because U.S. demand for goods and services is the principal support for Canadian exports. Canada's relatively high dependence on weak commodity industries, such as metals, grains, and livestock, poses risks for producers and for local economies closely tied to these commodities.

Mexico. Mexican GDP growth was 4.6 percent in 1998, reflecting relatively strong employment and wage gains, high levels of foreign direct investment, and robust non-oil export growth. Looking ahead, inflation remains a concern. At the end of 1998, the inflation rate was 18.7 percent, up from a low of 15 percent in the middle of the year. The ***Blue Chip Economic Indicators*** consensus forecast calls for real GDP growth of 2.9 percent during 1999, down from 4.6 percent in 1998.

Western Europe. Europe's problems are similar to those of the United States in that they stem from declining growth in manufacturing exports. Despite a 175 basis point cut in short-term interest rates in the U.K. since October 1998, the Bank of England forecasts economic growth of less than 1.0 percent in 1999. In Germany, manufacturing activity has also decreased, owing to weakness in export markets. German GDP shrank by 0.4 percent during the fourth quarter of 1998, while unemployment remains above 10 percent. In response to signs of growing weakness in Germany and other major economies in the 11-member "Euro-zone," the European Central Bank cut short-term interest rates by 50 basis points to 2.5 percent on April 8, 1999.

Eastern Europe. Much of Eastern Europe is faced with slow growth or recession following the devaluation of the ruble and the default on Russian government debt in August 1998. The Russian economy shows few signs of recovery amid high inflation and halting progress in economic reform. Poland and Hungary, Eastern Europe's engines of growth before the Russian crisis, are facing rising current account deficits and a slowdown in export growth.

Asian Pacific Rim. The Japanese economy remains mired in a long-running recession that has resulted in a greater number of bankruptcies (up 17 percent in 1998), falling domestic demand, and pessimism among consumers and businesses alike. Japanese GDP fell by 2.8 percent during 1998, and analysts call for a drop of 0.8 percent in 1999.

There are signs that the worst phase of the Asian economic crisis may have passed.[3] In the Philippines, South Korea, Hong Kong, and Thailand, current accounts have moved from deficit to surplus as devalued currencies continue to depress imports. Foreign capital is returning to the region, as evidenced by the 27 percent increase in foreign direct investment in Korea during 1998. However, weak consumer spending remains a problem for the entire region, which ships fully 40 percent of all exports to other Asian Pacific Rim nations.

In China, which has been relatively immune to the worst of the region's economic crisis, slower growth is also forcing economic restructuring. With annual economic growth below the targeted 8 percent mark, economic planners have been forced to reduce production and close plants in the oil, steel, glass, and cement industries. Meanwhile, the government is trying to stimulate demand by investing in public infrastructure and by urging banks to increase lending to the private sector.

[3] See "The Asian Economic Crisis: Implications for the U.S. Economy," *Regional Outlook,* Third Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19983q/ny/infocus1.html.

Latin America. With the apparent stabilization of the Asian economies, attention has now focused on emerging problems in Latin America. The 50 percent devaluation of the Brazilian *real* versus the dollar that began in January 1999 has depressed economic activity and renewed fears of inflation. Consensus estimates place Brazilian economic growth at negative 3.5 percent for 1999, while short-term interest rates are likely to remain high (currently about 42 percent) to prevent further capital flows out of the country.

Risks Remain despite a Positive U.S. Economic Outlook

Robust economic growth, low inflation, and stable interest rates appear to be the most likely economic scenario for the remainder of 1999, according to the consensus forecast of the ***Blue Chip Economic Indicators.*** If this outlook actually comes to pass, we can expect that the vast majority of insured institutions will continue to enjoy moderate loan growth and generally favorable indicators of financial performance and condition.

Despite this positive outlook, the risk remains that the expansion could be derailed by one of three types of shocks. The first would be a resurgence of inflation resulting from demand-induced shortages of labor or other key economic resources. Although inflation has been consistently low in recent years, investors remain on the lookout for any signs of higher prices. While it is not certain that a recession would result, it is worth noting that rising short-term interest rates in response to increasing inflation have preceded every recession during the past 40 years.

The second type of shock that could end the expansion is a sustained period of deflation. Concern about deflation arises from the low prices many commodity producers are receiving and the effects of foreign currency devaluations on U.S. import prices. Although these trends have helped to keep U.S. inflation and interest rates low, at some point they could impose a heavier burden on U.S. businesses by shrinking revenues and profit margins, mirroring what has already occurred in some commodity-based industries.[4]

The third type of shock is financial market instability. Consumer confidence, which has reflected recent increases in stock market wealth, could tumble in the event of a severe and prolonged decline in the stock market. Business investment has also depended on the support of strong and stable financial markets that offer firms access to capital on favorable terms and facilitate restructuring in troubled industries. A recession accompanied by financial market instability could pose a particular threat to bank loan performance because it would likely produce a disorderly shakeout of troubled firms marked by a rise in bankruptcies and loan defaults.

[4] See "How Will the Expansion End?" *Regional Outlook,* Second Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19982q/sf/infocus2.html.

Trends Affecting Banking Lines of Business

Overview

Trends in bank and thrift lines of business align closely with those of the economy. Most insured institutions have prospered during this economic expansion, as shown by the industry's continuing earnings growth, strong capital levels, and improving or stable loan performance across most major loan categories. Likewise, today's strong economy depends to a great extent on the continuing availability of consumer and business credit from banks and thrifts. Even during the closing months of 1998, when capital market funding sources became quite volatile, credit continued to flow from insured institutions. During that turbulent period, insured institutions may have acted as a stabilizing force for businesses, consumers, and farmers by continuing to provide credit, albeit at higher prices and with stricter underwriting terms in some cases.

Although credit conditions appear strong, a number of insured institutions' loan portfolios are shifting toward a riskier mix of credits. Underlying reasons for these shifts vary, but likely explanations include opportunities to earn higher yields and confidence about the overall economic outlook. The following paragraphs discuss credit risk trends and highlight possible areas of concern in the major lending lines of business at insured institutions. The influence of recent interest rate changes and competitive factors on asset/liability and credit risk management is also explored.

Consumer Lending

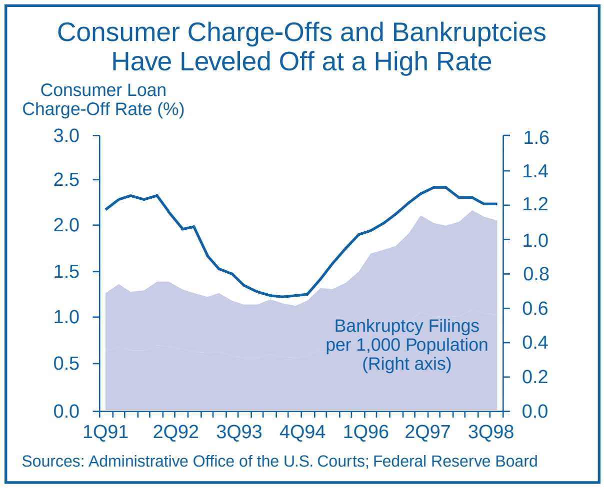
Debt Growth Sustains Consumer Spending but Could Contribute to Financial Strains under Less Favorable Economic Conditions

Much of the strength and stability of the overall U.S. economy owes itself to the continuing growth in consumer spending. While higher personal incomes and consumer confidence are important contributing factors, lower interest rates and expanding avenues of credit access have also played key roles in supporting consumer spending. With mortgage debt leading the way, consumer loan growth rates accelerated in 1998. The key factor driving mortgage loan growth was lower interest rates, which encouraged many consumers to purchase homes, refinance existing mortgages, and consolidate their personal debts through home equity loans. As a result, the growth in home mortgage credit during 1998 reached a post-recession high of 10 percent. Other consumer loan types, such as auto and credit card debt, grew at slower but accelerating rates of 8 percent and 5 percent, respectively.

Nonmortgage consumer loan loss rates remain above previous recession levels despite the apparent strength of the consumer sector. Chart 5 shows that nonmortgage consumer loss rates have declined slightly from their peak in the fourth quarter of 1997, but remain above the rates experienced during the prior recession. The chart also shows that consumer credit loss rate trends are closely related to the rise in personal bankruptcy filings, which reached an all-time high of 1.4 million in 1998.[5] The good news for consumer lenders is that the growth rate in personal bankruptcies has slowed. However, this leveling off does not mean that consumer credit quality concerns have abated. The overriding concern is how personal bankruptcies and consumer credit losses, already at high levels, would be affected by less favorable economic conditions. Another concern is whether current consumer spending patterns will be supported by a new round of credit card growth. Since revolving credit card balances typically carry higher interest rates than home equity loans, this "reloading" of credit card debt would further strain the financial flexibility of consumers.

[5] Reasons for the rise in personal bankruptcy rates are further explored in a series of ***Bank Trends*** articles published by the FDIC. See, for example, "A Time Series Model of the U.S. Personal Bankruptcy Rate, 1970-1996," February 1998, and "The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and Personal Bankruptcy Filings," March 1998. Both reports can be accessed at www.fdic.gov/publish/bktrnds/index.html.

CHART 5



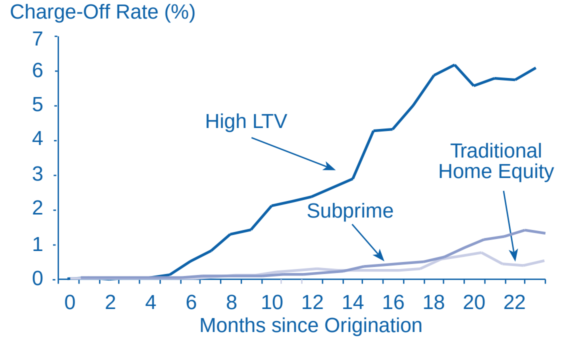
High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

Consumer lending practices have changed significantly since the last recession. Because of intense competition and declining net interest margins, consumer lenders are reaching out to borrowers further down the credit quality spectrum and relaxing traditional collateral requirements. Bank supervisors have indicated that a growing number of insured institutions are involved in some form of subprime lending. Subprime loans, designed for borrowers with blemished or limited credit histories, can take a variety of forms, including home equity, automobile, and credit card loans. As compensation for increased risk, subprime loans carry higher interest rates than prime-rate loans and often require substantial collateral margins.

Insured institutions are also embracing another relatively new consumer loan product: high loan-to-value (LTV) loans. High LTV loans, where the combined amount of senior and junior liens against a home exceeds its value, are usually made to borrowers with "clean" or unblemished credit histories. However, the lack of collateral protection results in much higher loss experience when a borrower defaults. As Chart 6 shows, high LTV loans have had a higher loss rate experience (adjusted for seasoning) than either traditional home equity loans or subprime loans. Moreover, the delinquency rates on recent-vintage home equity loan pools

CHART 6

High LTV Mortgages* Have a Higher Loss Experience than Other Mortgage Types



* Includes home improvement loans
Source: Moody's Investor Services

have deteriorated as high LTV loans have proliferated.[6] At the same time, recent regulatory surveys of credit underwriting practices show easing standards on home equity loans.[7] The loss experience of these higher risk consumer products during less favorable economic circumstances is unknown and continues to be a concern.

Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

Continued strength in the corporate sector is reflected in the level of corporate bankruptcy filings, which have declined since the middle of 1997 to just under 10,000 in the fourth quarter of 1998. Bank losses on commercial credits remain low but did register a modest increase during the fourth quarter (see Chart 7). In addition to strong economic fundamentals in high tech, construction, finance, service-related, and other sectors, U.S. businesses have benefited from significantly lower interest rates and an abundant supply of credit. Credit access provided by banks was particularly important to U.S. businesses in the latter part of 1998. During this period, sharply higher interest rate spreads on corporate bonds[8] and commercial paper led many companies to tap cheaper funding sources, including existing unused credit and commercial paper lines held by commercial banks. As a result, commercial banks experienced a 15 percent (annualized) rate of growth in fourth quarter 1998, the highest rate of commercial loan growth in 16 years.

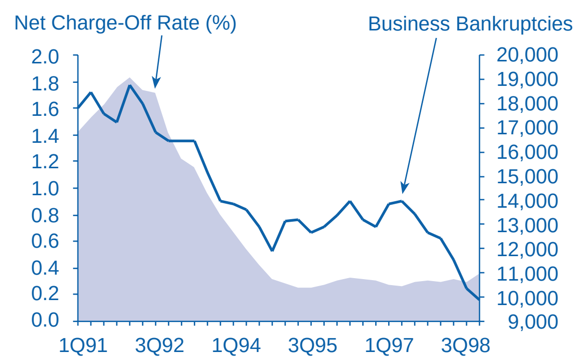
Although commercial loan loss rates are low, financial strains are becoming apparent among certain U.S. business sectors. Bank lending to U.S. businesses has grown at a faster pace than GDP during each of the past eight quarters. Moreover, growth in bank commercial lending through 1998 has come at a time when total after-tax U.S. corporate profits have begun to decline.[9] Deteriorating profits are especially prevalent in sectors with exposure to weak commodity prices and slower export growth. For many businesses, lower profits have resulted in a reduced capacity to service outstanding debt obligations. For instance, a recent ***Bank of America Corporation*** study reported that amendments to syndicated loans in the latter half of 1998 were driven increasingly by borrowers seeking relief from financial performance-related covenants.[10] Financial strains are

[6] "Moody's Home Equity Index Update." *Moody's Investor Services*, October 2, 1998, p. 3.
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[8] ***The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index*** indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.
[9] See the ***Bureau of Economic Analysis Corporate Profit Index.***
[10] "Covenants Provide Loan Repricing Opportunity." *Bank of America Report*, January 25, 1999.

CHART 7

Domestic Commercial Loan Losses Remain Low and Business Bankruptcies Decline



Sources: U.S. Courts; Bank Call Reports

also reflected in the level of corporate bond defaults, which ***Standard and Poor's*** reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).[11]

As Debt Markets Become More Cautious, Syndicated Lending Shifts toward Higher Risk Borrowers

Although the longer-term trend has been toward more aggressive corporate lending strategies, many insured institutions responded to the financial market turmoil in late 1998 with a heightened sense of caution. Recent surveys of underwriting practices conducted by the federal banking agencies show that many banks tightened standards in late 1998 across many product lines.[12] However, tighter lending terms do not appear to have quelled either loan demand or loan production substantially.

Syndicated lending trends suggest an increase in corporate lending risks.[13] Despite the flight to quality that occurred in the latter part of 1998, syndicated loans to leveraged companies jumped 41 percent to $273 billion during 1998. Over the same period, nonleveraged loans declined 35 percent to $599 billion. Although corporate merger activity accounts for much of the increase in leveraged lending volume in 1998, some lenders appear to be taking advantage of the higher yields available in this market relative to yields on lower risk credits. The apparent shift toward a higher risk mix of total syndicated credit outstanding is occurring at the same time that corporate bond defaults for speculative grade issues are trending upward.[14] Moreover, trends in corporate bond spreads and rating agency actions on corporate bond debt suggest a bond market that is becoming increasingly cautious about the outlook for U.S. businesses (see Chart 8).

[11] "Corporate Defaults Rise Sharply in 1998," ***Standard & Poor's,*** March 5, 1998.

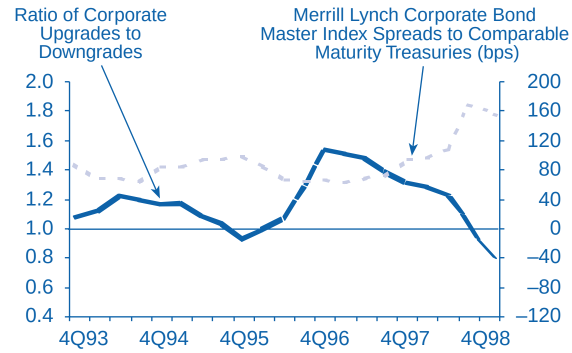
[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

[13] Syndicated loans are credit facilities made to medium and large corporate borrowers by a group or syndicate of lenders. Analysts often segment this market into "leveraged" lending (loans to heavily indebted companies) and nonleveraged lending.

[14] ***Moody's Investor Services*** reports that trailing 12-month default rates for speculative-grade issuers rose from 2.02 percent at the end of 1997 to 3.31 percent at year-end 1998. These default rates compare to an all-corporate trailing default rate of 0.68 percent in 1997 and 1.27 percent in 1998.

CHART 8

Corporate Bond Ratings and Required Yields Reflect Greater Market Uncertainty



Sources: Moody's Investor Service; Merrill Lynch

Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

In 1998, the value of private commercial construction rose 4.0 percent over 1997 levels, reflecting a moderate slowdown in growth compared with a compounded average annual growth rate of 8.4 percent since 1992. In contrast, the pace of residential development has accelerated. The value of private residential construction rose 11.5 percent in 1998, compared with an annual average growth rate of 8.0 percent since 1992. Construction loans at insured institutions grew 20 percent in 1998, the highest growth rate since 1986.[15]

Although market fundamentals are strong throughout most major U.S. markets, some metropolitan areas appear to be vulnerable to an oversupply of commercial space. The ***Regional Outlook***, First Quarter 1999, highlighted nine markets that may be susceptible to commercial overbuilding on the basis of the following factors: 1) the rapid pace of current construction activity in those markets; 2) high vacancy rates relative to construction in progress in some cases; 3) projections of rising vacancy rates by market analysts; and 4) various recent shifts in demand indicators. Data through June 1998 indicate that construction activity in these markets

[15] Construction loan growth captures growth in both residential and nonresidential development.

has not yet abated to reflect moderating demand levels.[16] Overbuilding concerns may be tempered to the extent that tighter commercial real estate lending standards slow the pace of development.[17]

Loan Underwriting Study Reveals Sounder Practices Compared with the 1980s, but Intense Competition Forces Some Concessions on Pricing and Structure

Beginning in August 1998, FDIC analysts set out to investigate construction loan underwriting practices in banks servicing various rapidly growing markets. The study identified several differences between today's lending practices and those prevalent during the last cycle. Most importantly, today's lenders are making credit decisions on the basis of improved appraisals, increased attention to project cash flows and project feasibility, and better market information on competing projects. However, intense competition has forced an across-the-board reduction in loan pricing margins even compared with margins at the height of the 1980s building boom.

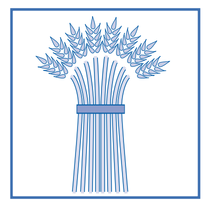
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger developers, who presumably have the resources and financial flexibility to weather adverse conditions. Nevertheless, waiving personal guarantees and eliminating a borrower's financial exposure to project risks are practices often cited in conjunction with the heavy construction loan losses experienced during the previous real estate downturn. Finally, the study found that many real estate investment trusts and large corporate developers have been able to obtain long-term unsecured financing for development purposes. The lack of collateral protection could make these loans particularly vulnerable to declining commercial real estate prices.[18]

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

Farm banks generally performed well in 1998, reporting a modest increase in nonperforming loans from 1.09 percent at year-end 1997 to 1.13 percent as of year-end 1998. Although delinquent loans rose only slightly in the aggregate, farm banks in some localized areas such as northeast North Dakota and northwest Minnesota experienced sharply higher problem loan levels and reduced profits in the aftermath of three consecutive years of low prices, bad weather, and crop disease-related problems. Moreover, recent surveys by the federal banking agencies, which show rising levels of farm carryover debt at farm banks, suggest that nonperforming loan data may understate borrower difficulties.

During 1998, the outlook for significant portions of the farm sector deteriorated following a dramatic fall in prices for several major farm commodities. Prices for wheat, corn, soybeans, and hogs fell to ten-year lows and were below the economic breakeven cost of production for many producers. For areas heavily dependent on these commodities, the ***U.S. Department of Agriculture*** (USDA) projects that producers will experience substantial declines in net cash income from 1999 through 2003.[19] In 1999, the USDA projects farm income to fall 7.1 percent, to $44.6 billion, from last year's level of $48 billion.



Although current conditions have the potential to cause stress for substantial numbers of farm banks in certain regions, some significant differences exist between today's circumstances and those that led to the farm

[16] The nine markets are Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland, and Salt Lake City. "Commercial Development Still Hot in Some Markets but Slower Development May Be Ahead." *Regional Outlook,* First Quarter 1999, www.fdic.gov/publish/regout/ro19991q/na/index.html.

[17] Consistent with commercial and industrial underwriting trends, commercial real estate lenders reacted to market volatility in late 1998 by tightening loan terms and raising pricing margins. See, for example, the Federal Reserve Board Senior Loan Officer Opinion Survey for November 1998 and January 1999.

[18] Loan covenants may mitigate some of the risks of lending without collateral protection. Common covenants include maximum leverage ratios, minimum equity requirements, and limits on encumbered assets through recourse or cross-collateralization to third parties.

[19] A substantial portion of the ***USDA's*** projected decline in the net cash income for U.S. farmers over the next five years is attributable to reductions in government payments to farmers.

bank crisis of the mid-1980s. Current favorable factors include 1) lower debt-to-equity for farm producers; 2) substantially lower interest rates; 3) moderately appreciating farmland prices relative to the more rapid appreciation (and subsequent price corrections that followed) in the 1970s and 1980s; and 4) better underwriting practices by farm lenders. Nevertheless, if weak exports of farm products and low commodity prices continue for the remainder of this year, the condition of farmers could deteriorate significantly, increasing financial stress at insured farm banks.

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

Competitive pressures in the banking industry are not restricted to lending. Insured institutions are also finding it difficult to attract deposits in today's marketplace, largely because of the existence of higher yielding investment products. For example, the ***Investment Company Institute*** reports that net inflows into mutual funds have exceeded net increases in deposit accounts in all but three quarters since mid-1991. The fourth quarter of 1998 marked the sixteenth consecutive quarter that mutual fund inflows outstripped deposit increases. As deposits have become more difficult to attract, loan portfolios have expanded in line with the overall growth in the economy. As a result, institutions have turned increasingly to other borrowings for funding. These trends are captured in Chart 9, which shows that the ratio of bank and thrift loans to deposits reached a record 88 percent in December 1998. Small community banks and thrifts (institutions with less than $1 billion in assets) are most affected by deposit trends, since they tend to rely more heavily on deposit funding than larger institutions with greater access to the capital markets.

Interest Rate Changes Pose Asset/Liability Management Challenges

Interest margin pressures are posing challenges for insured institutions. In addition to the effect of competitive pressures, changes in interest rates have had a substantial influence on institutions' net interest margins. The flattening of the yield curve in 1998, for example, appears to have contributed to a decline in margins to their lowest levels since 1991 for both large and small insured institutions (see Chart 10). For insured institutions with more traditional asset/liability structures (longer-term asset holdings funded with shorter-term deposits and borrowings), a flatter yield curve results in lower spreads between asset yields and interest costs.

The decline in long-term interest rates during 1998 also led to a record volume of mortgage refinance activity, as indicated by the ***Mortgage Bankers Association's Refinancing Index.***[20] Among many mortgage lenders, the most immediate impact from this refinancing activity was the revaluation of servicing assets and lower servicing fee income. Some mortgage lenders also saw a significant increase in overhead as they expanded staff to accommodate higher loan application volumes. A

[20] This index hit its peak in mid-October and has since declined in line with a modest upward movement in fixed mortgage rates.

CHART 9

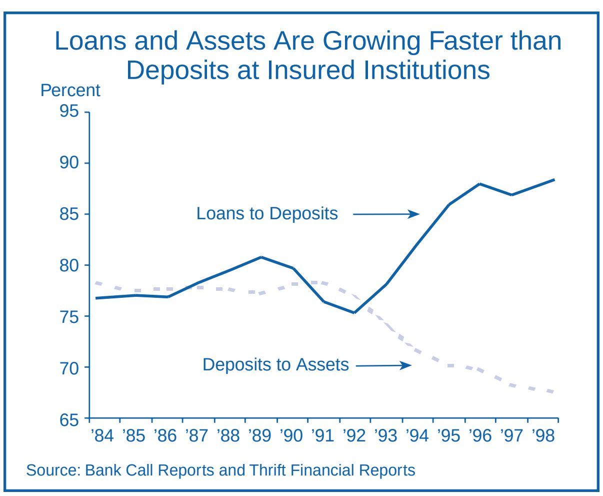
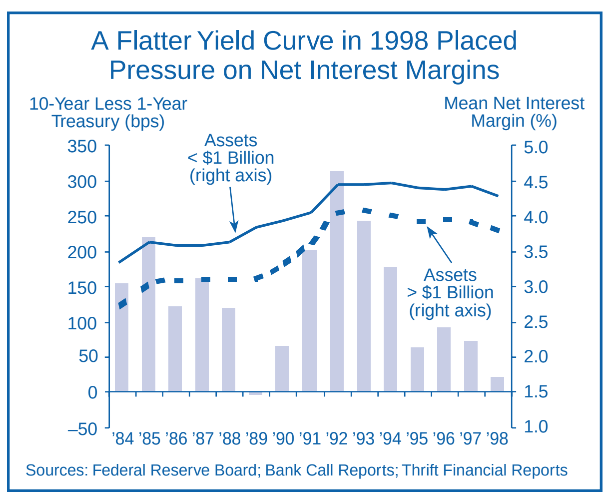


CHART 10



longer-lasting impact involves the shift in borrower preferences toward fixed-rate mortgages. According to ***Freddie Mac,*** approximately 65 percent of adjustable-rate mortgages refinanced in 1998 were replaced with 30-year fixed-rate mortgages. Another 30 percent were refinanced into 15- and 20-year fixed-rate mortgages. As a result of this activity, mortgage lenders may tend to have a higher proportion of assets held in longer-term mortgage loans, leading to further margin pressures should interest rates rise.

As discussed in previous sections, many insured institutions appear to be turning toward higher risk consumer and corporate lending strategies. Such strategic shifts may be at least partially in response to pressures on net interest margins. The search for higher yield spreads may also explain the continuing growth in nondeposit funding sources, which often take the form of complex obligations with embedded options that can reduce funding costs at the expense of additional interest rate risk.

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

Diminished concerns over the near-term economic outlook and reduced financial market volatility resulted in a sharp turnaround in investor attitudes toward banks in the fourth quarter of 1998. During the quarter, the ***SNL Bank Stock Index***[21] rose 21 percent, recovering all of the value it lost during the turmoil of the third quarter. The index has continued to rise in 1999.

Although equity indicators have been generally positive, ratings actions in 1998 for the long-term debt of U.S. banks and finance companies reflect developing problems for certain industry segments. In sharp contrast to the previous six years, when upgrades far exceeded downgrades, ***Moody's*** downgraded as many bank and finance company debt ratings as it upgraded during 1998. In the fourth quarter of 1998, Moody's downgraded the long-term debt ratings of 27 bank and finance companies and upgraded only 15—the highest quarterly ratio of downgrades to upgrades since 1992. Downgrades during 1998 were centered in finance companies specializing in nonportfolio subprime lending and bank holding companies with exposure to emerging markets.

Bank Performance Remains Strong but Earnings Variability Is Increasing

Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent in 1994 to a high of 1.24 percent in 1997.[22] However, the variability in commercial bank profitability, as measured by the distribution of the industry's ROA excluding the top and bottom 5 percent, has widened since 1994 (see Chart 11). For example, ROA for the worst 5 percent of the industry was negative 0.29 percent or less in 1998, reflecting a steady decline from 0.2 percent in 1995. Similarly, ROA for the most profitable 5 percent of commercial banks was above 2.16 percent, up from 1.94 percent in 1994.

Reasons for the increasing variability of commercial bank ROA can be further analyzed by segregating institutions along predominant product or business lines. Chart 12 (next page) details the distribution of 1998

[21] This index tracks the market capitalization of approximately 520 banking companies.

[22] *FDIC Quarterly Banking Profile,* Fourth Quarter 1998, www2.fdic.gov/qbp.

Chart 11

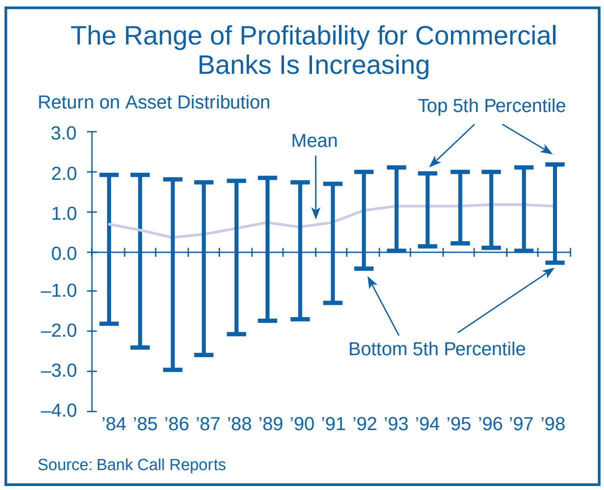
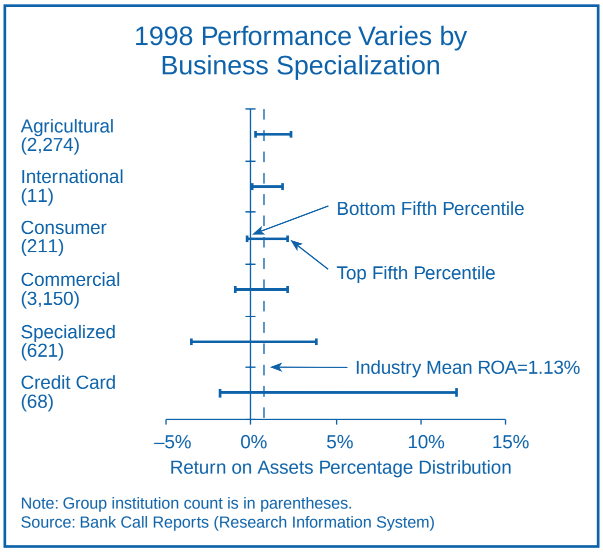


CHART 12



ROA for six selected groups of banks segregated by line of business concentrations. This chart reveals that bank performance varies considerably by business specialty. For example, the distribution of ROA of credit card lenders[23] differs significantly from that of other bank groups, including other consumer lenders.[24] Small specialized banks[25] and commercial lenders[26] followed credit card lenders as the groups with the greatest variability in profitability in 1998. Moreover, 75 percent of the least profitable commercial banks were members of small specialized or commercial groups. New banks have also influenced the dispersion of bank ROA. Banks chartered in 1997 and 1998 make up more than 60 percent of the industry's worst performers. However, earnings variability widened in 1998 even when newer institutions are excluded from the analysis.

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.

[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.

[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.

[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

Far fewer commercial banks posted losses in 1998 than during the period from 1984 to 1992. Still, the number of unprofitable institutions appears to be rising despite generally favorable economic conditions. These concerns are mitigated somewhat, since today's worst-performing institutions are generally much better capitalized and are burdened with fewer problem assets than their counterparts during the 1980s.

Summary

Most indicators of U.S. economic health remain robust in spite of the difficulties posed by low commodity prices and falling exports during 1998. The consensus forecast of leading economic analysts calls for continued growth in the U.S. economy for the rest of 1999. At the same time, a number of threats to this favorable outlook exist, including the possibility of higher inflation and higher interest rates stemming from strong economic growth. Other scenarios involve a very different threat—namely, price deflation brought on by global overcapacity and a decline in U.S. exports. Shocks that might arise in the foreign sector or in the financial markets, as experienced during 1998, remain a significant concern during 1999. Consumer spending and business investment seem particularly vulnerable to such shocks at this stage of the expansion.

Favorable economic conditions are reflected in the overall performance of the banking industry. Still, a number of indicators suggest that the risk profile of some insured institutions is increasing. Responding to significant competitive pressures, and perhaps emboldened by the long duration of the current expansion, many institutions are expanding their involvement in higher-risk consumer loan products, such as subprime and high LTV loans and higher-risk leveraged commercial loans. The overall shift toward higher-risk credits is occurring despite signs of financial strain on the part of many consumers (in the form of record personal bankruptcies) and businesses (in the form of declining profits and increasing bond default rates). Credit-related concerns also extend to commercial real estate, where some markets are exhibiting rapid commercial real estate development at the same time that demand indicators are trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

Bank and thrift net interest margins are being pressured by a flatter yield curve and heightened competition. Community institutions, which rely most heavily on interest income, are particularly vulnerable to tighter margins. The major concern in this area is that insured institutions will combat falling margins by entering into riskier funding and lending strategies.

Market indicators and reported financial data reflect favorable industry performance as well as new sources of risk. Investor attitudes toward banking companies have improved since late 1998 because of an improved near-term economic outlook and a reduction in financial market volatility. However, a recent increase in ratings downgrades of bank and finance company long-term debt suggests growing concern over bank exposures to such areas as subprime lending and emerging markets. Despite relatively strong aggregate industry performance, profit variability among individual commercial banks has increased because of new chartering activity and pressures in consumer and commercial lending. As a result, for the first time since 1992, the worst performing 5 percent of all commercial banks were unprofitable last year.

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

Maureen E. Sweeney, Associate Director

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

Atlanta Regional Perspectives

Economic growth in the Atlanta Region and the nation remains strong, especially given the age of the current expansion. In February 1999, the current expansion, at 95 months, became the second-longest since World War II, according to the ***National Bureau of Economic Research.*** Employment in the Region in February 1999 was up 3.1 percent from one year earlier, compared with a 2.2 percent increase nationwide. Nonetheless, growth may have moderated slightly after reaching a peak during the summer of 1998, when year-over-year job growth in the Atlanta Region and the nation measured 3.7 percent and 2.7 percent, respectively.

The Atlanta Region commercial bank return on assets (ROA) of 1.40 percent in the fourth quarter of 1998 comfortably outpaced the national average of 1.11 percent. North Carolina, Georgia, Virginia, and **South Carolina** reported above-average returns in the quarter, while **Florida, Alabama,** and **West Virginia** lagged their regional and national peers. The gap between large and small bank performance widened in the fourth quarter. Large banks (assets over $1 billion) benefited from noninterest income gains, lower reserve provisions, and profitable credit card banking operations. Small banks (assets under $1 billion), which account for 95 percent of the Region's institutions, continued to be hurt by declining net interest margins and limited fee income production. Banks in the Atlanta Region had limited direct exposure to the troubled foreign markets that led to trading losses and asset write-downs for some of the industry's largest institutions in the second half of 1998.

Although performance remains strong overall, earnings momentum may be slowing. The percentage of unprofitable commercial banks in the Atlanta Region has been edging higher on a comparative-quarter basis over the past three years. The upward trend in unprofitable institutions has been consistent across asset sizes, although the constraining factors differ for large and small banks. The ratio of unprofitable small banks has been influenced by heavy de novo activity, as more than half of the unprofitable institutions with assets under $100 million in the fourth quarter of 1998 were chartered within the past three years. Conversely, unprofitable banks with assets over $1 billion generally have been affected by restructuring and merger-related expenses.

Consumer loans at insured commercial banks in the Atlanta Region actually have been falling relative to assets since 1995. A few factors may help to explain the downward trend in the consumer portfolio allocation. First, the data exclude institutions with more than $1 billion in assets as well as all credit card specialty lenders. This exclusion ignores the potentially large in-Region consumer lending activity of 55 commercial banks and 11 credit card specialty banks headquartered in the Region. (The exclusion was necessary because Call Reports do not collect geographic lending data, and the activities of these institutions extend well beyond Regional boundaries.) Second, the Region's continued strong economy has sustained high demand for larger and potentially more attractive real estate and commercial and industrial loans at many institutions. A third possible explanation may be that credit unions and nonbank finance companies are becoming increasingly competitive with insured institutions and may have captured some of the consumer market in recent years.

Consumer credit exposure at Atlanta Region institutions is not excessive, but the Region's exposure to the potentially more risky nonmortgage segment is slightly above the national average. These conclusions are supported by a recent nationwide survey conducted by ***National Decision Systems, Inc.*** (NDS), which found total household debt in the Atlanta Region to be less than the national average when measured as a percentage of household income. However, the annual survey found nonmortgage debt-to-income levels for households in the Atlanta Region to be slightly above the national average. The fact that Call Report data and the NDS survey show higher levels of nonmortgage consumer debt in the Atlanta Region is notable because delinquency and charge-off rates for this portfolio segment have been rising since 1994 and are nearing levels reached during the 1991 recession. Given high employment, rising household incomes, record levels of unrealized financial-market wealth, and low interest rates, these would appear to be the "best of times" for U.S. consumers. For that reason, upward trends in consumer delinquencies and charge-offs raise some concern, as an economic slowdown (lower income and employment growth) or an increase in interest rates (higher interest burden) could weaken consumers' ability to service an unprecedented level of personal debt.

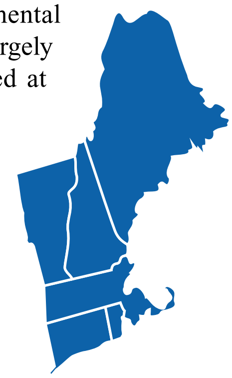
Boston Regional Perspectives

The Boston Region enjoyed another year of solid economic expansion in 1998. Manufacturing was the only sector to show some weakness, although a net gain in factory jobs was still seen in many of the Region's states last year. The Region's job growth seemed likely to continue at a somewhat slower pace in the early months of 1999, as ongoing global weakness was still being offset by a very strong national economy.

Existing home sales for the Region rose at almost twice the rate seen nationally between 1994 and 1998. Favorable interest rates, continued job and income growth, a strong stock market, rising household wealth, and still-affordable pricing contributed to the home sales advances. Across the Region, residential building permit issuance rose by 13 percent. Last year's gain was the strongest since the first year of the expansion in 1992. Nevertheless, permit volume remained only 40 percent of the volume seen in 1986, when residential construction activity last peaked in the Region.

The Boston Region's insured institutions reported another strong year for earnings in 1998. Earnings continue to benefit from strong asset quality. Aggregate loan losses remain subdued; however, consumer loan losses are elevated but stable. The only other sector exhibiting credit quality weakness in 1998 was commercial and industrial (C&I) loans. This weakness was limited to the larger institutions in the Region, suggesting that the losses resulted from exposures to sectors hurt by weak international and capital markets in the second half of the year. Many of those losses were well publicized and included several finance companies involved in subprime consumer lending.

For institutions with limited exposure beyond the Region, C&I losses remained low. Core deposit growth remains lackluster for the Region's insured institutions. The inability to grow core deposits has long-term liquidity implications. It is also weighing heavily on net interest margins, as incremental asset growth is being supported largely by funds that are effectively priced at national market rates of interest.



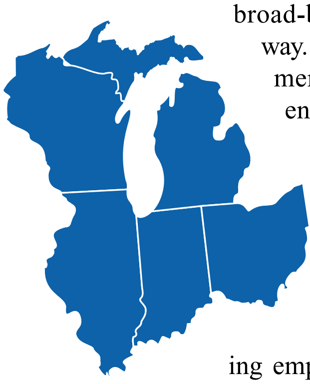
Aggregate data are masking a weakening earnings posture for many of the Region's insured institutions. In 1998, strong performance by credit card banks, coupled with increased levels of securities gains, bolstered profits; however, underlying trends pointed to a weakened earnings posture for the industry. Weaker earnings are arising primarily from increased loan loss provisions at larger institutions and a narrowing net interest margin that is negatively affecting a wide range of institutions.

The internal and external pressures related to building shareholder value are resulting in an increasingly higher risk profile for the Region's insured institutions that are affiliates of publicly traded companies. When compared with closely held and mutually owned institutions, public companies operate with significantly higher degrees of leverage. Public companies also have been steadily shifting the mix of both the loan and securities portfolios toward higher risk instruments.

Chicago Regional Perspectives

The Region's economy remains healthy. Yet, as typically happens in an aging expansion, some indicators suggest that its robust economic health of recent quarters may not be sustainable as the year unfolds. Additional improvements—such as significantly lower unemployment rates or a pick-up in hiring by manufacturers—may be both small and hard to achieve.

While some important manufacturing industries, like autos, continue to post strong sales, overall growth in the industrial sector is slowing. The ***Midwest Manufacturing Index*** (MMI) illustrates that a broad-based slowdown is under way. The steel and farm equipment industries have experienced sharp output declines recently, while the production of chemicals and of paper and related products has fallen less sharply. Because the MMI is a leading indicator of manufacturing employment in the Region, a recent slowdown in the MMI's pace of expansion suggests that factory employment growth likely will remain tepid through midyear, at least.



Unemployment remains low, but job growth is slowing unevenly across the Region. Since midyear 1998, the Region's unemployment rate has hovered around 3.9 percent, while job growth in 1998 was a moderate 1.7 percent. However, the pace of job growth has both slowed in a growing number of counties and been uneven across the Region. The most dramatic downshifting has taken place among counties in **Michigan** and **Ohio.**

New residential construction and home resales continue to be buoyed by low unemployment, favorable interest rates, and households' rising net worth. Only Michigan fell short of posting double-digit growth in both permits for new single-family homes and home resales in 1998. The widespread weakening of job growth in the state may have contributed to the relatively weaker performance of its housing market.

The Region's banks and thrifts reported generally healthy financial conditions in the fourth quarter of 1998. However, aggregate results reflect a modest deterioration in some performance measures. The decline in aggregate performance was driven chiefly by a narrowing net interest margin. Noninterest income continues to bolster net income for many insured institutions; however, an increase in the aggregate level of noninterest income in the fourth quarter was offset by a larger increase in noninterest expenses.

Ongoing weakness in commodity prices, declining farmland values in specific areas, and emerging repayment problems pose risks to insured institutions active in agricultural lending. The ***United States Department of Agriculture*** forecasts that farmers will continue to face low commodity prices in 1999. Despite the continuing weakness in this sector, most insured institutions active in agricultural lending continue to report strong capital positions and financial conditions. However, financial institutions typically do not immediately show the effects of one or even two consecutive years of poor agricultural conditions. Loans to farmers who experience financial difficulties are often "carried over" into operating loans for the subsequent year or are restructured to reflect "current" status. As a result, current reported asset quality measurements may not reveal a rising risk profile in the agricultural loan portfolio. Continued low commodity prices may impede farmers' ability to demonstrate adequate cash flow for both current operating and carried-over loans. Inadequate cash flow may force banks to base lending decisions on the value of available farm collateral rather than cash flow. Institutions making lending decisions based on the underlying value of farmland are most at risk to potential asset quality problems when cash flow difficulties combine with declining farmland values.

The Homeowner's Protection Act of 1998 is intended to prevent consumers from paying more private mortgage insurance premiums than necessary and to facilitate the cancellation of such insurance. The new law becomes effective in July 1999. Failure to ensure that requisite systems are in place to meet the Act's requirements may expose insured institutions to potential liabilities for noncompliance.

Dallas Regional Perspectives

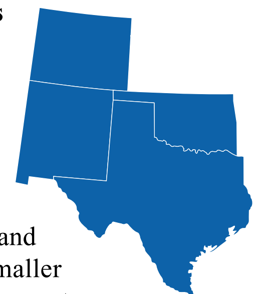
Insured institutions in the Dallas Region continued to report strong financial results and few credit quality problems for 1998, despite some signs of weakness in the fourth quarter's results. The Region's return on assets (ROA) and return on equity (ROE) for the fourth quarter were 1.00 percent and 11.60 percent, respectively, the lowest figures reported for both profitability measures in the past 12 quarters. Despite this fourth-quarter decline, the Region's 1.16 percent average ROA for 1998 was equal to the national average. An important factor driving the decline in fourth-quarter profitability was the increase in the number of banks that lost money during this period. Increased loan losses and a declining net interest margin for small banks (those under $100 million in assets) also contributed to declining profitability.

Farm banks in the Dallas Region continue to report financial strength, despite significant losses experienced by Texas and Oklahoma cotton and livestock producers. Crop insurance and early disbursements of production flexibility contract payments have provided cash flow to help farmers meet short-term needs. Prices for grain and cotton that are forecast to remain weak in 1999 could stress agricultural producers.

The four states in the Dallas Region have enjoyed economic expansions of longer duration and with typically faster growth than the current national expansion. The Region's economy, however, is expected to experience slower growth in 1999 because of weak commodity prices, continued global economic turmoil, and a tight labor market. The Asian crisis could continue to weaken demand for the Region's chemicals, oil, semiconductor chips, cattle, wheat, and cotton. Economic conditions for each state in the Region are summarized below.

Colorado is one of the most diversified states in the Dallas Region, with a large share of employment in the fast-growing services, trade, and communications industries. Weak oil and natural gas prices have resulted in continued consolidation in the energy industry, placing pressure on the state's mining employment. However, the state's expanding services, construction, and trade sectors should more than offset weaknesses in its mining and manufacturing base.

New Mexico has lagged behind the nation in employment growth since 1996. Employment growth is forecast to grow moderately from 1.5 percent to 2.0 percent in 1999. The fallout from weak commodity prices in oil, copper, and molybdenum has hurt the state's mining sector. New Mexico's oil producers account for approximately 4 percent of the state's gross product on an aggregate basis. Many small producers have had to stop production, often permanently, because of low prices.



Oklahoma employment has grown consistently between 2.5 percent and 3 percent for the past five years. An ailing oil and gas industry, however, is expected to cause some deceleration in Oklahoma job growth in 1999. Although oil and gas employment is a much smaller share of total nonfarm employment now than in the past, many manufacturers still depend heavily on the industry (e.g., producing oil machinery equipment, pipelines, etc.). A robust housing market, aggressive state and local economic development activities, and strengthening sectors in transportation and communications will help offset these losses.

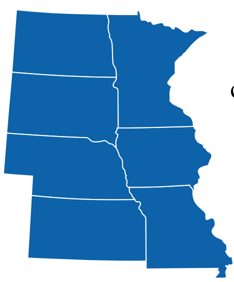
The Texas economy showed few signs of slowing in 1998. Still, job growth fell during the year, from approximately 4.5 percent at the beginning of 1998 to approximately 3 percent at year-end. Asia's problems and the lowest oil prices in a decade affected the state's manufacturing and mining industries, resulting in many job losses. Texas exports declined in the second half of 1998, primarily because of weaknesses in Asia and South America.

Consumer spending has been the key to the Region's growth, but continued growth could increase consumer credit risk. Financial institutions in the Dallas Region held $36.2 billion in consumer loans at year-end 1998, representing 19.5 percent of all loans in the Region. This exposure exceeds the national average of 15.8 percent. A total of 683 insured institutions in the Dallas Region have grown their consumer loan portfolios by 25 percent or more over the past three years. However, increasing debt-to-income levels, slowing job growth, and high consumer bankruptcy rates may make consumers vulnerable to potential adverse events such as an increase in interest rates, a slowing stock market, or a recession.

Kansas City Regional Perspectives

The Region's economy continued to be strong at the end of 1998, as the unemployment rate continued its decline late in 1998, falling to 2.9 percent in December, compared with a national rate of 4.3 percent. Annualized employment growth declined slightly to 1.8 percent in December, with growth declining more in the manufacturing sector than in the services sector.

Despite generally strong employment trends, points of vulnerability have begun to appear in the Region's economy. Low prices for agricultural products, including corn, soybeans, wheat, and hogs, have resulted in a decline in farm incomes, and in turn have negatively affected the rural communities that depend on agriculture. Evidence of eroding farmland values continues to accumulate across the Region, as expectations of reduced farm earnings influence land purchase decisions. Through the third quarter of 1998, personal income has grown at a rate of 4.3 percent, compared with the national rate of 5.0 percent.



In aggregate, as of December 31, 1998, the Region's farm banks (institutions where agricultural operating loans and agricultural real estate loans total at least 25 percent of their total loans) continued to report sound financial conditions. Reported earnings and capital levels remained historically strong.

In aggregate, farm banks reported few problem loans despite the precipitous drop in corn, soybean, and wheat prices that occurred in 1998. Generally, significant changes in farm bank past-due loan ratios lag decreasing prices by at least two harvests because banks typically "carry over" unpaid loans from a poor year into subsequent years, suppressing the loans' delinquency. As such, aggregate past-due ratios in the Region still reflect farmers' strong earnings in 1996 and 1997. However, in the northeast corner of **North Dakota** and the northwest corner of **Minnesota,** farmers have experienced several poor years, first because of disease-ravaged wheat harvests and then because of low wheat prices in 1998. As a result, past-due and noncurrent loan rates are rising in these areas, and continued low prices forecasted for 1999 could signal even higher levels of problem loans.

Low energy prices threaten jobs in Kansas and North Dakota. Prices of crude oil and natural gas have declined significantly since early 1997, threatening employment in the energy industries of Kansas and North Dakota. Much of the employment at risk is located in sparsely populated areas that are already suffering the effects of low cattle prices during the past several years. These areas also lack other significant employment opportunities for displaced workers. The current period of low prices may lead to a long-term contraction of the industry as many marginal oil wells are permanently abandoned.

According to an analysis by the Kansas Geological Survey, as many as 3,600 jobs in the extraction sector will be at risk in 1999. The same study estimates that another 2,000 jobs will be lost in 1999 owing to indirect effects of depressed energy prices throughout the state's economy. Companies have been laying off less-experienced and lower-paid workers, but the cuts are now moving up the experience ladder, depleting the industry stock of human capital in the form of expertise.

Sprint's new office complex may challenge Kansas City's office market. Sprint, Kansas City's largest employer, is building a new 3.9-million-square-foot world headquarters in suburban Johnson County, Kansas. Sprint plans to vacate about 2.5 million square feet of leased office space in Kansas City over the next three years, which could significantly drive up office vacancy rates in the metropolitan area. Developers have slowed but not stopped speculative office construction in anticipation of Sprint's move. Perhaps more important, however, is the timing of this significant office project so late into an economic expansion. A recession could dampen the growth in office employment and related demand for office space. Sprint's new world headquarters is expected to increase area vacancy rates, which could adversely affect both owners of existing office properties and the financial institutions that fund such properties.

Memphis Regional Perspectives

Employment growth in the Memphis Region continues to slow. The trend will likely persist throughout 1999 because of continuing tight labor markets, the potential for slowing real estate construction, and the cumulative effects of the economic crises in Asia, Russia, and Brazil. Employment growth in 1998 was hindered by slowing growth in the service sector, which represents approximately 25 percent of the Region's total employment, and accelerating job losses in the manufacturing sector.

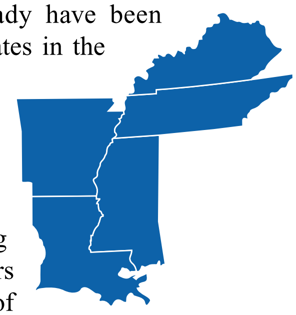
The Region's banks and thrifts reported generally healthy financial conditions as of December 31, 1998, although earnings performance declined. The Region's average return on assets ratio (ROA) was 1.06 percent for the year, down 6 basis points from 1997. Lower net interest margins (NIMs) were the driving factor in lower performance. The average NIM was 4.33 percent, compared with 4.47 percent in 1997.

The Region's important agricultural sector continues to be monitored closely as weaknesses are projected to continue into 1999. The ***United States Department of Agriculture*** projects the value of agricultural exports to fall for a second consecutive year in 1999 in response to weaker worldwide demand. Prices for many commodities are expected to remain low, and some crop prices, such as soybeans and cotton, will likely finish the year well below 1998 levels. Net farm income in the Region is expected to decline for the second consecutive year.

Although agricultural loan losses remain low, other asset quality indicators are showing the effects of lower commodity prices and 1998's poor growing conditions. Total past-due agricultural loans rose at the end of 1998, and anecdotal evidence suggests that carryover debt is increasing. Asset quality concerns for the Region's agricultural lenders will likely increase in 1999 with a second consecutive year of declining farm income. During the most recent period of two consecutive years of declining farm income, past-due agricultural loans and agricultural loan losses at the Region's agricultural lenders were largely unaffected at the end of the first year of lower farm income, but rose substantially in the second year.

Other financial institutions in the Region may be affected by lower farm income. Low commodity prices and last year's poor growing conditions also have an indirect effect on commercial banks that do not have high agricultural loan concentrations but are located in agriculture-dependent counties. Such counties have historically reported greater employment and personal income volatility than other parts of the Region.

Farmland values may weaken in 1999 because of expectations of lower farm income. Early indications of falling land values already have been reported in parts of some states in the Midwest. Declining land values could erode collateral protection for banks as well as a primary source of farmers' net worth. Some farmers may have difficulty arranging financing in the coming years because of the combination of lower farm income, reduced collateral values, and declining net worth. Other farmers may be unwilling to "farm on their equity" and could sell out, adding to the downward pressure on land values.



The energy, timber, and primary metals industries also have been affected by weaker worldwide demand. Louisiana's energy sector reported a loss of 3,000 jobs in the second half of 1998. The rebound in oil prices in the first quarter of 1999 could benefit the sector's employment, but efforts by energy companies to cut costs may limit job gains. The timber industry also experienced job losses in 1998, primarily in Louisiana. Employment in the primary metals industry was stagnant during 1998. New hiring plans have been announced recently because the Region's metals producers have comparative advantages, primarily lower labor costs and newer production facilities.

New York Regional Perspectives

With the nation prospering from the longest peacetime expansion ever, the Region's economy is growing steadily. The combined gross state products for the Region increased for the seventh consecutive year, climbing 2.9 percent in 1998. This performance represents the highest increase since 1994, but it is a full percentage point below the nation's growth rate.

The financial services industry, which includes the banking, insurance, real estate, and securities sectors, is significantly more concentrated in the Region than in the nation. This industry accounted for 25 percent of the Region's total economic output in 1998, compared with 19 percent for the nation. Fueled by the stock market, this industry has experienced increased profitability, which in turn has led to a surge in workforce productivity in the Region. However, because of the strong link between economic growth and the stock market in the Region, a sustained disruption in the stock market could have particularly adverse consequences for the Region's economy.

The combination of recessions in Asia, Russia, and Brazil is putting pressure on the economies of both the Region and the nation. Regional exports to Brazil dropped more than 11 percent between 1997 and 1998, after rising for several years. During the same time, Regional exports to Asia dropped more than 14 percent. The Region's exporters could face a further drop-off if the Brazilian economy continues to contract. Moreover, some of the Region's manufacturers are being harmed by an influx of cheap imports from these troubled economies.

The Region's banks and thrifts reported generally healthy financial conditions in the fourth quarter of 1998. The Region's average return on assets (ROA) was 0.94 percent, compared with 0.97 percent at year-end 1997. The average net interest margin (NIM) declined to 4.0 percent in the fourth quarter, compared with 4.16 percent a year earlier. Aggregate past-due ratios continued to decline, although they rose slightly in commercial and industrial loans and consumer loans. The Region's international banks, after reporting lower earnings in the third quarter, rebounded in the fourth quarter, despite continued weakness in emerging markets.

The Region's 358 savings institutions (savings banks and savings and loan associations) are underperforming commercial banks. As of December 31, 1998, this group had an average ROA of 0.71 percent, compared with 1.10 percent for commercial banks. The primary reasons for the difference are lower average NIMs and a comparative lack of noninterest income. This group reported an average NIM of 3.37 percent as of year-end 1998, compared with 4.40 percent for commercial banks. The average NIM in savings institutions declined significantly from year-end 1997. Savings institutions are feeling the effects of two years of a flat yield curve and low long-term interest rates.

Different measures of consumer debt suggest a mixed picture for the nation's borrowers. For example, in 1998, household debt grew much faster than personal income. However, debt levels as measured against rising household net worth have been declining over the past several years. Further, the nation's debt service burden seems to have leveled off in the past two years because of lower interest rates, higher personal income levels, and the fact that mortgage-related debt is increasingly being substituted for credit card and other forms of consumer debt. This substitution reduces current debt payments but increases future liability.

Consumer borrowing behavior is very important to the New York Region because of its concentration of credit card banks. Growth rates of card receivables declined in 1998, reflecting increased competition, industry consolidation, and the influx of new products such as high loan-to-value loans and subprime loans. Nonetheless, unfunded commitments on credit cards in the Region surged 23 percent in 1998, suggesting intense competition for market share. Institutions that do not monitor card usage closely could be vulnerable to credit quality problems, because cardholders tend to draw down unused lines when they face financial distress. Although banks can reduce card lines voluntarily, knowing when to do so is difficult; warning signs may not be readily apparent, and banks may notice trouble only after cardholders have run up their balances.

San Francisco Regional Perspectives

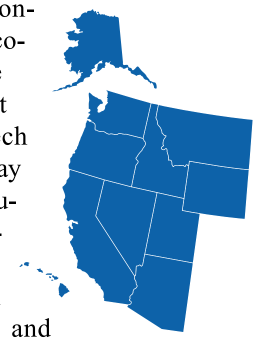
Although the San Francisco Region's manufacturing sector slowed significantly during 1998, its economy continued to outperform the nation in job growth. The Region added jobs at a seasonally adjusted 3.0 percent rate—well above the nation's 2.3 percent rate—for the 12 months ending December 1998. **Nevada, Arizona,** and **California** significantly outperformed the nation, while **Wyoming** and **Hawaii** were far off the pace. The Asian crisis, a key factor in the Region's manufacturing job losses, did not materially affect the performance of most insured financial institutions. Insured institutions without international or subprime exposure benefited from the Region's strong economy and reported solid profits.

The emerging story in the San Francisco Region's economy in 1998 was the downturn in high-technology manufacturing jobs. The Region is heavily dependent on high-tech manufacturing jobs and exports, both of which have weakened following the Asian crisis. The weakness is even more pronounced in several states and metropolitan statistical areas (MSAs) in the Region because they have large high-technology job clusters. In part because of the expansion of high-tech industries prior to 1998, several of these MSAs experienced rapid growth in their real estate markets. In several of these MSAs, community bank exposure to construction and commercial real estate (CRE) lending now is far above the national averages of 3.3 and 16.5 percent of total assets, respectively.

The slowdown in San Jose's manufacturing sector in 1998 was sufficient to dampen employment growth in the entire San Francisco Bay Area. Measured in terms of total job growth, San Jose fell from one of the Region's fastest-growing MSAs in 1997 to one of its slowest-growing in 1998. Computers, defense electronics, and electronic components all reported job losses in 1998. Past growth in technology jobs had made San Jose one of the Region's most active real estate markets. Consequently, San Jose's community banks have much higher exposure to construction and CRE loans, at 11.8 and 31.7 percent of total assets, respectively, than similarly sized institutions in the Region and nation.

Portland, like other MSAs in the Region with a high-tech manufacturing cluster, has been hurt by the continued Asian crisis. Much of Portland's economic strength prior to 1998 had been attributable to its growing manufacturing sector, particularly high technology. However, after significantly outpacing the nation in terms of job growth, Portland's economy is showing signs of slowing, because of declines in exports to Asia. Although Portland's community banks have not yet been hurt by the high-tech slowdown, these institutions have significantly more exposure to construction and CRE loans at 7.8 and 26.4 percent of total assets, respectively, than their peers in the nation.

In 1998, combined employment figures for the Salt Lake City and Provo MSAs showed continued weakness in durable goods manufacturing, likely because of a reduction in high-technology exports to Asia. High technology also has contributed significantly to the economic expansion of Salt Lake City and Provo over the past decade. The current high-tech slowdown in these MSAs may increase the risk to area community banks that have significantly increased their exposure to traditionally higher-risk loan categories like construction and CRE loans. Community banks in Provo and Salt Lake City now have combined construction loans to total assets of more than 15 percent, well above averages for both the Region and the nation.



The Sacramento MSA also saw its manufacturing employment growth rate slow considerably during 1998. While the expansion of high-tech companies in Sacramento has brought manufacturing jobs to an MSA suffering from defense cutbacks, it has made the MSA more susceptible to the global trends hurting some high-tech firms. Before the recent high-tech slowdown, the expansion of technology companies had led to rapid development. Consequently, community banks headquartered in Sacramento now have construction and CRE loans totaling 12.6 and 33.7 percent of their assets, respectively, well above the national and regional averages.

Although the Phoenix-Mesa MSA continues to grow rapidly, its manufacturing sector is beginning to slow, principally in the area of high technology. The Phoenix MSA is relatively heavily dependent on high-tech exports. As yet, the slowdown in high-tech manufacturing has not hurt the MSA's strong real estate market or community banks.

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