Regional Outlook

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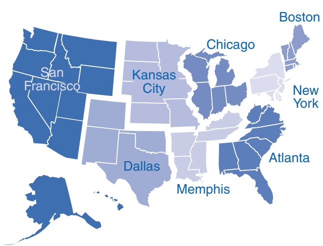

DIVISION OF INSURANCE

In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking***—**The banking industry continued to perform strongly through fourth quarter 2000 despite a noticeable slowdown in earnings growth. Industry performance during first quarter 2001 is not likely to improve dramatically in light of the recent slowdown in the U.S. economy. Analysts point to certain adverse trends in portfolio characteristics, particularly risk selection and loan concentrations, that could pose risk management problems for certain groups of insured institutions. However, the financial strength of the industry positions it to continue to meet loan demand from creditworthy borrowers.**

Reflecting the current uncertainty in the economic outlook, the business press has coined three scenarios as to where the economy could be headed: The V, U, and L scenarios. Analyzing historical relationships between business cycle drivers and banking industry performance, this article considers the implications of these scenarios for bank financial performance. *See page 4.*

By the Division of Insurance Staff

Regional Perspectives

◆ ***Atlanta***—**Atlanta Region insured institutions may be facing the most challenging environment in nearly a decade as key economic sectors weaken while competition in the banking industry remains strong.** *See page 15.*

◆ ***Boston***—**Strong aggregate capital and earnings are helping to mitigate the effects of any increase in credit and interest rate risk, a continued narrowing of net interest margins, and slower economic growth.** *See page 18.*

◆ ***Chicago***—**Insured institutions' performance remains favorable. Going forward, bank and thrift will be influenced by how current risk profiles interact with the slowdown in the national economy.** *See page 21.*

◆ ***Dallas***—**The region's insured institutions are vulnerable to softening in the Commercial real estate sector, higher energy prices, and agricultural borrowers' growing reliance on off-farm income during a slowing economy.** *See page 24.*

◆ ***Kansas City***—**Government payments and off-farm income have mitigated the effects of depressed farm operating revenues, and as a result, farm banks continue reporting favorable financial conditions.** *See page 27.*

◆ ***Memphis***—**The Memphis Region's economy slowed sharply during the second half of 2000 and is now considerably weaker than the national economy.** *See page 30.*

◆ ***New York***—**Weakening credit quality, particularly among the Region's large institutions, could pressure profitability, as loan loss reserves have declined to the lowest level since 1990.** *See page 33.*

◆ ***San Francisco***—**Higher energy prices and power shortages, technology sector weakness, equity market volatility, and softening in the commercial real estate sector could dampen the Region's otherwise strong economic and banking conditions.** *See page 36.*

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

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Letter from the Executive Editor

To the Reader:

The goal of the ***Regional Outlook*** is to provide useful risk-related information to bankers, banking agency staff, and other interested readers. To do this more effectively, the second quarter 2001 edition has a new look. We are publishing a single national edition that provides an overview of economic and banking risks and discussions of these risks as they relate to insured institutions in each FDIC Region. We tell the national story and, at the same time, alert the reader to specific trends and developments at the regional level.

After considering our experience with this new format, we may adopt it permanently for the second and fourth quarters of each year. The first and third quarter editions will continue to feature in-depth coverage of the economy and banking industry in each Region. Trying new formats will help us find the right balance between regional coverage of specific topics and analysis of economic and banking issues that cut across regional lines.

After you have read this edition of the ***Regional Outlook,*** we would like to hear from you. Does this new approach provide a more effective vehicle for reporting on banking and economic trends? What other suggestions do you have for improving our presentation of risk-related information? Call us with your comments at (877) 275-3342 or (800) 925-4618 (TDD) or e-mail them to lnejezchleb@fdic.gov.

Sincerely,

George E. French
Executive Editor

Economic Conditions and Emerging Risks in Banking

Introduction

The banking industry continued to perform strongly through fourth quarter 2000, despite a noticeable slowdown in earnings growth resulting from narrowing net interest margins (NIMs), increased loan loss provisions, and declining noninterest income. Industry performance during first quarter 2001 appears unlikely to improve in light of the recent slowdown in the U.S. economy. Furthermore, certain adverse trends in portfolio characteristics, including risk selection, loan concentrations, and funding and liquidity concerns, could pose risk management problems for certain groups of insured institutions. Overall, however, the financial strength of the industry positions it to continue to meet loan demand from creditworthy borrowers during a slowing economy. Using consensus economic scenarios, this article examines the potential effects of the current economic slowdown on banking industry earnings and capitalization.

The Banking Industry Remains Strong

Call report data continue to reflect the financial strength of the banking industry. According to a variety of financial measures, the industry is currently much stronger and better prepared for an economic slowdown than in 1990, when the last recession began. At that time, the industry was weakened and recovering from the fallout of excessive risk taking and problems relating to the agricultural sector, regional recessions, and sharply deteriorating conditions in local residential and commercial real estate markets.[1] Year-end 2000 data for capital, earnings, nonperforming loans, and exam ratings suggest that the financial position of the industry is historically strong, and the industry is better able to withstand similar adverse economic conditions.

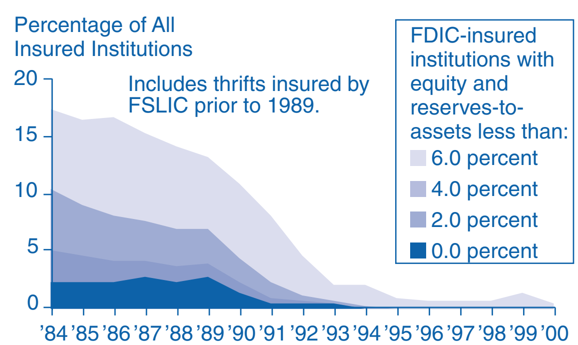
Insured institutions with weak capital ratios have declined both in number and as a percentage of all insured institutions (see Chart 1). In the mid-1980s, about 17 percent of the banking industry, or 3,000 institutions, reported equity and reserves less than 6 percent of assets. At that time, nearly 2.5 percent of all institutions were insolvent (reporting equity and reserves less than zero percent of assets). As the economy entered a recession in the early 1990s, capital positions had improved somewhat for most of the industry. By the end of 2000, however, the percentage of thinly capitalized insured institutions had fallen dramatically: only about 0.5 percent of the industry, or 45 institutions, held equity and reserves less than 6 percent of assets.

Higher levels of profitability contributed significantly to the improvement in capital levels at insured institutions in the late 1980s and early 1990s. During 1986 and 1987, more than 20 percent of the banking industry, or roughly 3,500 institutions, was unprofitable, operating with return on assets of less than zero (see Chart 2). By the mid-1990s, the industry had reorganized, the credit quality of loans had improved, cost-cutting measures had led to improved efficiency, and fewer than 5 percent of all insured institutions were unprofitable. The number of unprofitable institutions has risen to more than 700 (7.3 percent of insured institutions) as of year-end 2000. More than half of those unprofitable institutions are new banks that have been chartered since 1997. While new banks are often unprofitable during their start-up period, the onset of adverse economic conditions will pose additional challenges for these institutions.

The percentage of institutions with high problem loan levels and the percentage of institutions with a com-

Chart 1

The Number of Thinly Capitalized Institutions Has Diminished over the Past Decade



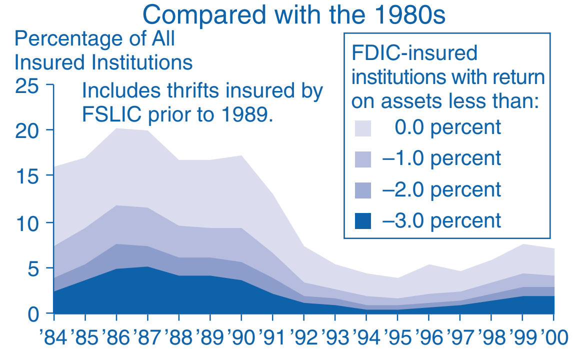
Note: FSLIC = Federal Savings and Loan Insurance Corporation
Source: Bank and Thrift Call Reports (FDIC Research Information System)

[1] For further information regarding the state of the banking industry in the late 1980s and early 1990s, see Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future. Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s,* Washington, DC: FDIC, 1997. www.fdic.gov/bank/historical/history/contents.html.

posite CAMELS rating of 3, 4, or 5 show a similar trend.[2] As the real estate crisis and regional recessions hit the banking industry in the mid- to late 1980s, the percentage of institutions with noncurrent loans greater than 6 percent of total loans rose past 10 percent. As the national and regional economies began to improve in the early 1990s, the performance of loan portfolios also improved. Today only a handful of institutions have high levels of nonperforming loans. Similarly, insured institutions rated 3 or lower rose to more than 25 percent at the beginning of the past decade, fell to less than 5 percent by 1997, and rose to 6.4 percent by the end of 2000.

Although the banking industry's financial performance remains solid overall, some signs of deterioration are emerging. Aggregate commercial bank and thrift earnings declined modestly in 2000, largely as a result of significantly higher loan loss provisions at a few large institutions.[3] Commercial banks also continued to experience downward pressure on NIMs; the industry NIM fell to 3.90 percent during fourth quarter 2000, the lowest level since 1990. Earnings of insured savings institutions also fell slightly in 2000 in large part because of declining NIMs. However, compared to ten years ago, when many banks were saddled with impaired capital and negative earnings, banks and thrifts are currently well positioned to meet loan demand from creditworthy borrowers and help support economic recovery.

CHART 2



Note: FSLIC = Federal Savings and Loan Insurance Corporation
Source: Bank and Thrift Call Reports (FDIC Research Information System)

Risk Management Issues Raise Concerns

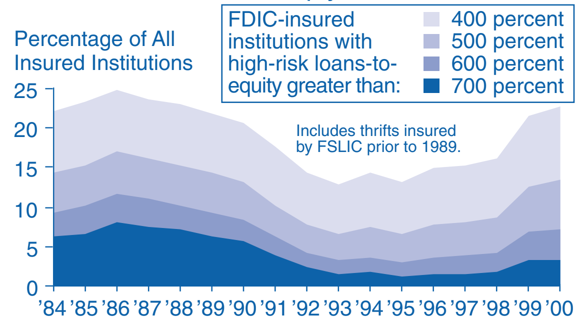
A number of risk management concerns related to changes in portfolio characteristics should be weighed against this overall financial strength. These concerns include loan concentrations, risk selection, funding and interest rate risk, off-balance-sheet exposures, and operational risks.

Loan Concentrations

Of particular importance at this stage of the business cycle are the rising loan concentrations in traditionally higher risk loan categories. Chart 3 shows the percentage of insured institutions with concentrations of commercial and industrial (C&I) loans, commercial real estate (CRE) loans, and construction and development (C&D) loans expressed as a percentage of equity capital. During the mid-1980s, more than 20 percent of all insured institutions held total concentrations in these "commercial and construction" loans greater than 400 percent of equity capital. By the early 1990s, that percentage had fallen by more than half. Since 1995 the percentage of institutions with concentrations in these loan types has begun to rise sharply and again reached 20 percent by the end of 2000.

Loan concentrations such as these traditionally have been associated with a higher frequency of failure. Chart 4 (next page) shows the percentage of insured institutions that failed within three years, according to concentrations of commercial and construction

CHART 3



Note: High-risk loans are defined as commercial and industrial, commercial real estate, and construction and development loans.
FSLIC = Federal Savings and Loan Insurance Corporation
Source: Bank and Thrift Call Reports (FDIC Research Information System)

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[2] The acronym CAMELS refers to the supervisory ratings system applied to insured depository institutions by federal and state regulators. Its component letters stand for: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.

[3] Federal Deposit Insurance Corporation, Division of Research and Statistics, *Quarterly Banking Profile,* fourth quarter 2000, www.fdic.gov/bank/analytical/index.html.

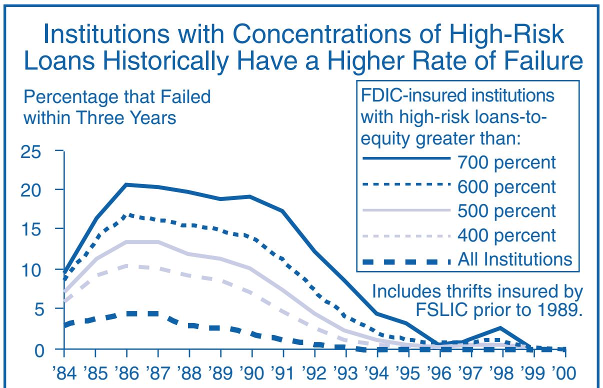
loans-to-equity capital. Institutions with elevated concentrations in these loan categories have consistently failed in higher proportions than other insured institutions. From 1984 to 1998, institutions with commercial and construction loans in excess of 400 percent of capital were two to three times more likely to fail within three years.

Similar concerns are noted for institutions with concentrations specifically in CRE or C&D loans. Some 18.6 percent of insured institutions showed CRE loan concentrations greater than twice their capital in December 2000, compared with 12.5 percent in 1989. For C&D loans, slightly more than 10 percent of insured institutions show concentrations greater than twice their capital—about the same percentage as in 1989. Again, history shows that the greater the level of concentration in these loan types, the greater the risk of failure within three years. However, the number of institutions with the very highest concentrations in CRE and C&D loans is lower than it was in the late 1980s.

Risk Selection

Some insured institutions are also holding a higher-risk asset mix, including subprime consumer loans, high loan-to-value (LTV) mortgages, and syndicated loans to highly leveraged companies, than they did a decade ago. Subprime lending refers to loans extended to borrowers with weak credit histories or questionable repayment capacity. In 2000, 13 percent of mortgage originations were subprime mortgage loans, up from 5 percent in 1994. Insured institutions increasingly have become involved in subprime lending as this market has expanded. Nearly half of the top 25 subprime mortgage lenders are bank or thrift holding companies or their affiliates.[4] Even the best grade of subprime mortgages (A–) is nearly four times as likely to be seriously delinquent as prime mortgages. Given the high delinquency rate on subprime loans even in a strong economy, insured institutions that hold a significant portion of these loans in their portfolios may need to prepare for greater credit quality challenges should the economy slow further.[5]

CHART 4



Note: High-risk loans are defined as commercial and industrial, commercial real estate, and construction and development loans.
FSLIC = Federal Savings and Loan Insurance Corporation
Source: Bank and Thrift Call Reports (FDIC Research Information System)

Insured institutions have participated in an expanding market for high-LTV mortgage lending. More than 20 percent of all mortgages originated during 2000 were for more than 90 percent of the value of the house, almost three times the rate in 1990.[6] Like subprime lending, high-LTV lending represents a new line of business that remains untested in a slower-growing economy. Should the economy enter a prolonged downturn, mortgage losses could be higher than in past recessions.[7]

Another sign of rising credit risk on bank balance sheets is an increase in the proportion of syndicated loan originations extended to leveraged borrowers.[8] Originations of leveraged loans as a percentage of total syndicated loans rose from 17 percent in 1996 to 31 percent in 1999.[9] As the level of problem loans rose and economic conditions weakened in 2000, banks scaled back lending to leveraged borrowers to 26 percent of total syndicated loans. However, total syndicated loan originations rose to a historic high of nearly $1.2 trillion in 2000.

[4] *Inside B&C Lending,* Bethesda, MD: Inside Mortgage Finance Publications, Inc., March 5, 2001, Volume 6, Issue 5, p. 2.

[5] According to Mortgage Information Corporation data from September 2000, 0.5 percent of all prime mortgages were seriously delinquent (at least 90 days past due or in foreclosure), while 3.4 percent of all A– subprime loans were seriously delinquent.

[6] Federal Housing Finance Board data.

[7] For additional information on high-LTV lending, see Kathy R. Kalser and Deborah L. Novak, "Subprime Lending: A Time for Caution," *Regional Outlook,* third quarter 1997; Diane Ellis, "High Loan-to-Value Lending: A New Frontier in Home Equity Lending," *Regional Outlook,* first quarter 1999; and Alan Deaton, "Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate," *Regional Outlook,* third quarter 2000.

[8] Ronald L. Spieker, "An Overview of Trends in Syndicated and Leveraged Lending," *Bank Trends: Analysis of Emerging Risks in Banking,* Number 98-04, February 1998; and Ronald L. Spieker and Steve E. Cunningham, "Recent Trends in Syndicated Lending," *Regional Outlook,* first quarter 1999.

[9] Loan Pricing Corporation.

U.S Agricultural Sector Continues to Struggle; However, Farm Banks' Performance Remains Solid

- U.S. agriculture has struggled during the past three years with depressed commodity prices, recurring drought conditions, and lagging exports.
- Record government payments in 2000 helped farmers mitigate the effects of a stressed agricultural sector. However, government payments are forecast to decline in 2001.
- Off-farm income for farm households averaged $60,000 at year-end 2000—a 90 percent increase since 1991. This income source could be vulnerable in the event of an economic downturn.
- A combination of record government payments and increasing levels of off-farm income has helped to protect farm bank portfolios from increasing stress in the agricultural industry. During 2000, the condition of the nation's farm banks improved.
- The congressional debate relating to the 2002 farm bill will have significant implications for farmers as this legislation will establish the level and nature of future government payments.
- For a more in-depth look at regional agricultural sector conditions and the effects on farm banks, see ***Dallas Regional Perspectives,*** first quarter 2000, ***Memphis Regional Perspectives,*** second quarter 2000, and ***Kansas City Regional Perspectives*** in this edition.

Funding and Interest Rate Risk

A scarcity of core deposits, particularly at community banks, during a period of sustained loan growth has resulted in an increased reliance on noncore sources of funds. This trend has contributed to an ongoing decline in NIMs and, in some cases, to increasing sensitivity to rising interest rates.[10] The recent decline in short-term interest rates could alleviate pressure on NIMs for many institutions. However, a general decline in interest rates also could spur significant growth in mortgage refinancing activity, which could lead to greater interest-rate sensitivity for institutions that invest heavily in fixed-rate assets, such as mortgage-backed securities (MBS) and long-term fixed-rate mortgages. The ***Mortgage Bankers Association Refinancing Index*** has risen sharply since fourth quarter 2000, when interest rates began to fall.[11] Call report data indicate that the interest-rate sensitivity of insured institutions may be rising. The number of banks with long-term assets greater than 40 percent of assets and noncore liabilities

Effects of Higher Energy Prices and Energy Shortages Could Contribute to a Slowing Economy

- Higher energy prices, particularly for oil, have preceded three of the past four U.S. recessions. Even though today the U.S. economy is only 60 percent as dependent on energy overall as it was in 1973, the economy remains vulnerable to energy price shocks because energy consumption continues to increase.
- Overall, rising energy prices and energy shortages can be viewed in the context of limited supply and excess demand. As such, a solution to, or even an easing of, the current situation is not expected in the near term.
- Highly leveraged consumers and those on fixed incomes could be particularly vulnerable to the effects of higher energy prices. Rising natural gas prices and insufficient electricity supplies will disproportionately affect particular energy-intensive industry sectors, such as heavy manufacturing, agriculture (driving up fertilizer and irrigation costs), mining, and lodging. Higher fuel prices will have significant consequences for consumers, as well as the entertainment, travel and leisure, and transportation industries.
- The electricity crisis remains primarily a regional issue, with heightened vulnerability in the western United States. Increasing natural gas prices (prices nearly tripled during 2000) are also affecting the cost and availability of electricity nationwide as the production of electricity now represents the most rapidly growing use of natural gas.

[10] For additional information on the effects of increasing levels of noncore funding on interest rate risk, see Allen Puwalski, "Increasing Interest Rate Risk at Community Banks and Thrifts," *Bank Trends: Analysis of Emerging Risks in Banking,* Number 00-01, March 2000; and Allen Puwalski and Brian Kenner, "Shifting Funding Trends Pose Challenges for Community Banks," *Regional Outlook,* third quarter 1999.

[11] The Refinancing Index rose from 761.5 at year-end 2000 to 2287.0 as of mid-April 2001. Mortgage Bankers Association of America/ Haver Analytics.

greater than 20 percent of assets has more than doubled since year-end 1997. At the same time, capital market developments—such as the emergence of deep, liquid markets for interest-rate swaps and floating-rate MBS—have expanded the range of tools available to bankers to manage interest-rate risk.

Off-Balance-Sheet Exposures

Innovations in risk management practices and the desire for enhanced fee income have led to a significant increase in derivatives activity over the past decade. Since 1990, the notional volume of derivatives contracts held by commercial banks has risen from $6 trillion to $40 trillion.[12] The growth in volume highlights the importance of maintaining risk management practices that are appropriate to this complex business activity. Risk-based capital requirements also have created incentives for lenders to remove risk from their balance sheets through securitization activities and credit derivatives. Significant growth in these off-balance-sheet risks poses a variety of issues, such as accurately valuing derivatives exposures and residual assets.

Since 1992, unused commercial loan commitments and letters of credit held by banks have increased rapidly—from $776 billion to $1.889 trillion.[13] Unused commercial loan commitments present banks with adverse selection risks when financially stressed companies draw on their credit lines. For example, in recent months several large corporations drew on commercial paper backup credit lines following downgrades in their commercial paper ratings. Also, many households that refinanced mortgages as a means of consolidating other debts between 1998 and 1999 now may have more unused credit available on credit cards and other revolving lines that these households could draw upon immediately if they experience financial distress.

Operational Risks

Well-run financial institutions use a variety of risk management and audit-related controls to safeguard against excessive risk taking, fraud, noncompliance with regulatory directives, and errors in financial reporting. The need for such systems and controls only increases as an institution expands its scope of operations or enters new lines of business. However, operational controls do not directly generate revenues, and the temptation to cut expenses in this area may be great, particularly when an institution is faced with prospects for reduced profitability. The role that fraud has played in some of the more recent bank failures highlights the importance of adequate internal control and audit procedures. To a great extent, operational risk, as well as off-balance-sheet exposures, can be evaluated only by on-site supervisory analysis of risk management practices and modeling techniques.

[12] Bank call report data.

[13] Bank call report items used to calculate unused commercial loan commitments include commercial and similar letters of credit, performance standby letters of credit and foreign office guarantees, and “other unused commitments,” which include commitments to extend credit through overdraft facilities or commercial lines of credit and retail check credit and related plans.

Current Economic Conditions: Are We Still in a “New Economy”?

The economic environment for the banking industry is now marked by considerable uncertainty.

As recently as nine months ago, virtually all the vital signs for the U.S. economy were positive. In February 2000, the economy entered its 108th month of expansion, making this the longest expansion in U.S. history. Sustained high rates of productivity growth were making it possible for the economy to grow rapidly (above 4.0 percent annually for four consecutive years) with low to moderate inflation. Equity market valuations reflected the optimism of investors and analysts, who began to conclude that much had indeed changed in the so-called “New Economy.”[14]

However, over the past year, three factors have significantly slowed the pace of economic activity. First, the cost of borrowing by households and businesses rose in 2000, in part a result of a cumulative 175 basis point increase in the Federal Reserve federal funds target rate between June 30, 1999, and May 16, 2000. Second, the price of oil in 2000 averaged more than twice that of two years earlier, increasing costs for consumers and businesses. As winter approached, the energy situation worsened as spot prices for natural gas soared and electricity production fell short of demand in California and other western states. Finally, high rates of capital investment in certain industry sectors led to overcapacity that was pressuring some companies’ ability to service debt. Examples of these companies could be found in the entertainment, telecom, and dot-com industries, among others.[15]

[14] See Maureen E. Sweeney et al., “Banking Risk in the New Economy,” *Regional Outlook,* second quarter 2000.

[15] See Steven Burton, “Credit Problems for U.S. Businesses Continue to Rise,” *Regional Outlook,* first quarter 2001.

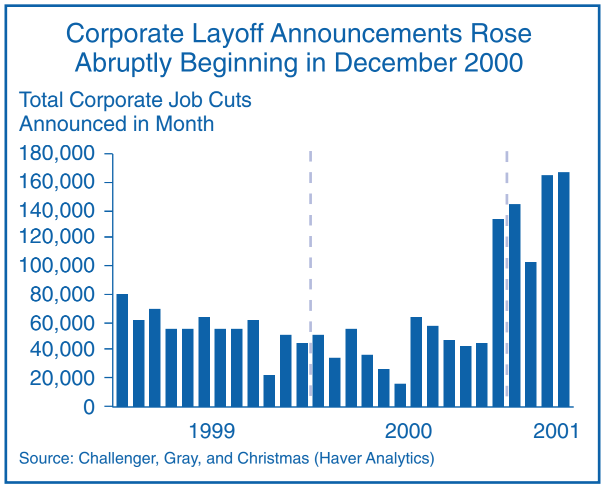
By fall 2000, signs of deterioration in economic activity were clearly visible. Equity analysts began cutting estimates of corporate earnings growth for the first half of 2001. Equity valuations continued to retreat from the high levels of early 2000, led by rapidly falling stock prices in the high-tech sector. Perhaps more troubling, credit spreads on risky corporate debt rose to higher levels than had been experienced during the financial crisis of late 1998.[16] Capital market conditions became particularly impaired in December 2000 as issuance of high-yield corporate debt virtually stopped.[17]

Signs of the economic slowdown were also visible on Main Street. Corporate layoff announcements in December 2000 tripled from year-ago levels to 133,000, and remained above the 100,000 mark through April 2001 (see Chart 5). The Conference Board's Index of Consumer Confidence fell for five consecutive months beginning in September 2000. Data released in early 2001 showed that capital investment by U.S. companies declined in the fourth quarter of 2000 for the first time since the 1990 to 1991 recession, while growth in consumer spending was only half what it had been the previous year. Weakening in these "twin pillars" of U.S. economic activity slowed the growth rate of the economy to a low 1.1 percent in fourth quarter 2000 before rebounding slightly to 1.3 percent in first quarter 2001.

Despite the negative economic news, it is by no means clear that the economy will slip into recession. Monetary and fiscal policies appear to be aimed at stimulating economic activity. Between January and mid-May 2001, the Federal Reserve reduced the federal funds target rate five times by a total of 250 basis points. Current budget proposals under consideration by Congress call for tax cuts in excess of $1 trillion over the next ten years. Moreover, despite earnings difficulties in the corporate sector, the consumer sector appears to be in better financial shape—at least for the present. Unemployment continues to be low (4.5 percent as of April 2001), while declining interest rates have contributed to a strong housing market and a renewed wave of mortgage refinancing.

The trend in productivity growth is also unclear. Output per hour at nonfarm businesses rose by a strong 4.3 percent in 2000 and at an annualized rate of 2.0 percent in fourth quarter 2000. But productivity essentially

Chart 5



Source: Challenger, Gray, and Christmas (Haver Analytics)

stood still in first quarter 2001, raising the question of whether the high levels of productivity growth that have been associated with the New Economy will persist. Strong productivity gains in recent years can be attributed, at least in part, to investment in new technologies and efficiencies generated in corporate restructuring. It would follow that maintaining productivity growth at or near these levels in the future will require a recovery in corporate investment in new technologies and continued access to sufficient financial capital to carry out corporate mergers and acquisitions. Therefore, it appears that a prompt recovery in financial market performance and economic activity will be essential to maintain the productivity growth that has been a hallmark of the New Economy.

Three Factors Will Shape the Economic Outlook

In this time of economic uncertainty, three factors will largely determine whether the United States will fall into a recession and how long such a slump could last.

Consumer and Business Confidence

The degree of optimism on the part of consumers and business managers is an intangible factor that is difficult to predict—or even explain after the fact— but is nonetheless crucial to the economic outlook. Although the index of consumer confidence declined from a cyclical high of 143 in September 2000 to a low of 109 in April 2001, consumer spending has continued to increase.[18] Retail sales increased 2.1 percent in the first

[16] Burton, p. 14.

[17] Board of Governors of the Federal Reserve System, "Monetary Policy Report to Congress," February 13, 2001, p. 10.

[18] The Conference Board, www.conference-board.org.

quarter of 2001 from year-ago levels. Concern exists, however, that high levels of consumer indebtedness and a negative household savings rate could result in consumers reducing their spending significantly if the economy enters a recession. Part of this concern centers on the so-called wealth effect, whereby consumers are thought to increase their spending in proportion to stock market gains when equity prices are booming. The corollary is that consumers may reduce their expenditures and increase their savings if equity market losses persist.

The confidence of business managers is also tied to events in the capital markets, which to a large extent determine the cost of capital. Willingness to invest in new equipment is tied not only to the cost of capital but also to expectations for future earnings. Investment spending fell in the fourth quarter of 2000 as profit expectations plummeted (see "Corporate Profits," below). Business investment likely will begin growing again at the double-digit rates of recent years only after managers see a sufficient decline in the cost of capital and a corresponding increase in profits to justify additional spending on equipment and software.

Availability of Capital

One of the keys to the New Economy has been an increasing reliance on market-based sources of financing. In 1997, for the first time, corporate sector borrowing from market-based sources surpassed its borrowing from traditional financial institutions.[19] Continual access to the capital markets has been an integral part of many New Economy business plans. Equity initial public offerings (IPOs) on the New York Stock Exchange and the NASDAQ totaled 445 in 1999 and 408 in 2000.[20] However, only 17 new companies issued shares on the two major exchanges during first quarter 2001. A resumption of capital market funding from these depressed levels appears necessary for a continuation of the New Economy and its high levels of new business formation and productivity growth.

Banks and other traditional intermediaries have proved to be more reliable sources of business finance than the capital markets in recent years. Holdings of C&I and CRE loans by FDIC-insured institutions rose 9.4 percent in 2000, following increases of 11.5 percent in 1998 and 9.8 percent in 1999. Underwriting surveys conducted by the federal banking agencies show that banks recently have tightened pricing and terms on commercial loans as evidence of corporate weakness and slowing economic activity has emerged. However, there is little evidence to suggest a significant reduction in the availability of bank credit for businesses, particularly in comparison with the recent volatility in the capital markets. Indeed, compared with the condition of the banking industry heading into the last recession, today's banking industry is composed of far fewer institutions with impaired capital positions and troubled loan portfolios—two factors that can interfere with the ability of insured institutions to make loans to creditworthy borrowers. On the whole, the current strong financial condition of the banking industry, and its ability to make loans to creditworthy borrowers, appears to be one of the brighter spots in the near-term economic outlook.

Corporate Profits

Prospects for a rapid and sustained economic recovery likely depend on the health of the corporate sector. One of the most important and most tangible determinants of the near-term economic outlook will be the corporate profit equation.

Recently, the news has been mostly negative. Equity analysts repeatedly have cut their 2001 estimates for earnings growth by S&P 500 companies, to the point that earnings for the year may not grow at all. Companies in a wide range of sectors have been hit by higher energy, labor, and debt service costs at a time when a slowing economy has reduced sales growth.

Some of the stress in the corporate sector is evidenced by rising corporate bond defaults and increasing losses on C&I loan portfolios. For example, net charge-offs of C&I loans by FDIC-insured institutions rose to more than $8 billion in 2000 from less than $5.5 billion in 1999. On the basis of the slowdown in economic activity in late 2000, commercial loan performance could deteriorate further before it improves.

Economic Scenarios and Bank Performance

Regardless of whether the U.S. economy goes into recession, a transition from the rapid growth of the 1990s to a period of slower growth will pose challenges to insured institutions. Some insight into insured institution performance in a slower-growing economy can

[19] See Sweeney et al.

[20] See "Gap Between NYSE and NASDAQ IPOs Gets Smaller," *The Investment Dealers' Digest,* April 9, 2001, and "A Quarter to Forget for Initial Offerings," *EBN,* April 9, 2001.

be gained from an analysis of historical relationships in past business cycles.[21] Our analysis emphasizes the relationships of the major components of banking industry profitability to aggregate economic factors, acknowledging that these relationships can differ for individual banks. Although history need not repeat itself, the relationships discussed below have been evident in many U.S. business cycles since 1960.

In recognition of the current uncertainty in the economic outlook, a consensus among business and financial analysts has developed since late 2000 outlining three possible directions an economic slowdown might take. These scenarios have been labeled in the business press as the V, U, and L scenarios because of the shape each suggests for the depth and duration of the slowdown and the rate of recovery in overall economic activity.[22]

The V, U, and L scenarios are described in the inset box. Chart 6 (next page) characterizes, from a historical perspective, the V and U scenarios that have characterized U.S. business cycle downturns since 1960. The chart shows that gross domestic product (GDP) growth typically accelerates four quarters before the beginning of a recession (period 0) and reaches a negative value (a decline in GDP) about three quarters after the beginning of the recession. The U scenario characterizes the 1990 to 1991 recession and differs from the typical post-1960 recessions in that GDP growth did not accelerate just before the recession and recovered at a much slower pace after the trough of the recession. For example, GDP growth did not reach 3 percent (near the long-run potential growth rate of 3.3 percent) until seven quarters after the start of the recession.

Net Interest Margin and the Term Structure of Interest Rates

A steeper yield curve generally results in improvements in banks' NIMs. A consistent, positive relationship between banks' NIMs and the yield spread between

Three Adverse Scenarios

V Scenario

- Economy rebounds quickly after a period of slower growth that may or may not lead to a brief recession
- Unemployment rate rises slightly, but the labor market remains solid, boosting consumer spending
- Fed interest rate cuts spur housing activity, capital investment, and equity market values
- Consumer wealth rises and consumer confidence rebounds
- Renewed flow of funds into equity markets occurs
- Slowdown and recovery take one year or less, following the average V-shaped scenario since 1960

U Scenario

- Economic growth remains below potential for several quarters, with the likelihood of recession increasing
- Unemployment rate rises, resulting in a further decline in consumer confidence and lower consumer spending
- The Fed aggressively lowers interest rates, which spurs spending on housing, consumer durable goods, and capital investment
- Equity markets recover after a period of below-average returns
- Slowdown and recovery takes one to two years

L Scenario

- After dipping into recession for several quarters, economic growth remains well below potential for an extended period
- Consumer confidence remains at depressed levels, leading to a drop in housing activity and greatly reduced spending on consumer durable goods
- Faced with falling profits, firms engage in widespread job cuts that push up the unemployment rate
- A protracted period of stagnation in equity markets occurs
- Fed aggressively lowers interest rates; however, businesses and consumers remain reluctant to borrow
- Slowdown and recovery take longer than two years

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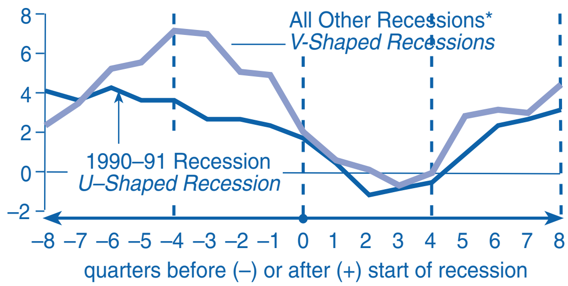
[21] Economic factors such as the growth of aggregate demand, gross domestic product (GDP) growth, equity market performance, and interest rate levels and term structures are expected to be related to banking industry performance.

[22] Another way to view the degree of uncertainty is to recall that, as late as November 2000, most analysts were discussing the timing of the "soft landing," interpreted as GDP growth slowing to a sustainable rate of 3 percent. By mid- to late-December 2000, analysts had shifted to the V, U, or L scenario characterization of the slowdown, with the V-shape being most prominent. By late March 2001, the U-shaped scenario had gained more support as the accepted way to view the current slowdown in economic activity.

Chart 6

GDP Growth Exhibits Different Patterns Depending on the Type of Recession

Year-over-Year Percent Change in Gross Domestic Product

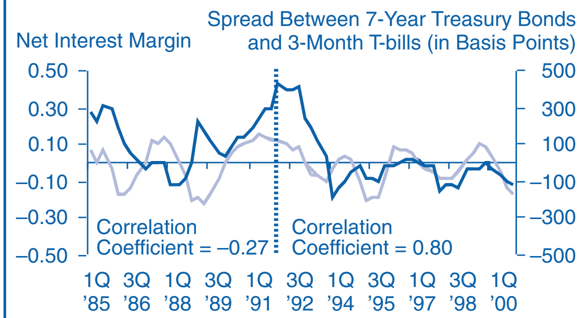


*Line represents the average value associated with four recessions between 1960 and 1982, treating the twin recessions of the early 1980s as one.
Source: Bureau of Economic Analysis (Haver Analytics)

Chart 7

The Correlation between Changes in Net Interest Margin and the Yield Spread Has Increased

(Year-over-Year Absolute Change)



Source: Bank and Thrift Call Reports (FDIC Research Information System)

short-term and long-term interest rates has been well established for some time.[23] As shown in Chart 7, an increase in the yield spread is associated with an increase in the NIM after one or two quarters. Since the early 1990s, moreover, the lag in this relationship has shortened.

Over the past 25 years, an inversion of the yield curve (a negative spread) has led most recessions by several quarters, although inverted yield curves have not always been followed by a recession.[24] An inverted yield curve suggests that banks are paying higher rates to borrow short term and earning lower rates of return on long-term investments. The yield curve became inverted in the final two quarters of 2000, and, as anticipated, net interest income declined (see Chart 7). The Fed's aggressive easing of the federal funds rate during the first quarter of 2001 has already reversed the negative spread in the yield curve that was in place at the beginning of the year.

Chart 8 indicates a tendency for the yield curve to become steeper as economic downturns run their course. Other things constant, this steepening would serve to buffer the NIM, offsetting the effects of declining credit quality as the recession progresses. Under a V scenario, the yield curve would be expected to invert before the recession and become positive within 12 months (see Chart 8).

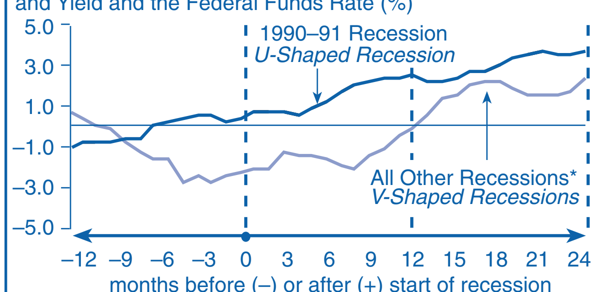
Noninterest Income and Stock Prices

Noninterest income has become an increasingly important source of revenue for banks and thrifts. As a proportion of earning assets, this source of income has grown steadily since the mid-1980s, and its growth has accelerated since 1992.[25] Furthermore, since 1992 this income source has become more market sensitive, particularly for large banks, and has shown a positive relationship with the rate of change in the S&P 500 stock index (see Chart 9). Changes in this index (year-over-year) have preceded changes in the noninterest income ratio by one or two quarters, and since 1992, this time lag has shortened. For example, the stock market declines of the latter half of 2000 were accompanied by

Chart 8

The Yield Curve Exhibits Different Patterns Depending on the Type of Recession

Spread between the Yield on 10-Year Treasury Bonds and Yield and the Federal Funds Rate (%)



*Line represents the average value associated with four recessions between 1960 and 1982, treating the twin recessions of the early 1980s as one.
Source: Bureau of Economic Analysis (Haver Analytics)

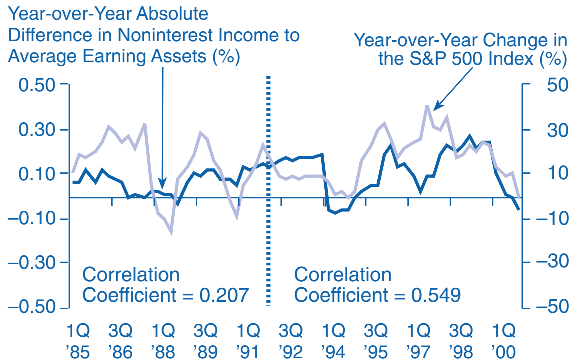
[23] Gerald A. Hanweck and Thomas E. Kilcollin, "Bank Profitability and Interest Rate Risk," *Journal of Economics and Business,* Spring 1982, Volume 36, Number 1, p. 77.

[24] Christopher J. Neely, "What Is the Slope of the Yield Curve Telling Us?" Monetary Trends, Federal Reserve Bank of St. Louis, MO, August 2000, p. 1.

[25] Bank call report data.

CHART 9

Noninterest Income Has Become Much More Sensitive to the Market in Recent Years



Source: Bank and Thrift Call Reports (FDIC Research Information System)

a decline in the ratio of noninterest income to earning assets reported over the same period.

The rate of change of the S&P 500 index has shown a consistent relationship with the business cycle over the past 40 years (see Chart 10). Declines in the S&P 500 returns have preceded recessions by 12 months and have recovered to positive returns within at least 12 months after the start of the recession. Through March 27, 2001, the S&P 500 index had dropped 20 percent from its high in September 2000; this decline is considerably greater than during past recessions (see Chart 10). Regardless of whether the economy enters recession, if the correlation between stock prices and noninterest income is maintained, as suggested in Chart 9, the effect could be a decline in noninterest income, with the duration and magnitude depending on the length of the economic slowdown.

Noninterest Expense

Wages, salaries, and other operating expenses drive changes in bank noninterest expenses. The ratio of these expenses to earning assets has remained practically constant since 1992. Historically, the ratio of noninterest expense to earning assets shows no discernible cyclical relationship, possibly because of offsetting factors making up noninterest expense. For example, wages and salaries for some banking functions tend to slow during a recession, whereas expenses for loan workouts and related costs rise.

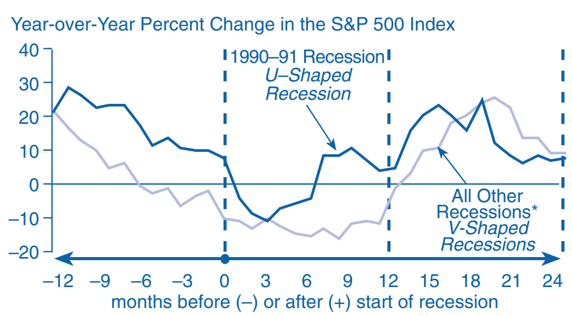
Loan Losses

Over a number of business cycles, bank loans have tended to be procyclical, with total loan growth falling for three quarters before a recession, continuing to decline through the recession, and beginning to rise four to five quarters after the beginning of the recession (see Chart 11). During the 1990 to 1991 recession, which exhibited characteristics of a U-shaped scenario, loan growth was negative for five quarters and returned to increasing, positive growth some eight quarters after the recession had begun. These patterns are similar for growth in mortgage, CRE, consumer, and C&I loans.

This cyclical pattern suggests that the rapid loan growth during the upswing of the business cycle may be associated with loans whose credit quality will become weaker in the event of an economic slowdown. Recent loans, however, typically will not be the ones that initially become nonperforming. Consequently, growth in nonperforming loans, loan loss provisions, and loan charge-offs would be expected to lag total loan growth and the GDP growth cycle.

CHART 10

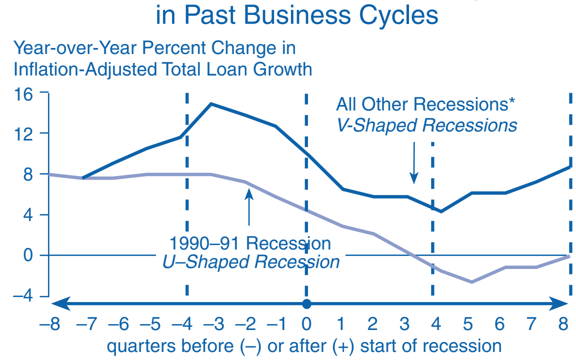
Equity Prices Historically Have Tended to Begin Recovery within a Year of the Onset of a Recession



*Includes three recessions between 1960 and 1980. Excludes the double-dip recession of the early 1980s.
Source: Interactive Data Corporation

CHART 11

Loan Growth Has Tended to Be Procyclical in Past Business Cycles



*Line represents the average value associated with four recessions between 1960 and 1982, treating the twin recessions of the early 1980s as one.
Source: Federal Reserve Board of Governors *Flow of Funds* (Haver Analytics)

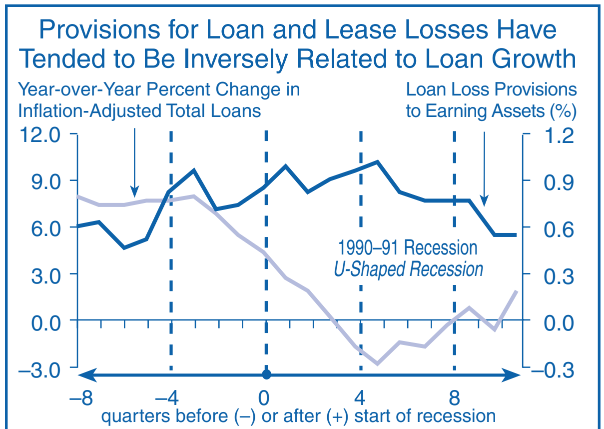
During the 1990 to 1991 recession, loan loss provisions began to rise six quarters before the beginning of the recession. As loan growth slowed dramatically, loan loss provisions increased, peaking about five quarters after the recession had begun as loan growth was nearing its trough (see Chart 12). In many ways, however, the 1990 to 1991 recession was unique. Coming into that recession, commercial real estate was experiencing an unrelated downturn, causing loan loss provisions to rise. Loan loss provisions may behave differently during other business cycles.

Summary of the Scenario Analysis

At this point we can summarize our general observations about how banks in the aggregate might be expected to perform in a slower-growing economy. Noninterest income and loan loss provisions would typically worsen in the early part of an economic slowdown. At some point, the return to an upward sloping yield curve and a stock market rebound would boost the NIM and noninterest income, respectively. This boost could occur even as loan loss provisions, a more lagging indicator, continue to rise.

These observations are distilled from the experience of the past. However, at least two caveats are needed. Typically, each business cycle has its own unique features; the present economic slowdown need not follow the course of any previous economic downturn. Even more important, the results of the scenario analysis

CHART 12



Sources: Bank and Thrift Call Reports (FDIC Research Information System); Federal Reserve Board of Governors Flow of Funds (Haver Analytics)

applies to banks in the aggregate, whereas the outcome for an individual bank depends on the risks that bank assumes and the way it manages those risks.

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The authors would like to thank Paul Bishop and Lisa Ryu for their contributions to the analysis of economic scenarios in this article.

Atlanta Regional Perspectives

Slowing Economy Poses Challenge for Region's Insured Institutions

Insured institutions may be facing the most challenging economic environment in nearly a decade (see this quarter's ***In Focus*** article). Economic growth in the Atlanta Region has moderated, but not to the same degree as growth in the nation. By early 2001, the Region's employment growth had slowed to 2.3 percent, down from nearly 3 percent during the first half of 2000. In all states in the Region except **Florida,** job growth rates have declined in recent quarters. Despite the slowing, labor markets in the Region generally remain historically tight. However, the downward trend in unemployment rates may have reached its nadir and, particularly in the case of ***North Carolina,*** jobless rates saw a significant increase in late 2000. Layoffs, which until recently have been limited primarily to the manufacturing and high-tech sectors, could spill over into the rest of the economy. The cumulative effect of layoffs across several industries could derail certain areas' economic growth, particularly in rural portions of the Atlanta Region. The magnitude of the Region's slowdown, however, will depend heavily on the depth and duration of any slowing in the national economy.

The slowing economy could pose revenue challenges for many insured institutions in the Atlanta Region. Reduced demand for credit and tightening underwriting standards likely will lead to slower loan growth. Moreover, net interest income could decrease because of the downward shift in the yield curve over the past year. Adjustable-rate loan products, for the most part, reprice immediately, and lower mortgage rates are swelling the refinancing of fixed-rate mortgages. For many commercial banks, the benefit of lower liability costs may take some time to materialize because of the repricing lags of maturity deposits and minimal room to lower nonmaturity deposit pricing. Additional profit pressures could result from lower levels of fee income, particularly fee sources that are market sensitive. The slowing economy also could lead to higher credit costs resulting from loan loss provisioning and higher overhead charges to collect nonperforming assets.

Community Banks in Highly Competitive Urban Markets Are More Vulnerable to Slowdown

Although the slowing economy may affect the entire Atlanta Region adversely, community banks operating in areas where there is a confluence of several risk factors could be more vulnerable. These risk factors include high growth, strong competition, aggressive lending practices, and relatively high rates of bank formation. Although perhaps characteristic of several metropolitan areas in the Atlanta Region, these attributes may be most apparent in the **Atlanta** metropolitan area.

Market Growth and Bank Formation

The Atlanta metropolitan area experienced significant market growth in the 1990s. Between 1990 and 2000, its population increased nearly 40 percent, adding more than 1.1 million new residents. The 3.3 percent compound annual rate of increase was more than double the national average. A rapid population increase may encourage new bank formation (for greater detail, see **"De Novo Banking in the Atlanta Region,"** ***Atlanta Regional Outlook,*** first quarter 2000). In fact, the Atlanta metropolitan area has led the Region in the number of new bank charters since the end of the 1990 to 1991 recession.

Real Estate Development and Lending

In response to the rapid population growth of the past several years, Atlanta has experienced high levels of both commercial and residential construction activity. According to ***F.W. Dodge,*** the pace of Atlanta's commercial construction starts during the first three quarters of 2000 was nearly equal to the sum of the next five largest markets in the Atlanta Region.[1] Similarly, residential permitting in Atlanta during 2000 was greater than the combined totals of the next two largest markets, **Orlando** and **Charlotte.** Unexpected declines in absorption rates associated with the recent weakening in economic growth may affect the future performance of current real estate development, however. The downsizing in the high-tech and dot-com industries may prompt existing leased commercial space to return to the market. Areas such as Atlanta, **Raleigh, northern Virginia,** Charlotte, and **Huntsville** may be especially vulnerable. Greater

[1] In descending order: Charlotte, Orlando, Ft. Lauderdale, West Palm Beach, and Tampa.

difficulty in marketing new space and rising building costs (associated with higher energy prices) may be prompting developers to tap existing lines of credit. Community banks, many of which are non-recession-tested, have been very active in supporting a metropolitan area's real estate development and could experience weakening asset quality in a slower growth market.

At 15.5 percent, construction and development (C&D) lending as a share of assets among Atlanta's community banks was nearly three times the U.S. metro average during fourth quarter 2000. This exposure is the highest in the nation and could pose significant credit risk if growth slows. Nearly one-third of community banks (39 institutions) in the Atlanta metropolitan area report a C&D exposure exceeding 15 percent. In contrast, before the 1990 to 1991 recession, the number of community banks in Atlanta with this exposure peaked at 20 in 1988. Moreover, the aggregate C&D exposure at year-end 2000 was 25.9 percent, in contrast to the previous peak of 21.1 percent in 1990 (see Chart 1). Given the high and rising C&D exposure, Atlanta may be more vulnerable than several other metropolitan markets in the Region to the effects of a slowdown in the local real estate market.[2] **Macon,** Raleigh, **Naples,** and **Savannah** also have exposures that exceed the national metropolitan average.

Competition

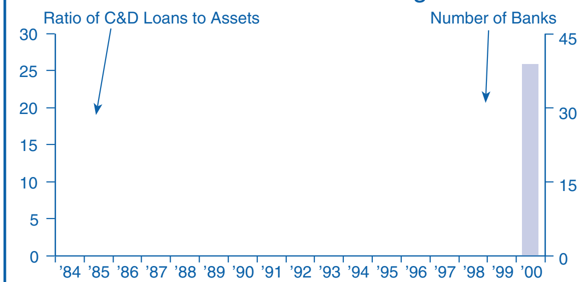
Internet banking, alternative forms of saving and financing, bank acquisition activity, and the surge in new bank openings in recent years have altered the banking landscape in many urban areas. Competition has become increasingly fierce on both sides of the balance sheet. One indicator of the increasing level of competition in recent years is the rise in banks' cost of funds in several urban areas, such as **West Palm Beach,** Macon, **Miami,** and Atlanta. Slowing economic growth may prompt some lending institutions to relax underwriting standards to meet growth goals and capture market share.

It May Not Be Only Atlanta

Other metropolitan areas in the Region are also exposed in varying degrees to each of these potential vulnerabilities. Among them, Charlotte, **Greenville,** Orlando, and

CHART 1

The Number of Community Banks[1] with Large Construction & Development Loan Concentrations[2] in Metropolitan Atlanta Is Increasing



[1]Community banks have assets less than $1 billion.
[2]Large concentrations are more than 15 percent of assets.
Source: Bank Call Reports, data through December 31, 2000

Greensboro rank relatively high in terms of cost of funds growth, C&D exposure, non-recession-tested banks, and market growth. Other areas, such as Macon, **Richmond, Norfolk,** and Naples, also exhibit some of these higher-risk factors.

Rural Areas Exhibit Unique Concerns

Rural areas in the Atlanta Region continue to face challenges in key components of the local economy: agriculture and manufacturing. The recent slowing in economic growth may further strain these economies and, consequently, the local banking industry.

Farming

A prolonged drought, structural changes in the tobacco industry, and continued low commodity prices have affected farmers' cash flow adversely in the Atlanta Region. Higher energy and fertilizer costs add further pressures. Farmers' ability to meet financial obligations will depend on continued government support. Moreover, farm land values must remain near current price levels in order to provide collateral protection for lenders. Residential and commercial development spreading outward from urban areas has helped to support farm land values. However, this support could weaken if economic growth continues to slow in urban areas. Anecdotal evidence suggests that farm land values not near urban centers have been supported by the purchase of "recreational" farms financed by accumulated gains in stock market wealth. Given the recent equity market declines, demand for land may decline. Also, should economic growth continue to slow, farmers may be faced with declining levels of off-farm income.

[2] The fact that C&D exposure can have a significant impact on bank performance during an economic downturn is made apparent by tracking the performance of banks at year-end 1988 with a C&D exposure in excess of 15 percent through the mid-1990s. Each of these institutions experienced a downgrade in its Uniform Bank Performance rating to a 3, 4, or 5 during that time. The number of banks with ratings of 3, 4, or 5 peaked in 1991 during the recession.

Financial hardship among Atlanta Region farmers could affect rural banks' asset quality adversely. In fourth quarter 2000 the Region was home to 31 agricultural banks with assets totaling $2.2 billion. Low commodity prices, drought, and higher input costs are most evident in **Georgia,** home of two-thirds of the Region's farm banks. In fourth quarter 2000, the percentage of farm loans in the Region's farm banks that were noncurrent or charged off exceeded the national averages by 53 and 12 basis points, respectively. Farming remains a critical component of the economy in many rural areas. Therefore, other nonagricultural assets held by rural community banks also may be vulnerable if agricultural sector weakness filters through the rest of the local economy.

The Lumber Industry

Economic conditions in the Region's softwood lumber industry have deteriorated recently and may affect many rural area economies adversely (see ***Atlanta Regional Outlook,*** third quarter 1998, for greater detail about this industry). The building boom of the mid- to late 1990s fueled demand for wood products and resulted in increases in lumber prices. In response, the Atlanta Region's lumber industry expanded rapidly. After building peaked in many areas during 1999, loggers and sawmills continued producing at high levels to generate revenue to service debt incurred by the recent expansion. As a result of excess supply and declining demand, prices in the industry have declined significantly in recent months. In February 2001, the producer price index for softwood lumber was more than 15 percent below year-ago levels. As markets have weakened, some reports have emerged about credit-quality problems in the industry.

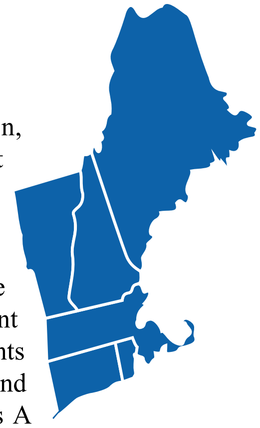
Foreign competition could stress the softwood lumber industry further. On March 31, 2001, the Softwood Lumber Agreement with Canada expired, prompting concern that imports to U.S. markets will increase significantly. The agreement set a quota on softwood imports from Canada, which currently account for one-third of the U.S. market. The increase in imports coupled with potential further slowing in the U.S. economy and higher energy costs could have a negative effect on the already troubled lumber industry (which employs nearly 150,000 in the Atlanta Region), surrounding communities, and, ultimately, credit quality in the local economies.

Other Manufacturing

Textiles and apparel are large manufacturing employers in rural areas of the Atlanta Region (for a more detailed discussion of the industry, see ***Atlanta Regional Outlook,*** second quarter 1998). Slowing economic growth could further weaken conditions in these industries; the most vulnerable is the carpet and rugs subsector, which has experienced substantial growth thanks to the nation's construction boom during the 1990s.

Atlanta Region Staff

Boston Regional Perspectives



The Region's Economic Expansion Continued through Early 2001…

In 2000, nonfarm payrolls in the Region rose at a somewhat faster pace than in the nation. This gap widened during the early months of 2001 because of a continued deceleration in annualized U.S. job growth. The Region's rate of decline in factory sector payrolls also eased through the 15 months ending March 2001. In contrast to the strength in employment, the Region's housing market showed some signs of cooling during 2000. Permit issuance in 2000 was down 7 percent from the prior year, versus a 4 percent drop nationwide, but it did rebound in the first quarter of 2001. Also, existing home sales in the Region slowed slightly in 2000 following peak volume in 1999. Despite the slight decline in sales, home prices throughout the Region continued to rise, suggesting that limited inventory (rather than weakened demand) was responsible for the reduction in home sales volume.

…but Its Economic Fate Remains Tied to the Nation's

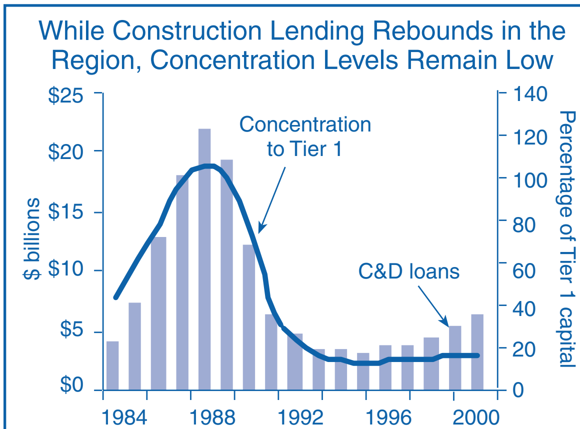
The national economic slowdown likely poses the most significant risk to the Region's economy at this time. The current absence of widespread economic imbalances in the Region's economy suggests that the health of the national economy will be the most important determinant of the Region's near-term economic performance. Slower growth in the national economy has resulted from protracted weakness in the manufacturing sector and a more recent, abrupt deceleration in information technology investment and consumer spending growth. The Region is just beginning to see the effects of the slowing national economy. For instance, after an initial lag, the Region's unemployment claims are now rising, in line with the national trend.

Office Markets around Boston Evidenced Some Cooling

Office real estate conditions eased in the Boston Region during first quarter 2001. Office vacancy rates in **Boston** and **Cambridge** increased slightly from record lows as blocks of sublease space were returned to the market because of a slowdown in the information technology sector. In downtown Boston, about 1.1 million square feet (about 3 percent of multi-tenant inventory) were on the market to be sublet in first quarter 2001, more than three quarters of the total amount absorbed in 2000. Average rents have leveled off between $50 and $65 per square foot for Class A space, following steady increases through 2000. Asking rents on select Class A properties, which commanded upwards of $85 per square foot in fourth quarter 2000, dropped to roughly $65 to $70 per square foot during first quarter 2001. Boston-area industrial markets, particularly in the suburbs, continue to exhibit lower vacancy rates. Hotel space remains in short supply around greater Boston, but demand appears to be softening with the national economy.

Construction lending in the Region increased during the latter half of the current expansion along with commercial real estate market activity and demand for space. Aggregate construction and development (C&D) loan growth has averaged 20 percent over the past three years. However, while C&D lending has increased in the nation and the Region, as business conditions begin to slow, concentration levels of construction to Tier 1 capital remain low compared with the late 1980s (see Chart 1).

Chart 1



Note: C&D = construction and development
Source: Bank and Thrift Call Reports, merger adjusted

The Region's Banks Are Well Positioned to Weather an Economic Slowdown…

The Region's insured institutions are facing an uncertain economic environment from a position of relative strength. A prolonged period of economic growth has contributed to their favorable condition. In addition, the positive effects of consolidation, deregulation, technological advances, and market forces should not be understated. The combined effect of these factors has resulted in the historically high capital and earnings levels of the Region's banks and thrifts.

Asset quality remains a major driving force behind earnings as net charge-off and delinquency ratios continue to reach new lows. In 2000, 44 percent of the Region's institutions had zero or negative net charge-offs. This was the highest percentage of institutions in the Boston Region without net loan losses in a calendar year since at least the early 1970s. Delinquencies also continued to decline. As a result, provision expense has been modest, while the low level of nonperforming assets has served to boost net interest income.

…but Trends in Certain Risk Areas Point to Potential Longer-Term Concerns

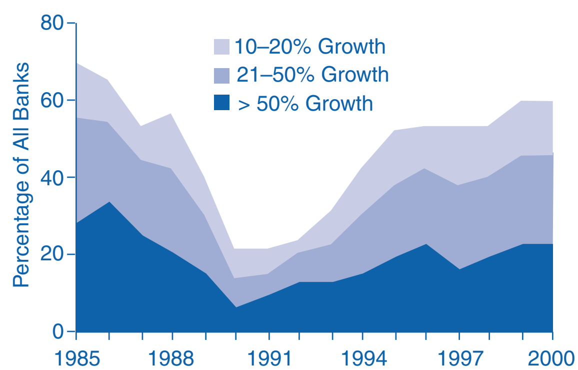
While most institutions continue to report strong asset quality, some signs of developing problems may portend a downturn in credit quality within the Region. Commercial loan losses, while modest, have been rising steadily in the Region's largest institutions, most likely as a result of exposures to large, nationally syndicated credits that have begun to deteriorate as the economy slows and credit availability tightens. The credit card portfolios of large-scale credit card lenders also are exhibiting signs of weakness. These situations reflect the effect of aggressive competition on underwriting standards in these specific markets. Many analysts have cited the loosening of underwriting standards, particularly in 1997 and 1998, as a major contributor to the deterioration noted today.

Most of the Region's insured institutions are not participants in the nationally oriented markets cited above, but many have expanded commercial loan portfolios aggressively over the past few years. Aggregate commercial loan growth in the Region has outpaced that of the nation on average for the past four years. In each of the past six years, 40 percent or more of the Region's institutions that make commercial loans had commercial loan growth in excess of 20 percent (see Chart 2). The growth has been particularly pronounced in the Region's savings institutions; more than 50 percent of those involved in commercial lending expanded their portfolios in excess of 20 percent in each of the past three years. For many of these institutions, commercial loan concentrations relative to capital remain modest, but they are growing rapidly and warrant close scrutiny. Competition for commercial loans in the Region clearly has been fierce. Traditional commercial lenders are now fighting for business from new entrants into the market, including the Region's savings banks, out-of-Region banks utilizing credit scoring techniques, and nonbank financial companies. To the extent that the strong growth has been achieved, in part, by easing underwriting standards, problems may begin to emerge locally as the economy softens. This situation underscores the importance of strong credit administration practices to monitor and manage borrowers effectively in an uncertain economic environment.

Overall, earnings remain fairly strong, particularly for commercial banks; however, profits in the Region's savings institutions have been declining steadily over the past three years, primarily because of net interest margin compression. Commercial banks have not been immune to margin compression, but savings institutions have felt the compression more acutely as their declines have been steeper on a percentage basis, and they typically have a greater reliance on net interest income as a percentage of total operating income. Between 1997 and 2000, nearly half the Region's insured institutions experienced a net interest margin decline of more than 20 basis points; more than a quarter experienced a decline of more than 40 basis points.

CHART 2

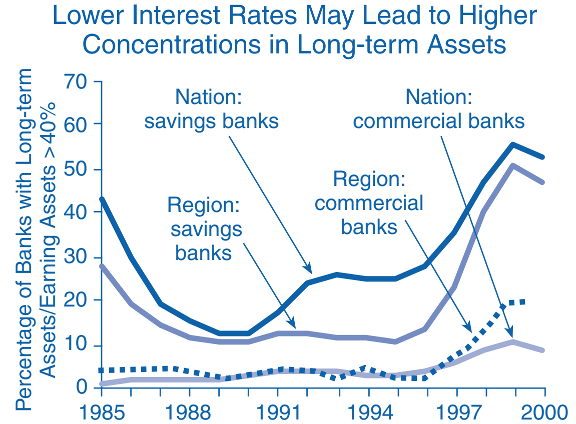
Rapid Commercial Loan Growth Continues in the Boston Region



Source: Bank and Thrift Call Reports

The bulk of the margin erosion occurred in 1998 and 1999 as a result of the heavy refinancing wave that occurred during that period, coupled with an unfavorably shaped yield curve that made it difficult to redeploy prepayments into new investments at favorable spreads. Additionally, because the yield curve was low and flat, customers preferred fixed-rate loans, and many institutions opted to hold onto these loans to prop up eroding margins. The asset extension has not been countered by a lengthening of liabilities, as the flat yield curve has offered little incentive for depositors to go long. As a result, the duration of assets expanded considerably and was not offset on the liability side of the balance sheet; the effect was to heighten exposure to rising interest rates for many institutions in the Region. The lengthening of assets was evident in both commercial and savings institutions (see Chart 3).

CHART 3



Source: Bank and Thrift Call Reports

The higher interest rates that prevailed throughout 2000 significantly dampened prepayments and increased the demand for variable-rate loans. However, the imbalances that developed between 1997 and 1999 will take several years to correct unless actively managed, and only a slight improvement was noted in 2000. Institutions are now facing a renewed wave of refinancing as interest rates have fallen considerably in the first quarter. The average ***Mortgage Bankers Association*** refinancing index during the first quarter of 2001 was the highest on record. Further rate declines, should the economy continue to soften, may result in another prolonged refinancing wave, leading to further extension of asset maturities and continued margin erosion.

Although active management of securities portfolios, extending liabilities via wholesale funding sources, and implementation of off-balance-sheet hedging strategies can help to mitigate the rising level of interest rate risk, banks in the Region have done little to counter asset extension. The failure to mitigate the growing imbalances that may result from the current downturn in interest rates may lead to undue exposure to a future rise in interest rates, particularly if it is accompanied by a steepening of the yield curve. The present low interest rate environment should provide sufficient opportunity to employ risk reduction strategies.

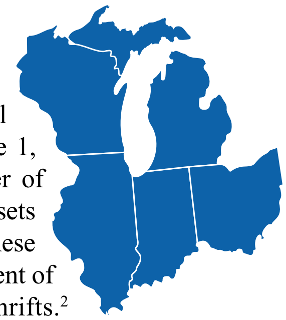
Boston Region Staff

Chicago Regional Perspectives

Banking and Economic Conditions Vary among Region's Larger MSAs

The Region's economy softened in 2000, in line with national economic developments. A slowing economy poses challenges for debt service capacity of businesses and consumers, thereby making credit quality of banks and thrifts an increasing concern. Intense competition in recent years has heightened the risk profile of many of the Region's financial institutions. Given their increased risk profiles, banks' ability to weather credit quality deterioration is a key issue to watch.

This article explores some characteristics of the Region's major banking markets using a combination of banking and economic data. Analyzed are the Region's ten metropolitan statistical areas (MSAs), listed in Table 1, that have the highest number of insured institutions with assets of $10 billion or less.[1] These institutions represent 29 percent of the Region's banks and thrifts.[2] Banking and economic data used for the analysis include, but are not limited to, the items in Table 1.



Economic data include employment volatility and industrial diversity statistics.[3] These two gauges provide insight into how an MSA could be affected by national

Table 1

Selected Banking and Economic Measures Show Variation among Region's Larger Metropolitan Areas (nonspecialty banks and thrifts with less than $10 billion in assets)

MSA	Number of Institutions	Cyclical Employment Volatility	Industrial Diversity Index	New Institutions (% of Total)	Loan-to-Asset Ratio	C&I and CRE Loans to Assets	Net Interest Margin	PDNA Ratio*	ALLL Coverage of Nonperforming Loans**
Chicago	270	94	75	6%	▲66%	▲34%	3.74%	1.74%	147%
Cincinnati	62	84	71	0%	▲74%	26%	▼3.55$	1.81%	130%
Cleveland-Lorain-Elyria	22	96	69	9%	79%	12%	3.58%	1.53%	140%
Columbus	22	84	71	9%	58%	20%	3.98%	▲1.29%	284%
Detroit	35	87	44	31%	79%	21%	▼3.36%	3.13%	73%
Grand Rapids-Muskegon-Holland	20	82	24	20%	82%	▲51%	4.20%	1.70%	254%
Indianapolis	24	82	75	4%	75%	▲27%	3.93%	▲2.83%	108%
Madison	23	18	60	0%	73%	38%	▼3.18%	0.96%	371%
Milwaukee-Waukesha	51	82	60	8%	70%	30%	3.57%	1.96%	177%
Peoria-Pekin	26	41	22	0%	▲60%	26%	3.62%	▲1.79%	245%
Chicago Region's All MSAs		NA	NA	7%	70%	28%	4.86%	1.93%	147%
Entire Nation's MSAs		100	100	10%	65%	32%	4.75%	1.92%	163%

For banking indicators, shaded cells are the three highest values except for coverage ratios and net interest margins, where shading shows the three lowest. Triangles flag the three markets with largest change over two years. For economic gauges, shaded cells show employment volatility > 65 percent or diversity index < 50.

PDNA = Past-due and nonaccrual. *PDNA loans as percentage of loans. **Allowance coverage of nonperforming loans.

Note: Ratios are aggregates (weighted averages.)

Sources: Bank and Thrift Call Reports (for December 31, 2000) and Economy.com, Inc.

[1] Institutions with assets greater than $10 billion were excluded because their operations likely span a larger area than the MSA in which they are headquartered. Nevertheless, the indicators in Table 1 undoubtedly affect their risk profiles. Specialty institutions also were excluded.

[2] Institutions located in the Cincinnati MSA but outside the Chicago Region were included in the ratio computation.

[3] Data for this analysis are from Economy.com, Inc.

economic trends. For example, the employment volatility measure shows the degree to which an MSA's employment growth rate varies with the national rate. The measure ranges from 0 to 100, with a low value indicating that an MSA's employment swings are mainly independent of national developments and a high value indicating the opposite. The industrial diversity index measures the industrial diversification of the MSA relative to the United States. A high value indicates diversity nearly as broad as the nation's, while a low value suggests that a few industries account for most activity in an MSA. All other things being equal, the higher the level of industrial diversification, the better positioned is an MSA to weather a national economic slowdown.

A comparison of values for **Indianapolis** and **Grand Rapids-Muskegon-Holland,** which are shown in Table 1, provides an example of how the gauges can be used to assess an MSA's vulnerability to national economic trends. Although the two MSAs are equally affected by national employment volatility, a slump in an industry operating in both MSAs could have a more damaging effect on the Grand Rapids area than on the more diversified Indianapolis area.

Just as employment volatility and industrial diversity differ among MSAs, so does banking industry performance. Banks and thrifts in some MSAs exhibit risks that appear relatively stable and modest, while institutions in other MSAs maintain relatively higher risk profiles and face rapidly changing competitive environments.

Chicago and **Milwaukee,** two of the larger markets, benefit from broad economic diversity. Asset quality indicators at Chicago's institutions remain generally favorable, although recent increases in the volume of traditionally higher-risk commercial forms of lending are among the highest in the Region. Although the past-due and nonaccrual (PDNA) ratio for insured institutions in the Milwaukee MSA is the third highest among the Region's top MSAs, it is only slightly higher than the national level.

Banking industry performance appears generally favorable for each of the markets analyzed, but a national economic slowdown could have a pronounced impact on MSAs with limited industrial diversity. Profiles of the three MSAs with the lowest industrial diversity index values in Table 1 are discussed below.

Detroit's industrial diversity is broader than it was in the 1980s, although the area remains heavily dependent on the motor vehicle sector and associated industries. Union workers at assembly plants and elsewhere who lose their jobs because of production cutbacks often continue to receive some income and benefits, which allow them to continue spending and making debt payments. The availability of these income supports is not as widespread, however, among nonunionized automobile suppliers or engineering and computer service firms tied to the motor vehicle sector.

The impact of an economic slowdown could be more significant for insured institutions in Detroit than for institutions in the Region's other large MSAs because they already are experiencing high funding costs, loan-to-asset ratios, and past-due ratios, as well as low and declining net interest margins. Meanwhile, aggregate Tier 1 capital levels and the allowance for loan and lease losses (ALLL) to total loans ratio have trended downward. A significant percentage of banks in the Detroit market are new. Their tendency to have higher levels of commercial and industrial (C&I) and commercial real estate (CRE) loans, as well as higher funding costs can be mitigated by higher capital levels. Institutions with C&I and CRE loans associated with industrial properties may face some challenges ahead. The MSA's vacancy rate for industrial properties has climbed over the past two years to 8.5 percent in 2000, the highest in the 12 years for which data are available. Additionally, vacancy rates for suburban office space remain moderate at slightly more than 8 percent, and they have been rising since mid-1999.

The **Grand Rapids-Muskegon-Holland** area stands out as an economic success story of the past decade, having benefited from a "Renaissance" development zone, the in-migration of people and businesses, and strong activity in its dominant sectors. The area's relatively high degree of cyclical employment volatility and low industrial diversity (high exposure to several manufacturing industries) likely will play a significant role in its near-term health should recent signs of economic weakness intensify. The area's auto suppliers and equipment manufacturers are relatively efficient and have a diversified customer base, but they could be affected adversely by recent vehicle production cutbacks and intense cost-cutting in this sector. Demand for office furniture, another major employment source, remained healthy through late 2000. Profitability pressures may trigger layoffs at a major office-furniture manufacturer, however, and the repercussions of slower growth in commercial construction nationally in the past year likely will be felt with a lag.

Grand Rapids' robust economy in recent years has led to very strong asset growth which, coupled with regional bank consolidation activity, has helped foster the entrance of new institutions into the market. The high percentage of new institutions has increased the level of competition and has contributed to significant increases in CRE lending associated with the MSA's economic expansion. The degree of competition in this market is underscored by funding costs that are among the highest in the nation; however, net interest margins are relatively strong given a loan mix weighted toward commercial forms of lending.

Peoria-Pekin's economy and financial institutions have weathered various economic challenges in the past decade, and their experiences may leave them reasonably well positioned for the current slowdown. Peoria's low cyclical employment volatility could shield it somewhat from a national slowdown, although it remains vulnerable to the presence of one dominant manufacturer. The MSA's manufacturing payrolls slid by about 1 percent over the past year, in line with the national pattern. The area's unemployment rate in January and February 2001 averaged 5.4 percent, up from about 4.5 percent in the same periods in 2000 and 1999, and average weekly hours worked in manufacturing have been falling for two years. Consequently, aggregate weekly earnings of factory workers in the area are shrinking. These trends could affect consumer credit quality and pressure the PDNA ratio. Mitigating this concern are the relatively low PDNA rate, high coverage of nonperforming loans, and a capital cushion built up at area institutions during the past two years.

Although most banking risk indicators in Peoria remain at modest levels relative to the Region's other large MSAs, the loan-to-asset and PDNA ratios are rising. Increases in the PDNA ratio in the past two years have been fairly widespread across nonresidential real estate, 1 to 4 family residential real estate, C&I, and consumer loan portfolios. Although consumer lending levels have been declining relative to other loan categories, they remain higher than in most other large MSAs.

Chicago Region Staff and Craig Thornton,
Acting Regional Manager

Dallas Regional Perspectives

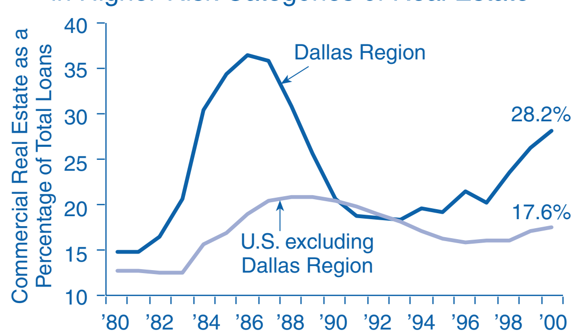
Vulnerability to a Downturn in the Real Estate Market Increases as Insured Institutions Expand Concentrations in Traditionally Higher-Risk Loan Categories

Real estate overbuilding contributed greatly to the Region's last banking downturn in the mid- to late 1980s. Major metropolitan areas, in **Texas** especially, saw significant deterioration in commercial and residential real estate values in a relatively short period.[1] While few expect a downturn in the Region's real estate market as serious as that of the 1980s, the experiences of that downturn highlight the risks associated with growing concentrations in traditionally higher-risk assets, such as commercial real estate and construction and development loans.

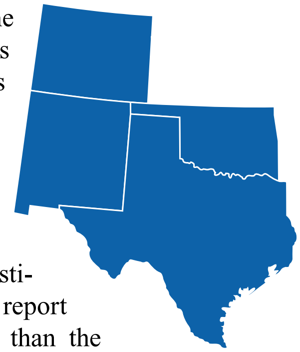
At year-end 2000, real estate loans accounted for 56.5 percent of the Dallas Region's total bank and thrift loan portfolio, the highest level since 1988. The traditionally higher-risk categories of commercial real estate and construction and development loans have dominated loan growth in the Region since 1997 and, at year-end 2000, accounted for 28.2 percent of the Region's loans, compared with 17.6 percent for the rest of the nation (see Chart 1).

CHART 1

Dallas Region Expands Exposure in Higher-Risk Categories of Real Estate



Note: Commercial real estate includes commercial, multifamily, and construction real estate.
Source: Bank and Thrift Call Reports



During the last half of the 1990s, real estate conditions improved in many Dallas Region markets; however, effects of the 1980s downturn linger. According to ***F. W. Dodge*** (FWD), only the **Austin** and **San Antonio** metropolitan statistical areas (MSAs) currently report office vacancy rates lower than the national average. Most of the office vacancy rates for the Region's MSAs covered by FWD are projected to improve over the next several years, based on current construction and absorption estimates. However, there are signs that the effects of the current economic downturn soon could be felt in the real estate industry. Results of a March 2001 ***KPMG*** survey found that 48 percent of the real estate executives polled predicted that property values will decline over the next 12 months, and 74 percent expect rents to decline.[2] While current real estate supply and demand factors appear in balance in most Dallas Region MSAs, should economic growth resemble a U- or L-shape scenario (as discussed in the ***In Focus*** article ***Economic Conditions and Emerging Risks in Banking***), employment growth could slow quickly, causing pressure on vacancy and rental rates for all types of real estate. This situation may hold true particularly for MSAs currently experiencing difficulties in high-tech industries such as telecommunications, semiconductors, and personal computers.

Signs of a slowing economy and identified weaknesses in some of the Region's important industry sectors may be pointing to challenges for insured institutions with high volumes of commercial real estate. At year-end 1997, commercial real estate loans held by 21 percent of the Region's insured institutions exceeded 200 percent of risk-based capital. By year-end 2000, 28 percent of the Region's banks and thrifts were in this category. Growing balance sheet concentrations in this traditionally higher-risk category warrant close attention because they represent increasing vulnerability to a downturn in the real estate sector.

[1] For more information, please refer to *History of the Eighties,* Federal Deposit Insurance Corporation, 1997.

[2] Robert Julavits, "Realty Execs Say Property Values, Rents Will Drop," *American Banker,* March 21, 2001, p. 11.

Rising Oil and Natural Gas Prices Present a Mixed Picture for the Region

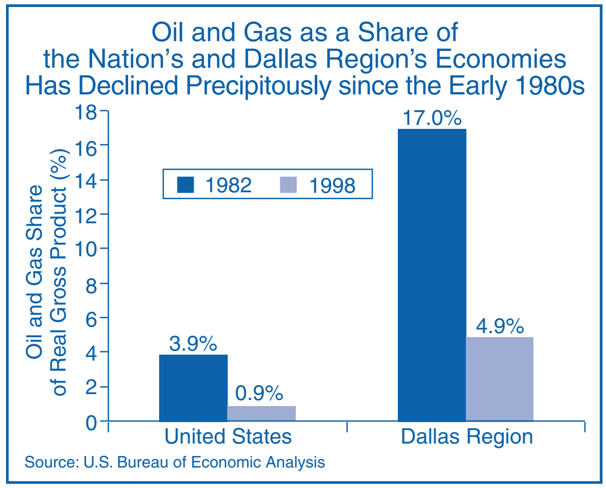
Oil and gas is an important industry for the Dallas Region. The Region produced more than 715 million barrels of crude oil in 1997 and employed 185,100 workers in the oil and gas extraction industry in 2000. According to the ***U.S. Bureau of Economic Analysis,*** the Dallas Region accounted for more than half the nation's oil and gas output and the industry's employment in 1998. The Region's reliance on oil and gas as an economic driver, however, has declined dramatically over the past 20 years. Oil and gas output as a share of overall gross regional product declined from 17 percent in 1982 to 5 percent in 1998 (see Chart 2). The growing importance of other industries, such as high tech, construction, and financial services, has more than offset the decline of oil's importance to the Region.

The fallout from higher oil prices on businesses has not been widespread. Rather, its effects are being felt by significant users of petroleum products. Corporate profitability has eroded in energy-intensive industries such as transportation, textiles, lumber, paper, chemicals, rubber and plastics, and steel. Higher gasoline and heating oil prices have reduced consumers' real income, displacing demand for other goods and services.

Oil and natural gas prices will likely remain high throughout 2001 because of lean inventories, particularly of crude oil, and strong demand for natural gas. The greatest risk to households and businesses in the Region is the growing price volatility. In the event of a disruption to supplies, no matter how minor, sharp price spikes are likely; this likelihood has resulted in a "risk premium" on the current price of oil and natural gas. Rising oil prices played a key role in the Region's booming economy during the 1970s, while declining oil prices contributed to its recessions in 1982 and 1986. As evidence of differences between the Dallas Region and the nation, however, energy prices were a contributing factor in three of the past four U.S. recessions.

During the 1980s, the relationship between the oil and gas industry, the Region's economy, and the fortunes of insured institutions was more direct. Today the Region's economies have diversified considerably away from oil and gas exploration and production toward other key industries. Consequently, most of the economic effect of rising oil prices on banks in the Dallas Region is channeled indirectly through insured institutions' local economies.

CHART 2



A Slowing U.S. Economy and New Farm Legislation Likely Will Affect the Region's Agricultural Sector

U.S. agriculture has struggled over the past three years because of depressed commodity prices, recurrent drought conditions in certain areas, a strong U.S. dollar, and lagging exports. Since 1997, the ***United States Department of Agriculture's*** all-farm index of prices paid by producers has increased while prices received by producers have dropped. Consequently, Congress has approved historic levels of government payments over the past three years, doubling the Region's receipt of government support.

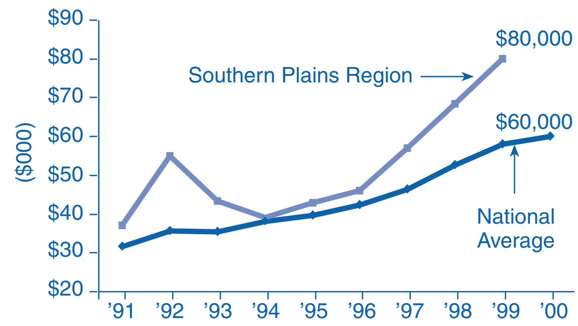
By 1999, 39 percent of the Dallas Region's net farm income was derived from government payments, significantly less than the 50 percent average nationwide. The primary difference is the livestock sector, which does not receive government payments. Specifically, 69 percent of the Region's agricultural cash receipts are derived from livestock products, compared with 51 percent for the nation. Government payments and net farm income for 2001 are forecast to be considerably lower than in 2000. Fortunately, livestock prices have performed well during the past two years, and the importance of this sector somewhat insulates the Region from the effects of lower government payments. However, the health and viability of the U.S. livestock industry could be adversely affected if the current outbreak of foot-and-mouth disease in Europe spreads to the United States.

While income from farming operations has suffered, the historic economic expansion and tightening labor markets helped create increased opportunities for nonfarm employment. Off-farm income in the Southern Plains averaged almost $80,000 per farm household at year-end 1999—an increase of 116 percent since 1991 and 38 percent above the U.S. average (see Chart 3). Increased reliance on off-farm income helped mitigate problems that could have resulted from depressed commodity prices, weather-related losses, and sluggish exports. However, this new reliance highlights the potential weakness that producers and their lenders may face during an economic downturn.

Record government payments and increasing off-farm income benefited the Region's agricultural bank earnings and credit quality. The Region's agricultural banks, on average, report strong performance. However, total loans have increased to the highest level in the past ten years, and bank managers are beginning to report credit quality deterioration, as evidenced by declining borrower equity, increasing carryover debt, and rising receivables amid slowing sales for input suppliers. Additionally, the ratio of loan loss reserve to total loans has not kept pace with loan growth and is at the lowest level in a decade. The combination of lower off-farm income as a result of slowing economic growth and decreased farm income as a result of declining government payments could weaken many agricultural producers' ability to repay existing debt and could erode credit quality at the Region's agricultural banks.

Chart 3

Off-Farm Income in Southern Plains Has More than Doubled since 1991



Note: Southern Plains includes Texas and Oklahoma.
Source: USDA Agricultural Outlook, January–February 2001

Dallas Region Staff

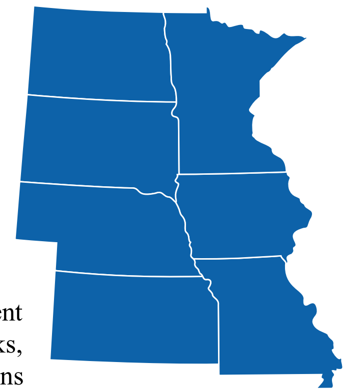
Kansas City Regional Perspectives

The Agricultural Sector Remains Depressed, with Low Commodity Prices

The Kansas City Region's farm sector continues to be plagued by low commodity prices. Strong domestic and foreign production of wheat, corn, and soybeans has resulted in large inventories, depressing prices every year since 1996, as shown in Table 1. Moreover, the ***U.S. Department of Agriculture's*** (USDA's) outlook for these commodities in the 2001 and 2002 marketing years shows little improvement over the low prices seen in 2000. On the positive side, cattle prices continue upward, and hog prices have rebounded somewhat from extremely low levels in 1998 and 1999.

The low prices contributed to declining farm net income. Net farm income for the Region dropped 28 percent, from $11.1 billion in 1997 to $8.0 billion in 1999 (the most recent data available on a state basis). Estimated 2000 net farm income, based on national price levels and regional production estimates, is not an improvement over 1999. Yet the Region has not experienced any major production problems in the past two years, which would have resulted in even lower net farm income numbers.

Farm Banks Continue to Report Healthy Conditions despite the Depressed Farm Sector



Despite tough times for farmers, the Region's 1,212 farm banks,[1] which represent 61 percent of the nation's farm banks, reported healthy conditions at year-end 2000, capping a decade of strong financial performance. For example, farm bank earnings, as measured by aggregate return on assets,[2] were reported at 1.10 percent in 2000, similar to 1998 and 1999 results. In addition, farm bank credit quality has been relatively high. As shown in Chart 1 (next page), total delinquent and nonperforming loans[3] continue to represent a low percentage of total loans when compared with historical levels. In addition, net loan charge-offs, which represented just 0.21 percent of total loans as of year-end 2000, have not increased significantly.

Table 1

Important Commodity Prices Are Expected to Remain Depressed through 2001

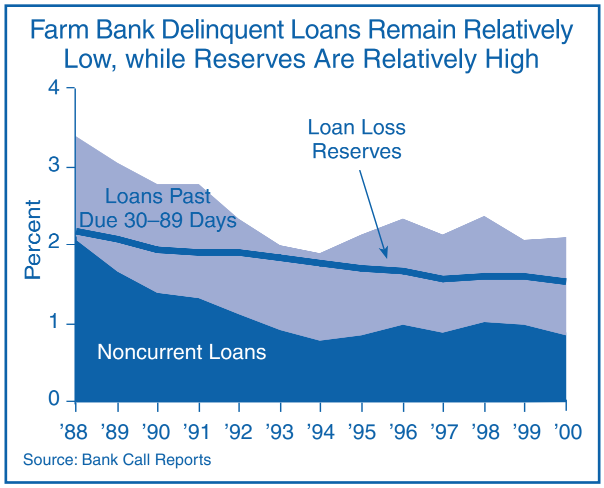
	1996	1997	1998	1999	Est. 2000	Proj. 2001	KC Region Proportion of Agricultural Cash Receipts (%)
Corn	3.24	2.71	2.43	1.94	1.80	1.85	17
Soybeans	6.72	7.35	6.47	4.93	4.65	4.90	14
Wheat	4.55	4.30	3.38	2.65	2.48	2.55	6
Cattle	65.05	66.32	61.48	65.56	69.00	75.00	32
Hogs	56.53	54.30	34.72	34.00	44.00	42.00	10

Note: Grain prices are for marketing year of each crop. Crop quantities are per bushel; livestock are per hundredweight.
Source: U.S. Department of Agriculture

[1] Farm banks are defined as banks having farm operating or farm real estate loans totaling at least 25 percent of total loans.
[2] Return-on-assets ratios were adjusted for banks that have elected Subchapter S tax status to make their earnings comparable to those of non-Subchapter S institutions.
[3] Delinquent loans are loans past due between 30 and 89 days. Nonperforming loans are loans that are placed on nonaccrual (not accruing interest) status or past due 90 days or more.

Reported capital and loan loss reserves, which cushion losses in lending and operations, also remain at relatively high levels. The aggregate equity capital ratio was 10.3 percent and the aggregate ratio of loan loss reserve to gross loans was 1.5 percent as of year-end 2000. These ratios were much lower at the beginning of the 1980s agricultural crisis, at 8.7 percent and 1.0 percent, respectively.[4]

CHART 1



Government Payments, Carryover Debt, and Off-Farm Income Have Insulated Farm Banks from Problems

Why have farm banks been able to withstand the poor agricultural environment? The answer lies in government payments, carryover debt, and off-farm income, which have been critical to farm banks' reported health during the past three years. An examination of these factors helps to explain why the Region's farm banks have not reported significant deterioration in conditions.

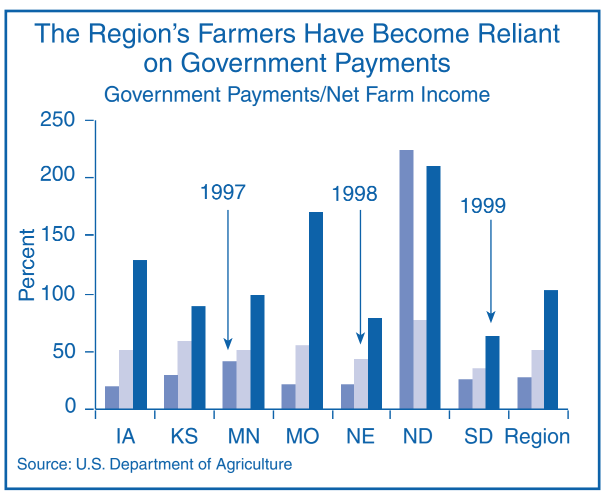
Most important, government payments to farmers in 1998, 1999, and 2000 have mitigated some—but not all—of the financial stress caused by low commodity prices. Nationally, government payments set records in each of those years, with payments in 2000 reaching $22.1 billion. As the agricultural economy has weakened in the Region, government payments also have grown dramatically in importance.

Chart 2 shows how the percentage of government payments to net farm income in the Region has grown from slightly over one-quarter of net farm income in 1997 to more than 100 percent of net farm income in 1999. As a result, farmers have become heavily reliant on government payments to meet debt obligations. Farm bank managers stressed this point during an outreach meeting in March 2000,[5] stating that many of their weaker farm customers waited for government checks before repaying operating loans.

Given the USDA 2001 and 2002 price outlooks, it appears that the Region's farmers will continue to rely on government payments in the near term. Any reduction in government payments could have a negative effect on farm banks, as borrowers would find it even more difficult to meet loan obligations and living expenses. All eyes will be on congressional negotiations pertaining to the 2002 farm bill, which could dramatically affect the Region's farmers and lenders.

Carryover debt also helps farm banks to report strong aggregate conditions. Because of the variability in production and price of agricultural products, bankers frequently carry over unpaid seasonal operating loans into the next season. The expectation is that a good operating season will offset one or two poor operating seasons. This practice effectively delays recognition of credit stress as these loans do not show up in reported delinquency figures. For example, in the 1980s farm crisis, farm banks' delinquency ratios

CHART 2



[4] See Table 3 in "Agricultural Sector under Stress: The 1980s and Today," *Kansas City Regional Outlook,* third quarter 1999, at http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/k3q1999.pdf.
[5] Agricultural Bankers Roundtable meeting hosted by the FDIC in Omaha, Nebraska, March 28, 2000.

did not rise significantly until 1984, three years into the crisis.[6]

FDIC examiners report[7] that the share of examined banks experiencing a "moderate" to "significant" increase in carryover debt levels jumped from about 10 percent in March 1998 to more than 40 percent by September 1999. Although the percentage of banks experiencing increases has moderated somewhat, it remains relatively high. Further persistence of low farm revenue could result in higher delinquency numbers at farm banks, because carryover debt has limitations, particularly for farmers without substantial real-estate equity to secure carryover loan extensions. Farm borrowers' balance sheets can be stretched only so far before bankers are unable or unwilling to extend additional carryover debt. At that point, delinquency levels escalate rapidly, as in the early 1980s.

The third factor that has benefited farm banks is that the strong nonfarm economy has boosted farmers' off-farm income levels. Off-farm income represents a large share of funds used to meet living expenses or make farm-related debt payments, particularly for smaller farming operations. USDA data for 1999 show that off-farm income represents 69 percent of total household income for farm households with farm revenues of $50,000 to $249,000. These smaller operations are the primary borrowers at many of the Region's farm banks. Data released in 1992 by the USDA show that most off-farm jobs are not related to farming. In fact, services and manufacturing employ 51 percent and 17 percent of rural workers, respectively, and government employment accounts for another 17 percent. Therefore, even in Midwestern states in which farm production represents the largest source of production output, off-farm income represents a critical share of farming families' total income.

The record-setting national economic expansion has been a tremendous boost to off-farm income, helping rural areas provide a wide range of employment opportunities. However, recent economic data and news releases suggest that the economic growth has slowed substantially and might be at or near zero. Reports of layoffs, lost shifts, and idled plants are increasing. A prolonged or severe economic slowdown could be harmful to farm banks' financial well-being, as farm borrowers might lose a substantial portion of household income through lost wages.

Thus far, farm banks have continued to report healthy conditions despite a depressed farm economy. However, stress cracks in their condition are apparent. Government payments and off-farm income have played important roles in preventing the cracks from widening. Currently there is uncertainty about the health of the general economy as well as about the role of government in farming and the direction that will be taken in the 2002 farm bill. Significant changes in these areas or a significant and widespread crop failure could expand the stress cracks.

Richard D. Cofer, Jr.
Senior Financial Analyst

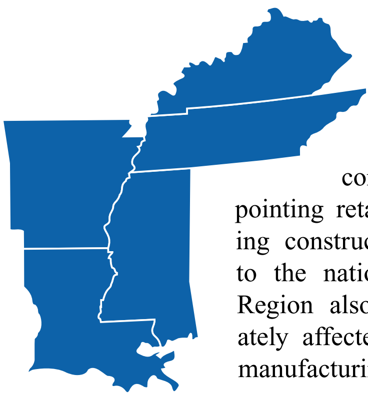
[6] For a discussion of how the current agricultural situation differs from that of the 1980s, including a discussion of carryover debt, refer to the *Kansas City Regional Outlook,* third quarter 1999, at http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/k3q1999.pdf.

[7] FDIC examiner loan underwriting survey results; examinations conducted between September 1996 and September 2000.

Memphis Regional Perspectives

The Region's Economy Has Stalled

The Memphis Region's economy slowed sharply during the second half of 2000 and is now considerably weaker than the national economy. Payroll employment was stagnant in the fourth quarter of 2000 and first quarter of 2001.[1] Personal income growth likewise slowed. The Region's economic performance was hampered by waning consumer confidence, lower corporate profits, disappointing retail sales, and declining construction activity related to the national slowdown. The Region also was disproportionately affected by weaknesses in manufacturing.



Nationally, the manufacturing sector is contracting. The ***National Association of Purchasing Managers' Index***[2] has been below 50, a level typically associated with a downturn in manufacturing, since the third quarter of 2000 (see Chart 1). The effects of the current slowdown in this sector are more pronounced for the Memphis Region than for the nation because of a higher concentration of manufacturing employment and the poor performance of the Region's manufacturing industries compared with the sector as a whole. Many of the Region's manufacturing companies have closed plants or laid off employees to reduce costs. The downturn in manufacturing has led to slower growth in other important sectors such as services, retail, and construction.

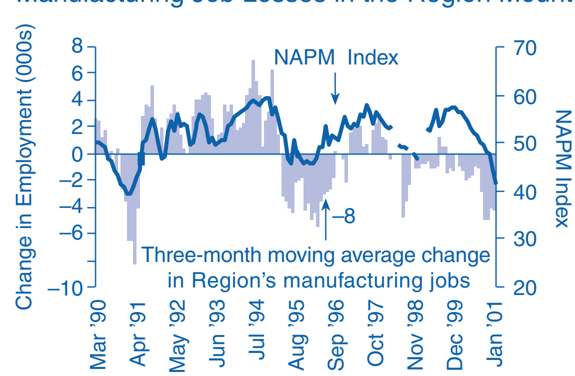
Mississippi's economy appears to be in a serious downturn. Mississippi shed almost 20,000 jobs during the nine months ended March 31, 2001, considerably more job losses than the state reported during the 1990 to 1991 national downturn. Although the losses were driven by weaknesses in manufacturing, almost all sectors have been affected. With the maturation of the gaming industry, job formation in the construction and service sectors, previous drivers of state employment growth, evaporated. Also, the agricultural sector continues to face low commodity prices and escalating costs, and the timber industry is struggling with lower demand following a severe winter. As a result of these negative trends, personal income growth in the fourth quarter of 2000 slowed to its lowest rate since 1983. While some positive developments are expected, primarily the initial construction work for a new automobile manufacturing facility, the state's economic recovery appears to be largely contingent on improvement in the national economy.

The current slowdown in Mississippi follows a decade of strong economic growth spurred in large part by gaming and hotel development. Many insured financial institutions in the state responded with rapid growth of their own in the 1990s to match the booming economy. This period of expansion, in the economy and among insured financial institutions, makes adapting to the current downturn all the more difficult for the management of banks and thrifts.

The economies of **Arkansas** and **Tennessee** also may be vulnerable. Arkansas is even more dependent on manufacturing employment than is Mississippi, and

Chart 1

Manufacturing Job Losses in the Region Mount



Note: NAPM = National Association of Purchasing Managers
Sources: Bureau of Labor Statistics and National Association of Purchasing Managers

[1] Seasonally adjusted annualized employment growth during the first three months of 2001 (measuring only changes from December 31, 2000, to March 31, 2001) that was a meager 0.3 percent, compared with the 3.2 percent annualized growth reported for the same period in the prior year, provides an indication of the magnitude of the recent slowdown.

[2] The index is based on a survey of more than 250 companies within 21 industries in all 50 states and covers areas such as production, orders, commodity prices, inventories, and vendor performance as well as employment.

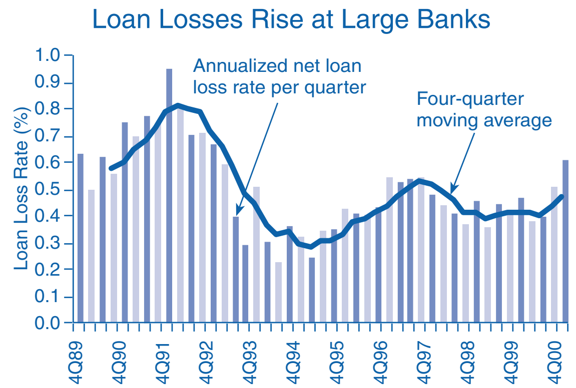
continued weaknesses in the sector could begin to affect the state's overall economic health.[3] After slowing appreciably in the fourth quarter of 2000, employment growth in Tennessee during the first three months of 2001 was close to zero. The rate of deceleration in employment growth over the preceding six months suggests that the state's economy has been affected disproportionately by the current national slowdown.

Bank Credit Quality Has Deteriorated with Economic Conditions

As the national and regional economies slowed during the second half of 2000, large banks (those with total assets of $1 billion or more) began reporting deterioration in credit quality. Past-due loan ratios increased and loan losses rose in the third and fourth quarters of 2000 among the Region's 25 largest insured financial institutions (see Chart 2). In response to changing economic conditions and credit quality concerns, these banks began to reduce loan exposure levels early in 2000 and more recently began to add to allowances for loan and lease losses.

Community banks (those with total assets of less than $1 billion) also reported deterioration in asset quality. In fact, community banks in the Region reported the largest spike and the highest aggregate ratio of past-due loans among the FDIC's eight Regions as of December 31, 2000.[4] Rising delinquencies were widespread, with almost two-thirds of the Region's banks and thrifts reporting increases in past-due loan levels from the prior year. Loan loss rates also increased for most institutions. Community banks and large banks have responded differently to changing economic conditions. Whereas many of the Region's largest banks have slowed loan growth and boosted reserves for loan losses, many community banks have not.

CHART 2



Note: Large banks are the 25 largest institutions in the Memphis Region, all with assets of $1 billion or more.
Source: Bank and Thrift Call Reports

Higher delinquencies were reported for almost every loan category, with consumer loans showing the largest jump.[5] Consumer loan portfolios likely were affected by the fourth quarter layoffs as well as by growing consumer debt burdens. Commercial and industrial loan delinquencies also increased as many area businesses experienced declining profitability associated with the slowing economy. Construction loan delinquencies were also notably higher, likely influenced by the growing inventories of unsold newly constructed homes in many areas.

Higher Credit Exposure Could Increase the Vulnerability of the Region's Banks

If economic conditions deteriorate further, Memphis Region banks and thrifts could be affected by credit quality problems more severely than during the previous economic downturn because of higher credit exposure levels. The aggregate loan-to-asset ratio for the Region's community banks at year-end 2000 was well above levels reported prior to the 1990 to 1991 recession (see Chart 3).[6] Furthermore, loan portfolios at year-end 2000 were much more heavily concentrated in traditionally higher-risk loan types, primarily in commercial real estate and construction and development lending,

[3] Manufacturing employment represents 22 percent of Arkansas' total nonagricultural employment, compared with a national level of 14 percent. Job losses in the manufacturing sector contributed to negative job formation in the state in January and February 2001.

[4] Memphis Region community banks reported an aggregate past-due loan ratio (loans reported as nonaccrual or past due 30 days or more) of 2.86 percent at year-end 2000. This represents a notable increase over the 2.47 percent reported as of December 31, 1999, and the 2.48 percent reported as of September 30, 2000, and is the highest year-end past-due loan level reported in the Region since 1992.

[5] The aggregate consumer loan past-due ratio for community banks and thrifts in the Region increased from 3.15 percent of total consumer loans at year-end 1999 to 3.68 percent at year-end 2000.

[6] The aggregate loan-to-asset ratio for Memphis Region community banks at year-end 2000 was 66 percent, compared with 56 percent reported at year-end 1989.

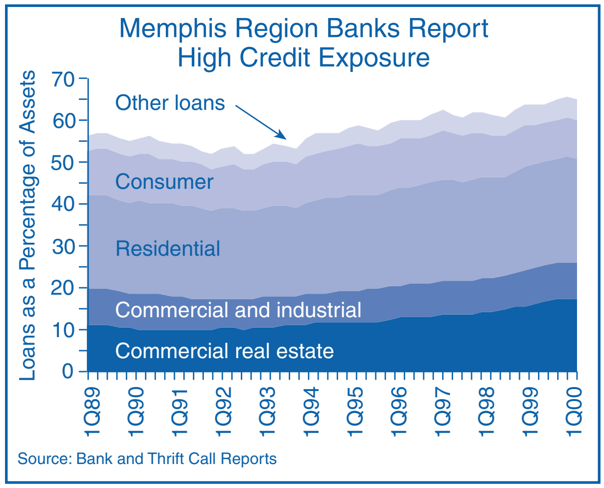
increasing the susceptibility of area banks to any downturn in local real estate market conditions.

Credit exposure levels are particularly high in many of the Region's metropolitan areas, such as **Lexington, Memphis,** and **Nashville.** In many metropolitan areas, growing competitive pressures have led to rapidly escalating funding costs. In response, many insured institutions, accommodated by previous economic strength, accepted higher credit exposure in order to improve asset yields and maintain net interest margins.

As a result, bank earnings may be more vulnerable to changes in economic conditions than in prior periods of slowing. Pressures on net interest margins, previously masked to some extent by increasing credit exposure and asset yields, may intensify as loan demand wanes and banks and thrifts tighten underwriting standards in response to worsening economic conditions.

Higher credit exposure also may necessitate additional provisions to the allowance for loan and lease losses. In recent years, most banks' provisions covered relatively low loan loss rates; however, allowance levels did not keep pace with burgeoning loan portfolios. While lower allowance levels may have been appropriate during a time of economic prosperity, provisions may need to increase in the near term given the weakness in area economic conditions and rising delinquencies and loss rates.

CHART 3



The effects of the slowing national economy are beginning to be felt by community banks. This seems particularly true for institutions in the Midwest and Midsouth, where economic conditions have weakened the most and credit quality concerns are emerging. The extent of credit quality deterioration and the resulting pressure on earnings and capital levels depend largely on the duration and severity of economic weakness in the nation and Region, as well as the response of financial institution management to changing conditions.

Memphis Region Staff

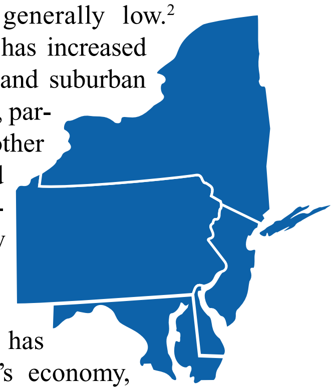
New York Regional Perspectives

Region's Economy, although Slowing, Performed Well; However, Pockets of Weakness Are Emerging

Some measures indicate that relative to that of the nation, the Region's economy, although slowing, performed well through first quarter 2001. The Region's labor markets were tight, commercial and residential real estate conditions were generally favorable, and consumer spending was stable.[1] Furthermore, except for manufacturing, the Region's industry sectors reported job growth in 2000, albeit at a lower rate than in 1999 (see Chart 1).

Pockets of weakness are emerging, however, particularly among communities that have a higher concentration of manufacturing jobs. Reduced demand nationwide for manufactured products, including automobiles, computers, electronic equipment, and industrial machinery, has resulted in job losses in areas such as **Buffalo** and **Elmira, New York,** and **Reading** and **York, Pennsylvania.** These metropolitan areas, as well as several others in Pennsylvania and northern and western New York, which also have a high concentration of manufacturing jobs, could be hurt by reduced demand for durable manufactured goods.

Furthermore, some of the Region's office markets may be more vulnerable to an economic downturn. Office construction has been at substantially lower levels during the 1990s business cycle than during the 1980s, and vacancy rates remain generally low.[2] However, office construction has increased in northeastern **New Jersey**[3] and suburban **Maryland.**[4] Moreover, layoffs, particularly among Internet and other high-technology firms, could result in leased space returning to these markets as new construction is completed.

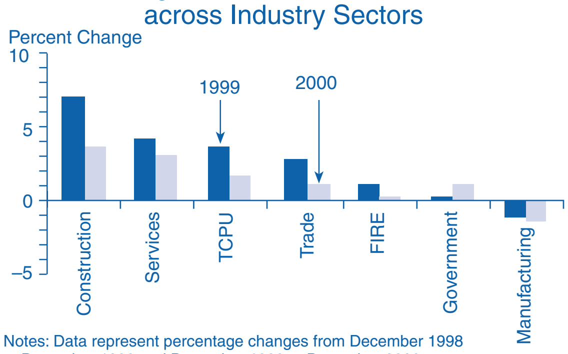


Uncertainty on Wall Street has implications for the Region's economy, particularly in **New York City** and surrounding areas. Although the finance, insurance, and real estate (FIRE) sector does not account for the largest proportion of the Region's job base, it represents a significant share of the Region's economy, as it provides some of the highest-paying jobs. The FIRE sector accounts for more than one-quarter (25.7 percent) of the Region's combined gross state products.[5] Moreover, the Region's FIRE sector has grown faster than its overall economy, increasing 5.4 percent between 1997 and 1998 compared with 4.2 percent for the Region's economy as a whole. Layoffs by the Region's large brokerage firms, however, have increased. Furthermore, a decline in initial public offerings and merger activity has contributed to a drop in earnings reported by the Region's large banks (assets greater than $10 billion), which derive a significant portion of operating income from market-sensitive revenues.

The Region's and the nation's economies also are linked to Wall Street by the wealth effect created by the rising stock market in the 1990s. Rising equity values have contributed to increased household net worth and have fueled consumer spending on homes, autos, and other purchases. During 2000, however, the wealth effect turned negative, as the nation's household net worth declined for the first time since 1945, reflecting declining equity prices. Reduced household net worth could depress consumer spending across the Region and the nation.

Chart 1

Region's Job Growth Slows across Industry Sectors



Notes: Data represent percentage changes from December 1998 to December 1999 and December 1999 to December 2000.
TCPU = transportation, communication, and public utilities
FIRE = finance, insurance, and real estate
Source: Bureau of Labor Statistics

[1] *Federal Reserve Beige Book, New York and Philadelphia Districts,* March 7, 2001.

[2] For additional information on commercial real estate conditions, see *New York Regional Outlook,* third quarter 2000.

[3] Kathleen Lynn, "Space Tight, Outlook Bright for Commercial Real Estate," *Bergen Record,* February 4, 2001.

[4] Grubb & Ellis, *Real Estate Forecast for Washington, D.C.,* 2001.

[5] Bureau of Economic Analysis. Excludes Puerto Rico, which was not available. Data for 1998 are the most recent available.

Credit Quality among the Region's Insured Institutions Shows Signs of Weakening

While reported credit quality indicators at year-end 2000 were generally sound, some weakening was evident, particularly among commercial and industrial (C&I) loans at the Region's large banks. Large banks' C&I past-due and charge-off ratios increased; however, these ratios remain below levels reached a decade ago. During 2000, the median C&I loan past-due ratio for the Region's large banks increased to 2.17 percent from 1.46 percent in 1999, while the C&I net charge-off ratio increased slightly to 0.47 percent from 0.44 percent. In comparison, during 1991, the median C&I past-due and net charge-off ratios reported by the Region's large banks reached 6.77 percent and 2.40 percent, respectively. Much of the C&I credit deterioration has been attributed to large syndicated loans booked between 1996 and 1998, when underwriting standards eased. Recent surveys prepared by the ***Federal Reserve Board***[6] indicate that nationwide, banks have tightened underwriting standards over the past year. Nevertheless, some indicators suggest that C&I credit quality may weaken further as C&I loans underwritten three years ago season and as the economy slows.[7] Furthermore, C&I credit-quality weakness may be extending beyond the Region's large banks, as regional banks (assets between $1 billion and $10 billion) also reported higher C&I past-due and charge-off rates.

The slowing economy also may be having a negative effect on credit quality at the Region's community banks (those with assets less than $1 billion[8]). While past-due ratios remain generally favorable, 57 percent of the Region's community banks reported an increase in the past-due ratio during the second half of 2000. The increase primarily reflected weakness in residential mortgages, consistent with national trends. According to the ***Mortgage Bankers Association of America,*** in fourth quarter 2000, the percentage of delinquent mortgages in the United States reached the highest level since 1992. Moreover, weakening credit quality reported by community banks headquartered in the Region's manufacturing-dependent counties suggests that these banks may be experiencing the effects of the national economic slowdown more than community banks headquartered in counties less reliant on manufacturing jobs.[9] Throughout the late 1990s, community banks in manufacturing-dependent counties reported a lower ratio of past-due residential loans than the Region's other community banks; however, in 2000, this trend reversed, likely reflecting weakness in manufacturing employment.

In addition, while community banks' C&I past-due ratios remained favorable in 2000, the amount of past-due C&I loans increased. Past-due ratios were largely diluted by strong commercial loan growth experienced over the past two years. The increase in past-due loans suggests that improvements in credit quality that occurred throughout the late 1990s are waning as economic conditions soften. Moreover, although commercial real estate (CRE) loan quality reported by the Region's community banks also was relatively favorable, a slowing economy could weaken office market conditions and adversely affect credit quality. Two-thirds of the Region's community banks have increased CRE loan exposure as a percentage of total assets since 1998. Furthermore, a high percentage of the Region's newer institutions have increased CRE loan exposure. CRE loans constitute the largest share of new banks' loans, more than the Region's established community banks and more than new banks a decade ago. For more information on the Region's new banks, see ***New York Regional Outlook,*** first quarter 2001.

Weakening credit quality could lead to higher loan loss provisions and lower profitability for the Region's banks, as allowance for loan and lease losses (ALLL) levels have not kept pace with loan growth (see Chart 2, next page). The median ratio of ALLL to Gross Loans for the Region's banks declined throughout the current economic expansion, falling to the lowest level since 1990. Nevertheless, capital ratios of the Region's banks are higher than a decade ago, providing additional cushion against potential losses.

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[6] Federal Reserve Board, *The Senior Loan Officer Opinion Survey on Bank Lending Practices,* March 2001.

[7] Moody's Investors Service, *U.S. Banking Sector: Commentary of 4th Quarter 2000 Earnings,* February 2001.

[8] Excluding insured institutions less than three years old and credit card specialists.

[9] Manufacturing-dependent areas are defined as counties whose manufacturing employment concentration is greater than the national average of approximately 15 percent. Of the 178 counties in the New York Region, 80, or 45 percent, have a ratio of manufacturing jobs to total jobs of greater than 15 percent. As of December 31, 2000, 212 established community institutions were headquartered in the Region's manufacturing-dependent counties.

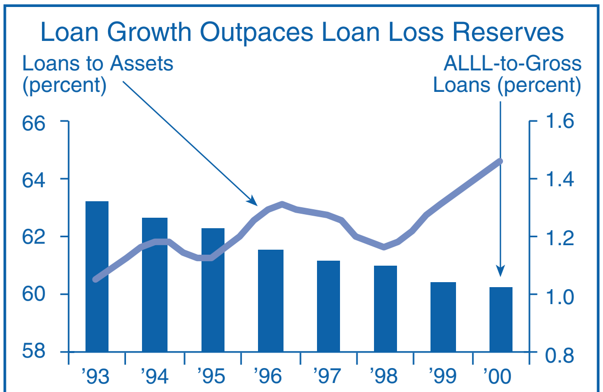
Asset Extension Could Pressure NIMs Following the Mortgage Refinancing Wave

Relatively low long-term interest rates and a flat yield curve, which prevailed periodically during the late 1990s and 2000, fueled consumers' preference for long-term, fixed-rate loans and contributed to lower net interest margins (NIMs) for the Region's community banks. These banks are generally more affected by NIM compression because of their dependence on the NIM or "spread" income, while large institutions derive much of their revenue from noninterest income.

More than two-thirds of the Region's community banks have reported an increase in concentration of long-term assets since 1997. In fact, 30 percent of the nation's community banks that hold a large concentration of long-term assets are headquartered in the Region,[10] reflecting its greater concentration of mortgage lenders.[11] Moreover, the proportion of long-term assets (those that reprice after five years) may increase further should the level of mortgage refinancing continue at a high level.[12]

While concentrations in longer-term assets should help bolster bank margins in a declining interest rate environment, a subsequent rise in rates, as occurred following the 1998 refinancing wave, could exacerbate NIM compression, particularly among institutions with high concentrations of long-term assets. As interest rates climbed following the 1998 mortgage refinancing wave, margins of community banks with greater concentrations in long-term assets tightened more than margins of other community banks.[13] Should the 1998 scenario repeat, banks with higher concentrations of long-term assets could again experience greater margin compression, highlighting the importance of interest rate risk management.

CHART 2



Note: Data represent year-end median amounts.
ALLL = allowance for loan and lease losses
Source: Bank and Thrift Call Reports, excluding institutions in operation fewer than three years and credit card specialists

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Robert M. DiChiara, Financial Analyst
Norman Gertner, Regional Economist
Alexander J. G. Gilchrist, Economic Analyst

[10] Established community banks with a ratio of assets maturing after five years to earning assets above the 90th percentile. Of the 443 banks that meet this criterion nationally, 135 are in the Region.
[11] Banks that have greater than 50 percent of assets in 1 to 4 family real estate loans and mortgage-backed securities.
[12] According to the Mortgage Bankers Association of America's *Mortgage Application Index for Refinancing,* the level of mortgage refinancings increased sharply during first quarter 2001.

[13] The median NIM decline from 1998 to 2000 for community banks with high concentrations in long-term assets was 10 basis points, compared with 3 basis points for other community banks.

San Francisco Regional Perspectives

Economic and Banking Conditions Are Sound but Face Increasing Pressures

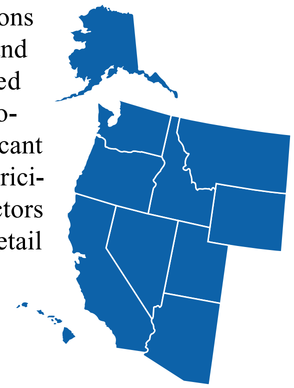
The Region's economy remained sound and expanded faster than the nation's through first quarter 2001, albeit at a slower pace than in previous periods. Because of this slowing, there is concern about the sustainability of the Region's growth. For instance, the **Oregon** economy has softened significantly since mid-2000, mainly because of contraction in the forestry and manufacturing sectors. In addition, continued slowing in the national economy or a confluence of key developments could dampen the Region's economy. In particular, energy price increases and power interruptions, technology sector and equity market volatility, and commercial real estate market softness could affect growth prospects adversely.

As of December 31, 2000, a majority of the Region's insured financial institutions reported sound financial conditions; however, the trend toward tighter liquidity and weaker asset quality continued. For example, two-thirds of institutions open three years or more reported year-over-year declines in core-deposit-to-asset ratios. In addition, delinquent commercial and industrial (C&I) loan ratios increased noticeably throughout the Region; institutions with more than $1 billion in total assets reported almost a 60 percent year-over-year increase in the median past-due C&I loan ratio.

The Energy Crisis in the West Poses Both Immediate and Long-Term Problems

The recent surge in natural gas prices in conjunction with electricity cost and availability problems could slow the Region's economy. The mining, lodging, and agriculture sectors appear particularly vulnerable. In addition, highly leveraged households or marginally profitable businesses could be affected disproportionately by higher energy bills.

Natural gas prices nearly quadrupled nationwide during the winter of 2000. In **California,** where inadequate pipeline capacity further constrained supplies, the spot price for natural gas surged even higher and continues to hover well above the national average (see Chart 1). Rising natural gas prices, coupled with an inadequate number of power plant facilities in California, drought conditions in the Pacific Northwest, and California's ill-structured electricity deregulation program, also led to significant increases in wholesale electricity costs. Overall, these factors have contributed to rising retail gas and electricity prices in many western states and electricity availability problems in California.



Rising energy prices and decreased electricity reliability could affect the Region's energy-intensive industries adversely. For example, mining and lodging consume a significant amount of electricity and could be affected disproportionately by higher energy costs. Mining is particularly important to the economies of **Alaska, Idaho, Montana, Nevada, Utah,** and **Wyoming,** while lodging is a major industry in Nevada and **Hawaii.**

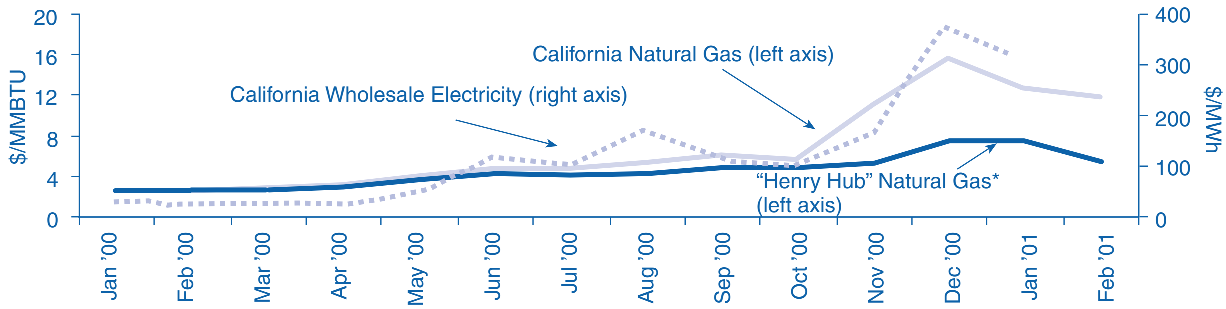
Escalating energy prices and rolling outages already have affected several agricultural subsectors. Dairy, greenhouse, and poultry producers not only use large amounts of natural gas but also depend on electricity as a critical element of production. In addition, agricultural operations that use fertilizer and irrigation could experience cash flow pressures. The combined effects on these areas of agriculture could be especially damaging to California, which has a significant percentage of irrigated crops and exposure to the dairy and greenhouse industries. The resulting pressure on farm cash flows could affect the 125 insured financial institutions in the Region that have agricultural loan exposures exceeding 100 percent of Tier 1 capital. California accounts for nearly 20 percent of these lenders.

Higher retail energy prices act very much like a tax that reduces consumers' discretionary spending. Data suggest that energy price increases have a relatively greater impact on lower-income households than on higher-income ones. Consequently, credit quality at the Region's subprime lenders could be most affected by rising household energy costs.

Energy will remain a longer-term issue in the West. The threat of rolling outages will not be eliminated until California's investor-owned utilities become solvent and

CHART 1

Higher Wholesale Electricity and Natural Gas Prices Contributed to California's Energy Crisis



Notes: MMBTU = millions of British Thermal Units
MWh = megawatt hour
*The Henry Hub (near major producing areas and many pipeline interconnections in Louisiana) is the official delivery point for natural gas futures trading on the New York Mercantile Exchange.
Sources: California Energy Commission and Enerfax.com

adequate generation capacity is built or conservation efforts become more effective. Given the interconnectedness of the West's power distribution network, other states also will continue to be affected.

Equity Market Weakness May Disproportionately Affect the San Francisco Region

Venture capital funding, which had been the growth engine in several of the Region's metropolitan statistical areas (MSAs) over the past several years, contracted during the fourth quarter of 2000. Northern California,[1] **Los Angeles/Orange County,** and **Washington** reported noticeable declines in venture capital funding, which contributed to layoffs and closings of a significant number of high-tech firms during late 2000 and early 2001. California and Washington accounted for about 33 percent and 5 percent, respectively, of all dot-com closures through February 2001. Furthermore, the significant number of layoffs reported in the surviving e-commerce, dot-com, and computer sectors nationwide correlates strongly with the large decline in the tech-heavy NASDAQ Composite Index between March 2000 and March 2001.

Weakness in the stock market also could affect household financial positions and consumer spending adversely. The net worth of U.S. households dropped 2 percent during 2000, the first annual decline in 55 years.[2] Although the percentage drop was not large, consumers may spend less on retail goods and tourist activities, both of which are important to several states in the Region, including Nevada and Hawaii. In addition, declining equity market values could dampen trust income at insured institutions because trust revenues are usually tied to asset market values. Trust income has become increasingly important for some insured institutions. For instance, for the 76 institutions in the Region that reported income from fiduciary activities as of December 31, 2000, the median ratio of trust income to total noninterest income was 14 percent, up steadily from 9 percent five years earlier.

Sustained Softening in the Commercial Real Estate Sector Could Affect a Majority of the Region's Insured Institutions

Softness in some commercial real estate (CRE) markets could adversely affect insured financial institutions in the Region with elevated CRE loan[3] concentrations. As of December 31, 2000, more than half of the Region's metropolitan insured institutions reported CRE loan concentrations exceeding 300 percent of Tier 1 capital, compared with only 29 percent of metropolitan institutions based elsewhere in the nation. Institutions with significant exposures to office, industrial, retail, and hotel properties in the Region's high-tech MSAs[4] and tourism areas could be most vulnerable to a downturn in this sector.

[1] Aggregated by PricewaterhouseCoopers; includes Silicon Valley and the San Francisco Bay Area.

[2] Federal Reserve Board, Flow of Funds Data (B.100 Balance Sheet of Households and Nonprofit Organizations), March 9, 2001.

[3] CRE loans include nonfarm-nonresidential, multifamily, and construction loans. Because of Call Report limitations, CRE loans may include credits used to finance residential construction projects.

[4] There are 13 MSAs in Arizona, California, Idaho, Oregon, and Washington, where the growth and concentration of high-tech employment exceeds the national average. (See *San Francisco Regional Perspectives,* third quarter 2000, for details.)

Demand for office and industrial space in the Region has been affected primarily by softness in the technology sector. Technology firm failures and layoffs reportedly have increased available office sublease space and placed downward pressure on CRE rents in the **San Francisco, San Jose,** and **Seattle** MSAs as well as the West Los Angeles office market. Given waning absorption rates and new construction in the pipeline, ***Torto Wheaton Research*** forecasts significant office vacancy rate increases in several of the Region's high-tech MSAs over the next two years (see Table 1).

Demand for hotel and retail commercial space also could suffer as a result of diminished consumer confidence and falling retail sales. Hotel and retail space in Nevada and Hawaii could be most vulnerable if a slowing economy contributes to a decline in leisure and business travel. Already, **Las Vegas** Strip hotels have reported falling room rates, a result in part of the slowing economy and of rising energy prices in California.[5] Demand for retail space also could wane throughout the Region, given reports of declining retail sales in the West.[6]

Insured Institutions in High-Tech Areas Could Be Most Affected

Of particular concern are insured institutions operating in certain MSAs in the San Francisco Region that are affected by a combination of the economic developments discussed in this article. The confluence of problems in the energy sector, volatility in the equity markets, and a weakening CRE sector could adversely affect CRE lenders in high-tech MSAs in California, Washington, and Oregon. These urban areas could be disproportionately affected by constrained energy supplies, declining levels of venture capital investment, layoffs among high-tech companies, and rising CRE vacancy rates.

San Francisco Region Staff

Table 1

Office Vacancy Rates Are Forecast to Increase in Most High-Tech MSAs

MSA Name[1]	Fourth-Quarter 2000 Vacancy[2]	Two-Year Vacancy Forecast
Ventura	High	High[3]
San Jose	Low	High[3]
Oakland	Low	High[3]
Orange County	High	High
Portland	Moderate	High[4]
San Diego	Moderate	High[3,4]
San Francisco	Low	High[3]
Phoenix	High	Moderate
Sacramento	Moderate	Moderate[4]
Seattle	Low	Moderate
Nation	**Moderate**	**Moderate**

Note: Torto Wheaton Research does not track the Boise, Santa Cruz, or Santa Rosa office markets.
[1] Listed in order of two-year forecast vacancy rate.
[2] High = greater than 10%; Moderate = 5–10%; Low = less than 5%.
[3] Forecast to increase significantly (i.e., increase by 500 basis points or more).
[4] Forecast to increase in suburban areas, but remain stable or decrease in downtown areas.
Source: Torto Wheaton Research

[5] Hubbel Smith, "Air Service to Las Vegas Keeps Growing But a Drop in Strip Hotel Room Rates May Signal Sagging Tourism Demand, Analyst Suggests," *Las Vegas Review-Journal,* March 23, 2001. www.lvrj.com/lvrj_home/2001/Mar-23-Fri-2001/business/15700408.html
[6] Bank of Tokyo Mitsubishi/Union Bank of Switzerland, Warburg Retail Sales Survey, February 2001.

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