

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

Background

This report summarizes emerging risks among insured financial institutions. It provides background for the Board's consideration of the deposit insurance premium rate case that follows. Prepared under the aegis of the Risk Analysis Center, this report combines the perspectives of FDIC economists, financial and risk analysts, examiners, and case managers. A previous version of this report was presented to the FDIC National Risk Committee on April 19.

Summary

Current banking industry performance and economic conditions are strong. Capital, earnings, and profitability are all at or just below record levels, while loan performance is beginning to weaken from a position of historical strength. Economic growth has become more balanced across the business and consumer sectors and is forecast to move to its long-run, average growth rate through late 2007. There are some areas of concern in the economy, such as high consumer indebtedness and a lack of saving from present income, but these are not expected to threaten the pace of economic growth in the next few years.

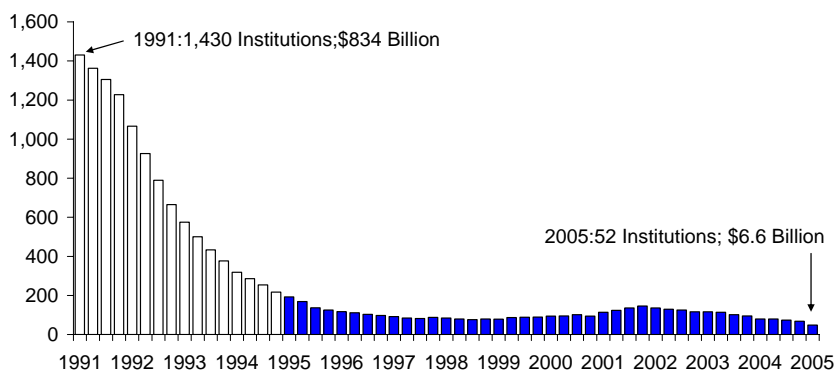
Despite the solid banking industry performance and the strong economy, there are some risk concerns going forward. These risks include the threat posed to consumer finances by high and volatile energy prices and an emerging slowdown in housing. In addition, there may be an elevated risk of a financial market shock given historically low risk premiums and credit spreads. In the banking industry, much of the concern revolves around declining net interest margins and rising concentrations of construction and commercial real estate loans.

Banking Sector Remains Strong

Depository institutions have benefited from a solid economy, and the industry remains healthy, with key performance indicators signaling continued strength. Earnings have set five consecutive annual records, capital is at historically high levels, and asset quality remains solid. The number of institutions on the Problem Financial Institution List is at a historical low of 52 firms, holding \$6.6 billion in assets. No insured financial institution has failed since June 25, 2004, and 2005 was the first calendar year in which no FDIC-insured institution failed.

The number of FDIC-insured "problem institutions" has fallen to historical lows during this expansion.

Number of FDIC-insured "Problem Institutions"
Includes all FDIC-insured institutions rated "4" or "5" by examiners.



Source: FDIC

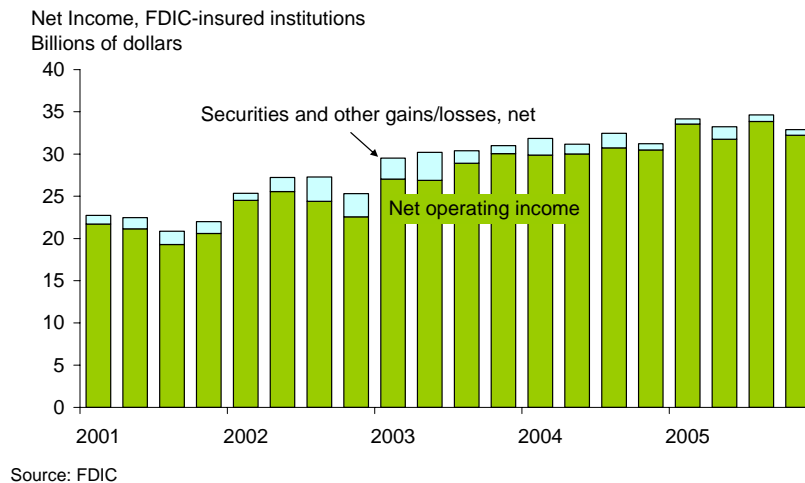
Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

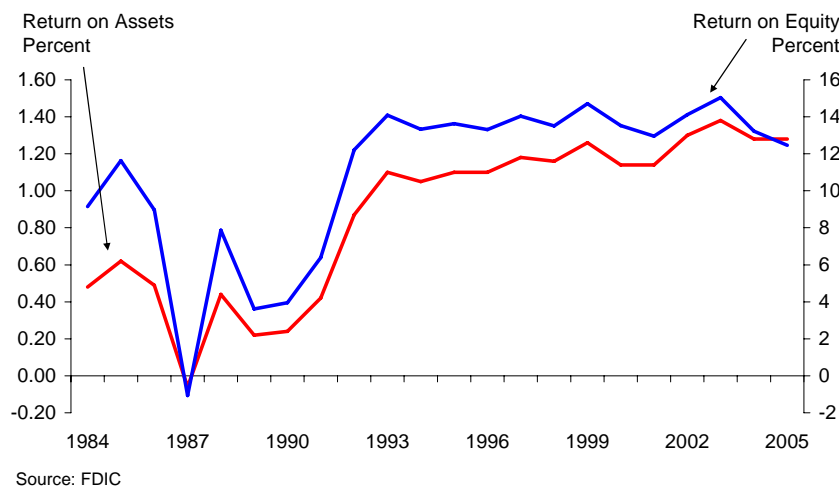
In 2005, the banking industry reported a fifth year of record earnings. The majority of profit growth in 2005 was derived from growth in net interest income. While narrower margins weighed on net interest income, this effect was more than offset by strong asset growth of 8 percent. Net loan growth of 10 percent in 2005 was down modestly from a 13 percent increase in 2004.

In 2005, bank earnings set a record for the fifth consecutive year.



The industry's two primary indicators of profitability remain at or near their recent highs. Return on assets (ROA) for 2005 equaled the 2004 performance of 1.28 percent. However, return on equity (ROE) trended lower, decreasing from 13.22 percent in 2004 to 12.46 percent last year. This decline in ROE reflected a strong year-over-year increase in the industry equity capital ratio to 10.29 percent—the highest since 1939. More than 99 percent of insured institutions and more than 99 percent of industry assets were in the highest regulatory capital category as of year-end 2005.

Profitability remains historically strong, but slightly lower than the industry highs set in 2002 and 2003.



Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

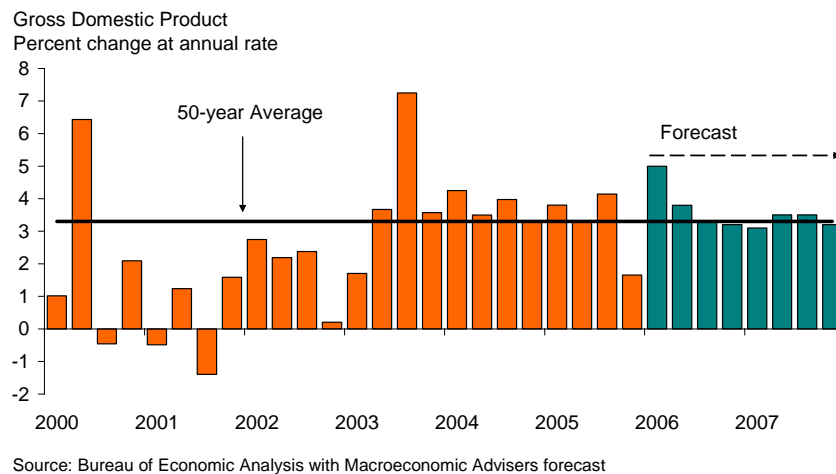
May 9, 2006

Asset quality in the industry remains solid. Although net charge-offs and noncurrent loans increased in the fourth quarter of 2005, these increases appear to be linked primarily to last year's changes in the consumer bankruptcy law and new accounting rules for GNMA-securitized mortgages. Despite a few exceptions, overall loan performance remains strong historically, and reserves continue to ease. At year-end 2005, FDIC-insured institutions held only \$1.15 in reserves for every \$100 of loans and leases on their books, the lowest level in more than 20 years.

U.S. Economic Expansion Continues

The U.S. economy appears to be performing well heading into the second quarter of 2006. Real GDP likely expanded at a 4 to 5 percent annualized rate in the first quarter and has grown at a healthy 3.5 percent pace over the past two years. Following a strong first half, many professional forecasters expect real GDP growth to move toward its long-term trend of 3 to 3.5 percent between the second half of 2006 and the end of 2007.

U.S. economic growth is expected to continue at its historical rate.



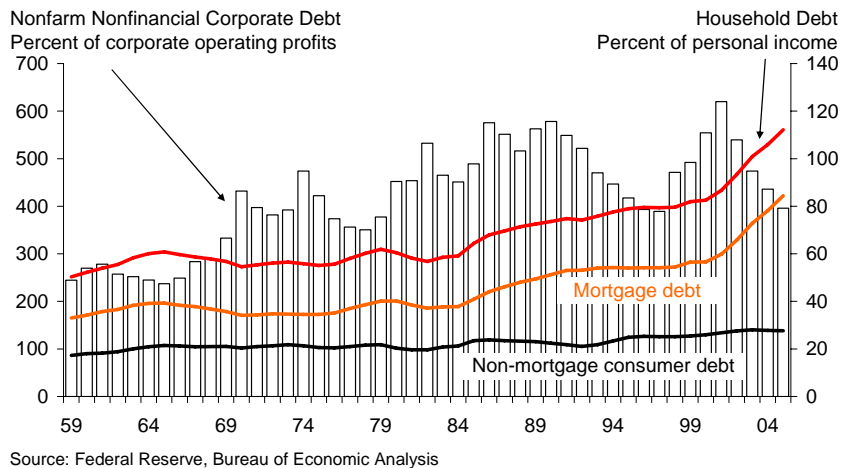
The corporate sector is in particularly healthy shape. Corporate profits currently make up over 11.5 percent of GDP, the highest proportion since the 1960s. Corporate balance sheets are strong. Businesses have pared their debt down to very low levels and are well positioned financially to maintain recent investment and hiring levels. Consumer balance sheets have benefited from the sharp rise in home equity experienced by most homeowners over the past five years. Still, personal saving was negative in 2005 for the first time since the 1930s, while overall consumer indebtedness and housing-related debt service costs have reached new highs. Moreover, although total real wages are rising because of steady job growth, average wages have lagged inflation for the past two years. Consumer budgets are under increased pressure from rising energy prices, but record liquidation of home equity in 2005 provided an offsetting buffer. The estimated \$444 to \$600 billion in cashed-out home equity even trumped the \$375 billion growth in disposable income last year.¹ Should household wealth be reduced or even grow at a slower pace, consumer spending and debt service capability may come under increased pressure from high energy costs.

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

Corporate debt as a share of profits has moderated in recent years, while consumer debt-to-income has risen to new highs.



Inflation remains historically modest even though an ongoing uptrend in global energy prices accelerated late in 2005. U.S. oil prices surged 36 percent in 2005, the largest percentage gain in several years. Despite this surge, the consumer price index has recently posted year-on-year gains of just under 4 percent—not much above its 20-year average annual growth rate of 3 percent. Furthermore, there has been little pass-through of higher energy costs to the prices of non-energy goods and services. Most non-energy price measures show year-on-year gains of 2 percent or less during early 2006.

Between June 2004 and March 2006, the Federal Reserve steadily raised the federal funds rate from 1 percent to 4.75 percent. The Federal Reserve may continue to increase short-term rates on any signs that economic growth is accelerating or that inflationary pressures are accelerating or are spreading beyond energy. In April 2006, futures markets were priced for one to two more short-term interest rate increases over the near term. Long-term rates are also starting to move higher, partly in response to rising global interest rates. To date, rising interest rates have not weighed significantly on the overall pace of economic growth.

Risks to U.S. Economic Growth and the Banking System

Although both the economy and banking industry are expected to remain in strong shape over the medium term, a number of downside risks exist. These risks include, but are not limited to, continued high energy prices or further energy price spikes; a disorderly or pronounced decline in home prices; or a sudden shock that creates financial market dislocations, such as a sharp upward spike in interest rates.

Energy Risks

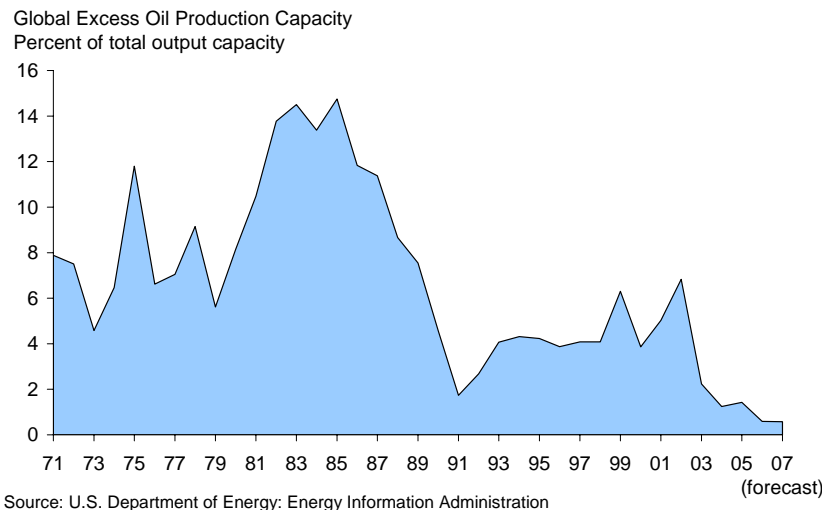
Energy price spikes affect the economy in three ways. First, they may cause a temporary lull in activity, as confidence and spending are curtailed. Second, they can divert spending away from other goods and services. Finally, higher energy prices may increase inflation expectations. Econometric simulations indicate that economic growth may be resilient to oil prices as high as \$100 per barrel. The U.S. economy already has absorbed the tripling in oil prices over the past five years with a surprisingly low level of disruption.

The gain in energy prices in recent years largely arose from growing global demand in the face of limited investment in production and refining capacity. As a result, the world currently has historically low levels of excess production capacity available to offset supply disruptions, such as terrorist acts, war, severe weather, or

Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
May 9, 2006

labor strikes in key producing regions. Because there is little spare capacity to absorb these supply disruptions, energy prices are likely to spike should these events occur.

Tight global capacity could lead to further energy price spikes.



Hurricanes Katrina and Rita provide an example of how a supply-disrupting shock can lead to much higher energy prices. However, unlike the 1970s OPEC oil embargo price shock, the economic effect of the hurricane-induced spike has been somewhat muted. This is due to the fact that the U.S. economic activity is only half as energy-intensive as it was during the 1970s. Another source of concern is that rising energy prices will at some point pass through to the prices of non-energy goods and services. There has been little evidence of this outcome thus far. Total consumer prices rose 3 to 4 percent in early 2006 from a year earlier, but prices excluding energy increased by only 2 percent.

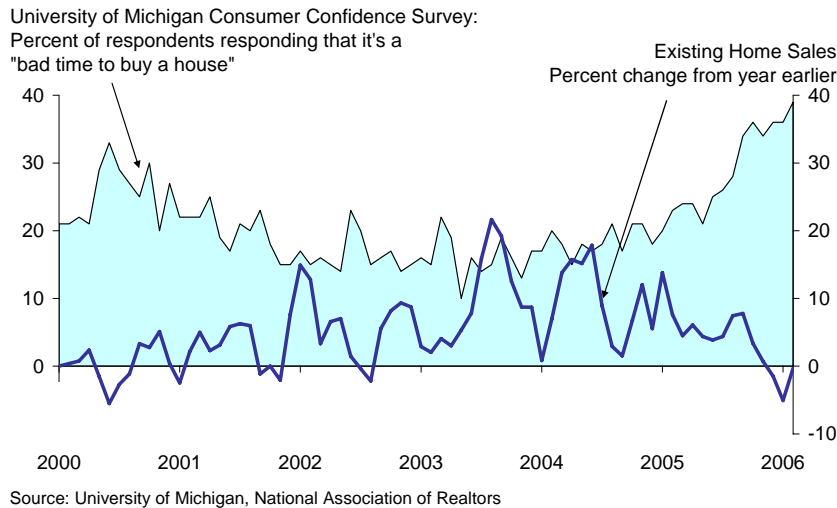
Housing Risk

The United States has experienced an unprecedented housing boom in recent years. As of 2005, we estimated that there were a record 89 cities with “boom” real estate conditions, in which home prices, after inflation, had appreciated by at least 30 percent during the prior three years.² Certain markets have seen exceptionally large gains in home prices. For example, in the past five years, average home prices have more than doubled in the District of Columbia, California, and Rhode Island. Moreover, by some estimates as much as one full percentage point of real GDP growth during 2005 could be attributed to the combined effects of housing investment and rising housing wealth.³ Over 20 percent of new jobs in 2005 came from the construction sector alone. Banks have benefited from the boom through rapid loan growth and servicing fees associated with mortgage underwriting, equity liquidation, and new construction lending.

However, buyers are facing increasing budget pressure as home prices continue to escalate. The number of respondents to the University of Michigan Consumer Confidence Survey saying that it is a “bad time to buy a house” has reached a five-year peak, and the number saying that it is a bad time to buy a house specifically because prices are too high is the largest since 1978. Weakening home sales volumes and rising inventories of unsold homes further attest to the slowdown in housing that has begun to emerge.

Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
May 9, 2006

Home buyer skittishness is weighing on home sales.



A slowing housing sector presents two primary risks to the economy. First, to the extent that the record liquidation of homeowner equity in the past few years has *induced* consumers to spend more (this assertion continues to be debated, see below), then consumer spending may come under pressure as home prices stop rising rapidly—spending may be especially harmed should home prices decline outright. Second, jobs and income generated by the housing boom are likely to decline with the slowdown in housing. A housing slowdown will directly reduce realtor commissions and job growth in industries related to housing, such as construction and realty services.

On the first point, there is some disagreement among analysts that the rapid accumulation of housing wealth has fueled more spending than otherwise would have occurred without a home price boom. Consumer surveys suggest that roughly one-third of liquidated equity is used to fund consumer purchases.⁴ The critical question, though, is would these purchases have been made anyway, but financed by other borrowing, were home equity lines of credit or refinancing opportunities not available? If the recent level of home equity liquidation has just reflected a rational financing choice, given the tax-favored status of mortgage borrowing and increasing ease of access to mortgage credit, then consumer spending growth may not be significantly curtailed as the housing market slows. Moreover, if the surveys are accurate, then two-thirds or more of the recent liquidation of equity has likely gone to pay down existing debt (a form of saving) or to fund investment in second houses or other assets.

As the recent economic boost provided by the housing boom winds down, the economy may become more vulnerable to recession. However, at this juncture it seems likely that, absent a significant reduction in employment or incomes, the emerging housing slowdown itself will not be a proximate cause of recession in 2006 or 2007.

Financial Market Shocks

Investors recently have been demanding far lower rates of return for risk than they have in the past. In recent years, real interest rates have been at some of their lowest points since 1980—a time when many interest rates were highly regulated. Furthermore, spreads between safe assets, like U.S. Treasuries and highly-rated corporate bonds, and riskier assets, such as high-yield corporate and emerging market debt, have all narrowed

Economic Conditions and Emerging Risks in Banking

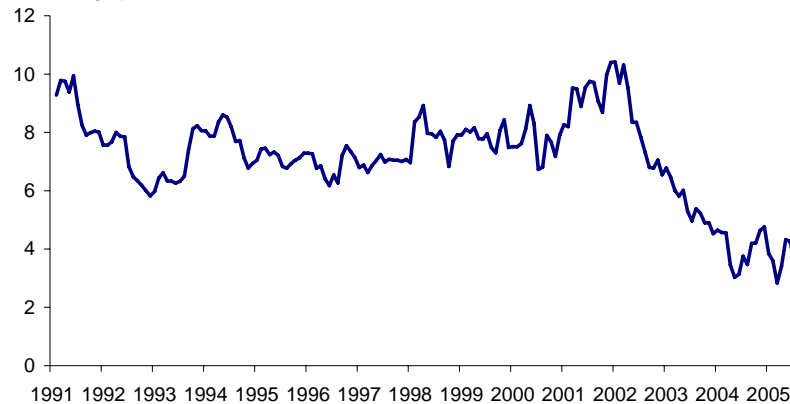
A Report to the FDIC Board of Directors

May 9, 2006

over the past few years. For example, the yield on bonds in the Standard and Poor's Kennybase (KBD) high-yield corporate bond index hit an all-time low in early 2005 and stayed low through early 2006.

Investors are taking on more and more risk: real yields on high-yield corporate bonds are at 15-year lows.

Yield on KBD high-yield corporate bond index less inflation
Percentage points

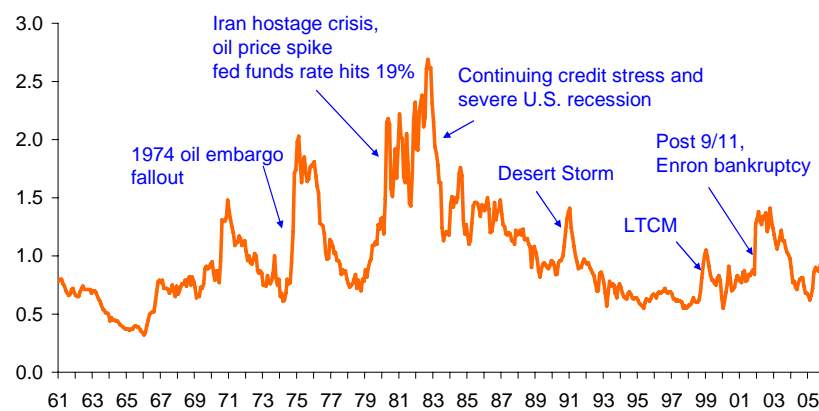


Source: Bloomberg, Bureau of Economic Analysis

The currently low risk spread may not be stable. The risk spread has been known to jump up suddenly during periods of turmoil, causing disruption to financial markets and leading to big swings in interest rates. An unexpected shock could produce a “flight to quality” response by investors and could quickly dry up the supply of available credit to riskier borrowers.

Risk spreads can spike very quickly in the case of a shock.

Credit Spread (BAA yield less AAA yield)
Percent



Source: Federal Reserve

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

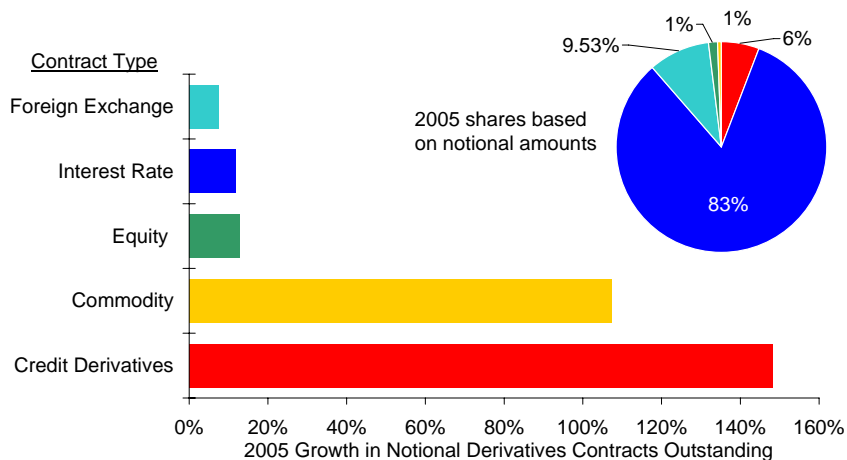
Risks Arising from the Banking Industry

Although economic or financial market disruptions are a key source of risk to the banking industry, some recent trends within the industry itself also merit scrutiny from a risk-management perspective. Some of these risks are discussed below.

Credit derivatives present operational as well as market risks

Credit derivatives, which give market participants a means to either hedge or expand credit risk exposure, have grown dramatically in the past five years and could pose both operational and market risks. The International Swaps and Derivatives Association (ISDA) reported that the credit derivatives market rose by 105 percent last year. On a notional basis, credit derivative contracts outstanding totaled \$17.1 trillion as of year-end 2005. The notional amount of credit derivatives reported by insured institutions has increased more than ten-fold over the past five years, while the total volume of all derivatives has increased approximately 2.5 times. Insured institutions and their subsidiaries reported total notional credit derivatives holdings of \$5.8 trillion as of year-end 2005. However, credit derivatives still represent a relatively small share of total derivatives on insured institution books, at just 6 percent as of year-end 2005. Interest rate swaps, at 83 percent of the total notional amount, remain the dominant exposure category.

Interest rate contracts comprise the bulk of bank-held derivatives, but credit derivatives are the fastest growing category.



Back office procedures for credit derivatives have lagged the explosive growth in demand for these instruments. Credit derivatives remain largely customized contracts, and the lack of standardization and reliance on manual processes increases the likelihood of processing and data entry errors. This manual process puts market participants at risk of being overwhelmed by transactions in the event of a large corporate default. It should be noted that as of March 15, 2006 the International Swaps and Derivatives Association reported that 91 percent of transactions *are* confirmed within the preferred five-day time period.

In late 2005, the Federal Reserve Bank of New York (FRBNY) garnered commitments from 14 major credit derivative market participants to improve their processes.⁵ In a press release dated February 12, 2006, the FRBNY indicated progress had been made by major industry participants to improve the processing of credit derivatives, including the reduction of the backlog of unconfirmed trades and improvement of the credit default settlement process.⁶

Economic Conditions and Emerging Risks in Banking

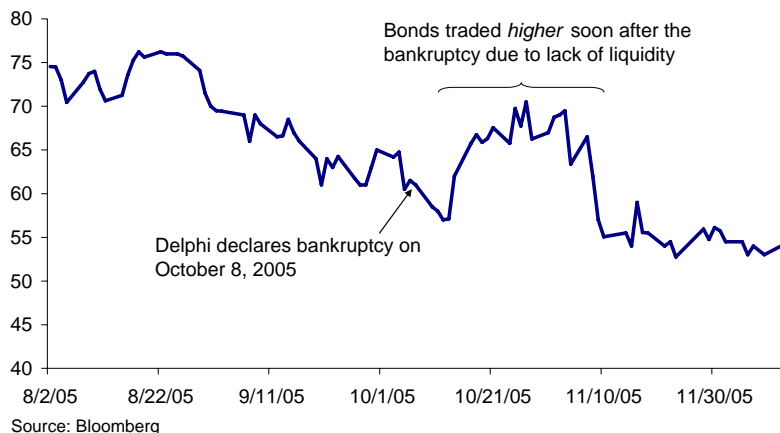
A Report to the FDIC Board of Directors

May 9, 2006

Improvement of the credit default settlement process is vital. Because of the growth in credit derivative contracts, market anomalies have occurred when corporations default or declare bankruptcy. A prime example is how corporate bonds of Delphi Corp. actually increased in value as traders bid up the price of bonds in order to physically settle credit derivative contracts. Industry participants are committed to implementing new procedures for settlements following a credit event, providing for net cash settlement at a single auction-based price.

Delphi corporate bonds spiked soon after bankruptcy as traders scrambled to make good on credit default swaps.

Price of Delphi 7 1/8, 30-year Bonds
Dollars per \$100 par value



Large settlements and emphasis on BSA compliance highlight operational, reputation, and compliance risks

Preventing fraud is a critical area of operational risk. The extent of insider fraud is evident in the Federal Bureau of Investigation's (FBI) May 2005 Financial Crimes Report to the Public, which estimates that 80 percent of all reported fraud losses involve collaboration by industry insiders. In the same report, a recent analysis of mortgage fraud surveys identified 26 different states as having significant mortgage fraud problems. Given the recent housing boom and corresponding surge in mortgage loans, mortgage fraud has become an increasing concern for mortgage bankers and regulators.

Financial institutions have increased their filings of suspicious activity reports and spent additional resources on Bank Secrecy Act (BSA) compliance, anti-money laundering, operational risk, and fraud detection; however, large fines are still being levied against institutions for noncompliance in these areas. With the regulatory focus on operational risk, financial institutions will continue to dedicate staff and funding to manage this risk area.

The industry faces varying degrees of net interest margin compression

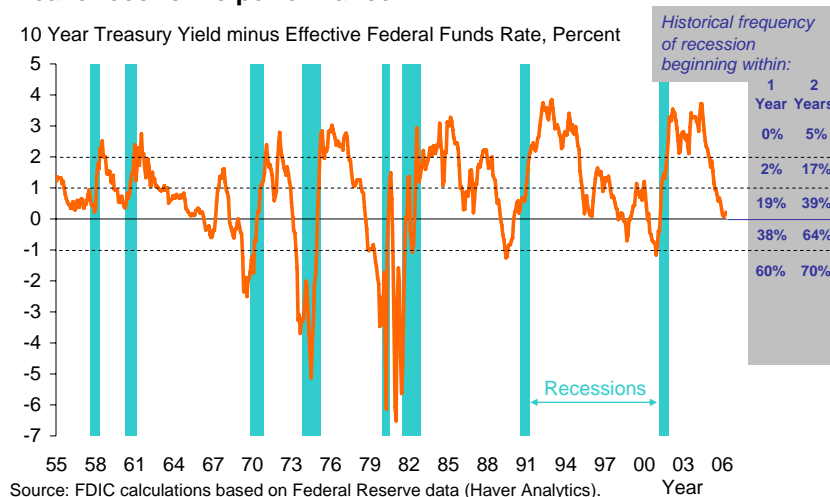
The yield curve has flattened since June 2004, as long-term interest rates remained steady in the face of rising short-term rates, squeezing net interest margins (NIMs) for many lenders. Many forecasters expect that further interest rate increases are likely to be spread evenly across the yield curve, thus maintaining a relatively flat structure through 2007.⁷

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

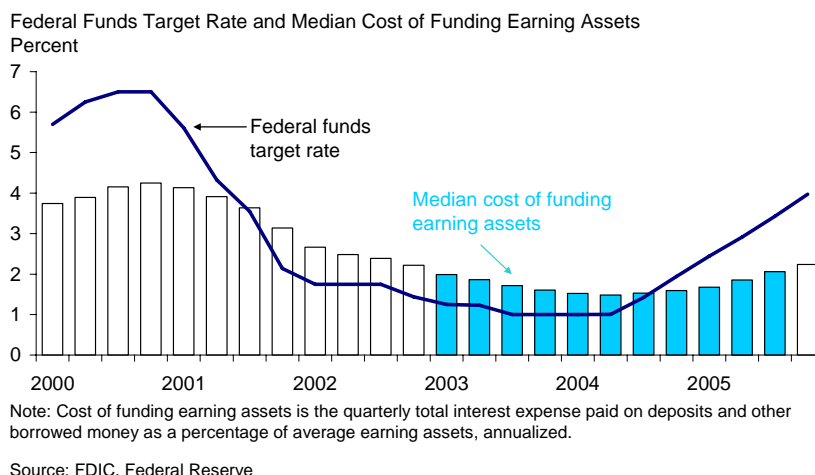
May 9, 2006

A flat or inverted yield curve has often preceded periods of weaker economic performance.



The cost of funding earning assets has been rising since the Federal Reserve began raising short-term interest rates in mid-2004. Asset yields have also been rising, especially for loans tied to short-term interest rates, such as LIBOR. But the effect on NIM has varied across the industry, as some FDIC-insured institutions have seen their funding costs rise more rapidly than their asset yields.

The cost of funding earning assets is trending upward, following the increases in the federal funds rate.



Although the 2005 NIM for the industry as a whole slipped to 3.49 percent from 3.53 percent in 2004, 55 percent of institutions actually reported higher NIMs last year. Large institutions are much more reliant on non-core, market-based funding sources than community banks. In 2005, banks with assets of at least \$10 billion derived 42 percent of their funding from non-core sources, versus only 22 percent for smaller FDIC-insured institutions. These market-based liabilities tend to reprice more readily than core deposits. As a result, large banks have seen their cost of funds rise more rapidly than have smaller banks. Since large bank asset yields have not risen faster than community bank yields, the median large bank NIM has declined in recent years, while the median for smaller banks has risen.

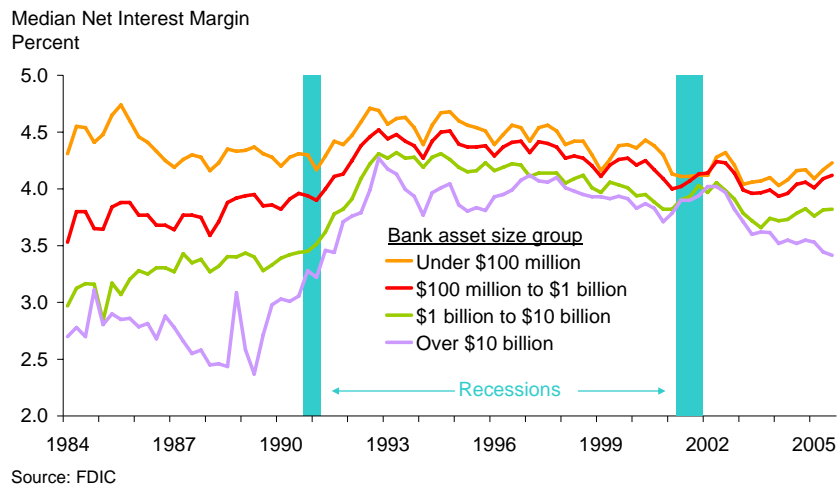
Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

Many mortgage lenders of all asset sizes also have seen increasing NIM pressure because of the flattening yield curve, which has capped asset yields on fixed-rate mortgages.

The largest institutions have experienced net interest margin compression.

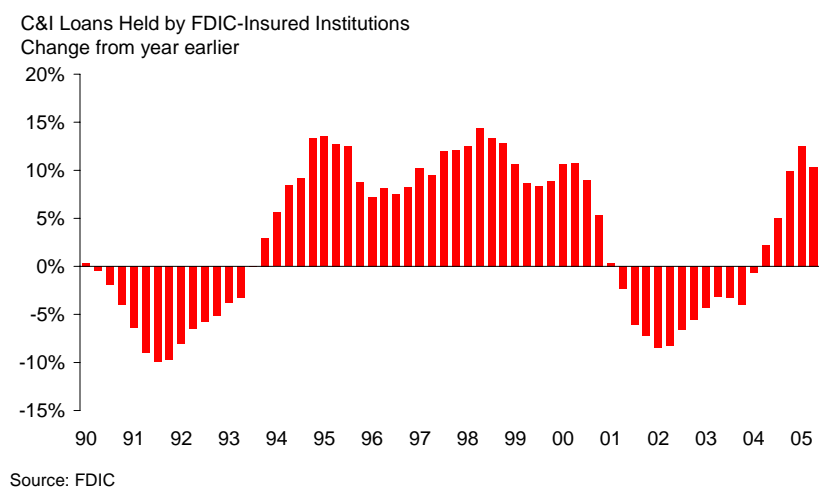


Although community institutions have generally been able to avoid NIM compression by lagging the repricing of their core deposit liabilities, a persistently flat yield curve will increasingly bring NIM pressures to bear on these institutions, as well.⁸

Commercial credit quality is only beginning to show modest deterioration

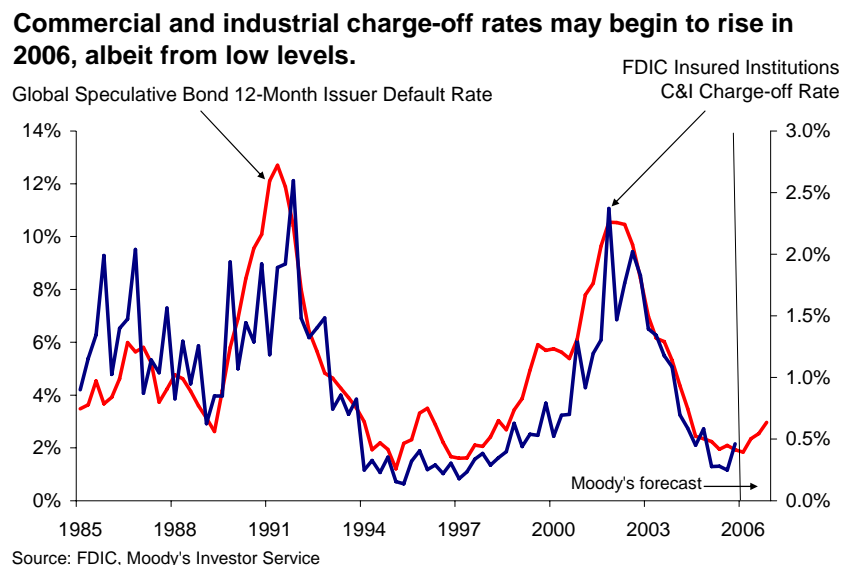
After a slow start in the current economic expansion, growth in commercial and industrial credit has accelerated, rising a strong 12 percent in 2005. Additionally, commercial lending outpaced growth in consumer lending during 2005, reversing the trend of the past two years. Increased business loan demand parallels the larger contribution that business investment has made to GDP growth during this period.

Growth in commercial and industrial loans continues to recover to more normal levels after a slow start in this expansion.



Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
May 9, 2006

Although the exceptionally good corporate profit situation makes the credit outlook positive for most commercial borrowers, there are some exceptions. For example, the airline and automobile industries have had well-publicized problems and do not appear poised for significant improvement over the near term. Also, even though commercial and industrial loan charge-off rates are at their lowest level in a decade, default rates are just beginning to increase. Nevertheless, based on the historical evidence of multi-year commercial credit performance cycles, any major credit stress in this part of the loan portfolio may not become evident for several years.



Consumer and mortgage lending not likely to see large-scale defaults through 2007

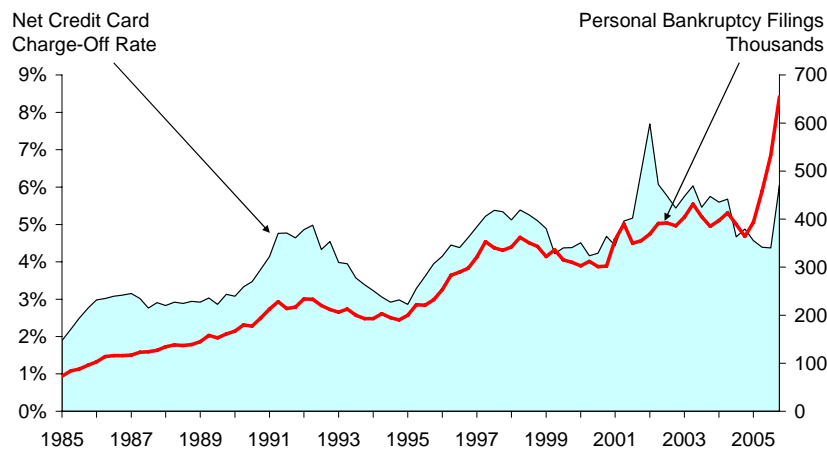
The trend toward higher levels of consumer debt and debt service appear to be indicative of ongoing structural changes in the economy, such as the democratization of credit. These trends may suggest that average consumer loss rates may rise in the future, as more marginal borrowers qualify for credit. Despite these long-term, secular trends, there are few signs of cyclical consumer credit stress at present. For example, even the upturn in credit card charge-offs in late 2005 largely reflected the result of changes in federal bankruptcy law—changes which resulted in a rush of preemptive filings late last year. Higher mandatory minimum monthly payments could also weigh on credit card charge-offs during 2006. Total consumer net charge-offs increased to \$7.6 billion in the fourth quarter of 2005. This was a nominal record and up \$920 million from one year earlier. But this increase was driven by a \$1.1 billion increase in net charge-offs on credit card loans; absent the increase in credit card losses, consumer charge-offs in the fourth quarter would have been \$206 million *lower* than a year earlier.

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

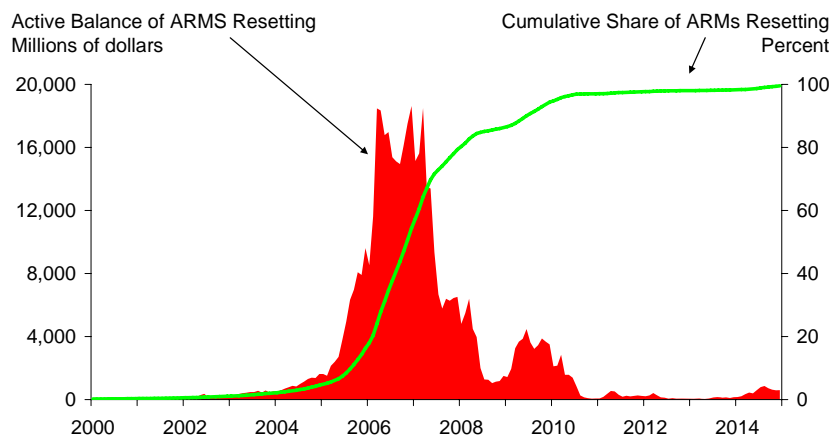
Credit card losses surged in fourth quarter 2005.



Source: FDIC, Administrative Offices of the United States Courts

As housing markets continue to cool in 2006, demand for mortgage loans may decrease. Credit quality also may suffer for those homeowners with little equity and those that may have cash flow difficulties when introductory teaser-rates reset. There are signs that borrower cash flows already may have been stretched by reduced housing affordability in 2005, including the rising popularity of innovative, low-payment, and low/no down payment mortgages. For instance, subprime mortgages accounted for a bigger share of mortgage originations in the past two years, while interest-only mortgages became more popular among subprime borrowers.⁹ Mortgage interest-rate resets are expected to increase in frequency over the next few years. These rate resets are most likely to negatively affect the credit quality of subprime adjustable rate mortgages (ARMs), especially those with high leverage, as well as ARMs underwritten with very low introductory teaser-rates or those allowing for negative amortization.

Subprime ARMs will see a surge in interest rate reset activity in the next two years.



Source: Loan Performance Corporation (nonprime database)

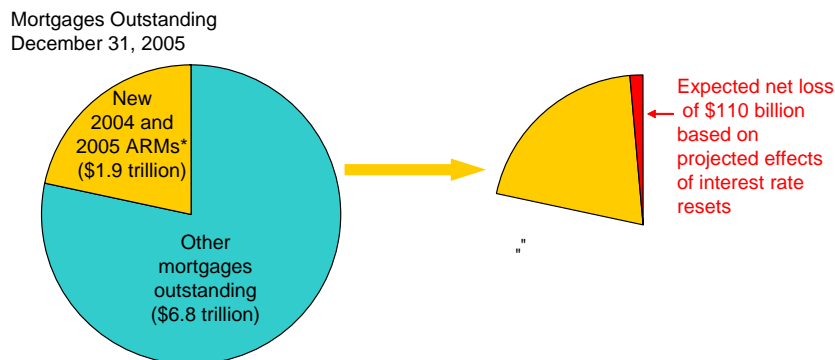
Despite this risk, one recent study indicates that nontraditional mortgage products may not represent a widespread, severe credit risk to the industry.¹⁰ Although ARMs originated in 2004 and 2005 account for just over one-fifth of all mortgages outstanding, or nearly \$2 trillion, the actual risk they pose may be much lower.

Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
May 9, 2006

A more narrow risk focus would consider just those loans where a rate reset renders a homeowner unable to make the monthly payment, or where a lack of sufficient equity makes it difficult to sell without a loss or refinance into a less costly mortgage. These loans represent roughly \$370 billion in outstandings, or 4.3 percent of all mortgages, and may ultimately result in just \$110 billion in net loan losses for the mortgage industry. In addition, it is likely that any foreclosures associated with these troubled mortgages will be spread over a number of years, and losses will be borne not just by banks, but also by investors in privately-issued mortgage-backed securities.

It should be noted that this analysis assumes the United States avoids a recession in the next few years. Should rate resets occur while employment and incomes are flat or declining overall, then mortgage defaults and foreclosures are likely to be worse than expected. Also, even though total losses may not be sufficient to cause an industry-wide problem, mortgage stress resulting from rate resets could be concentrated among certain FDIC-insured institutions and in specific geographic areas.

Interest rate resets for recently underwritten ARMs may not represent a systemic economic or banking risk.



Sources: "Mortgage Payment Resets: The Rumor and the Reality," Christopher L. Cagan, First American Real Estate Solutions, February 8, 2006, Federal Reserve
*Original balances

A relatively small number of institutions have significant exposure to the option-ARM niche. However, a recent survey of 10-K filings of the largest participants in this market shows a marked increase in negative amortization, as some borrowers defer interest and make only minimum payments. One large insured institution noted the final payment of the year resulted in negative amortization for 47 percent of its option-ARM borrowers. For the top option-ARM lenders, income from deferred interest and negative amortization made up as much as 60 percent of profits.¹¹

Construction loan growth is strong and concentrations are rising

The expected slowdown in housing during 2006 also potentially affects bank construction and development (C&D) lending. C&D lending exploded in 2005, surging 33 percent. This pace was the swiftest since 1986. Anecdotal reports suggest that up to one-half of recent C&D activity in some markets is funding residential construction. If demand for new homes slows significantly, lenders could see demand for C&D loans diminish, curtailing a lucrative revenue stream. Lenders could also face asset quality problems, should struggling builders run into debt services difficulties.

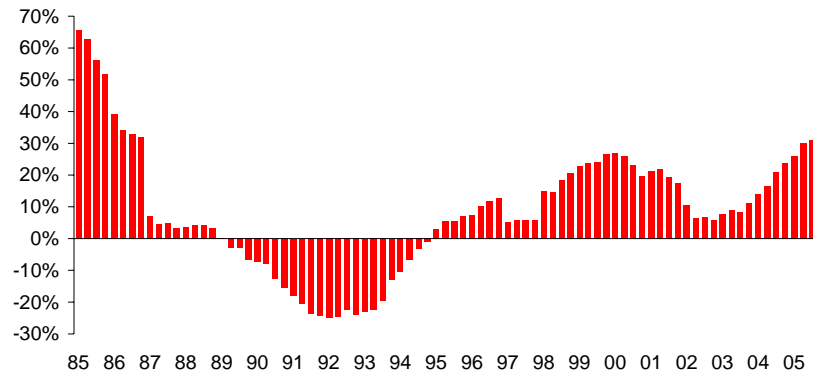
Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

Construction and development loans are growing at their fastest rate since 1986.

Construction and Development Loans Held by FDIC-Insured Institutions
Change from year earlier

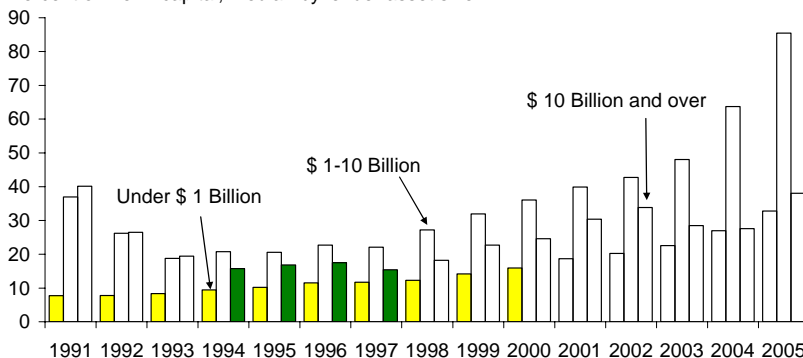


Source: FDIC

The percentage of the industry with elevated C&D concentrations is increasing rapidly, as well. More than two times as many institutions report C&D loans in excess of 100 percent of Tier 1 capital than did so in 1991. Moreover, institutions with total assets between \$1 and \$10 billion report significantly higher C&D concentrations than their counterparts. Many of these institutions may lack geographic diversification.

Construction concentrations are significantly higher at mid-sized institutions.

Construction & Development Loan Concentrations
Percent of Tier 1 capital, median by lender asset size



Source: FDIC

Note: All data reflect year-end totals. Construction loans are construction, land development, and other land loans secured by real estate.

Commercial real estate loan concentrations also high and rising

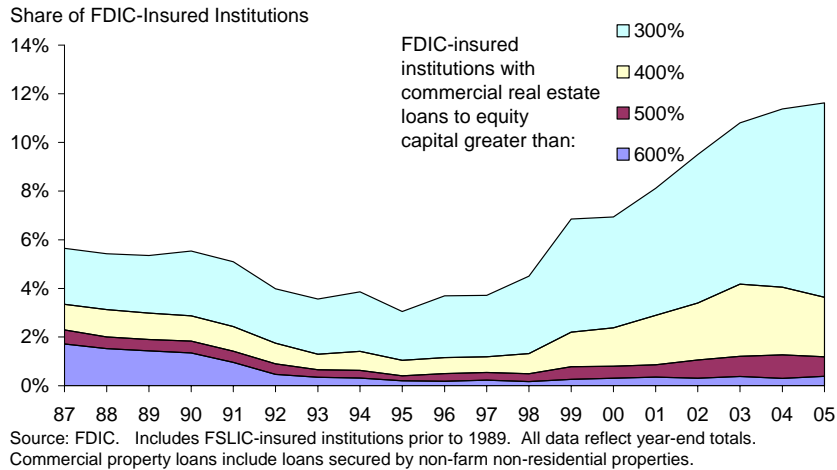
Concentrations for commercial real estate (CRE) have risen to new highs by some measures. The share of FDIC-insured institutions with CRE holdings in excess of 300 percent of total capital is now well beyond the level seen before the commercial real estate crisis of the late-1980s. Like C&D lending, in recent years CRE concentrations have increased the most at mid-sized banks with assets between \$1 and \$10 billion.

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

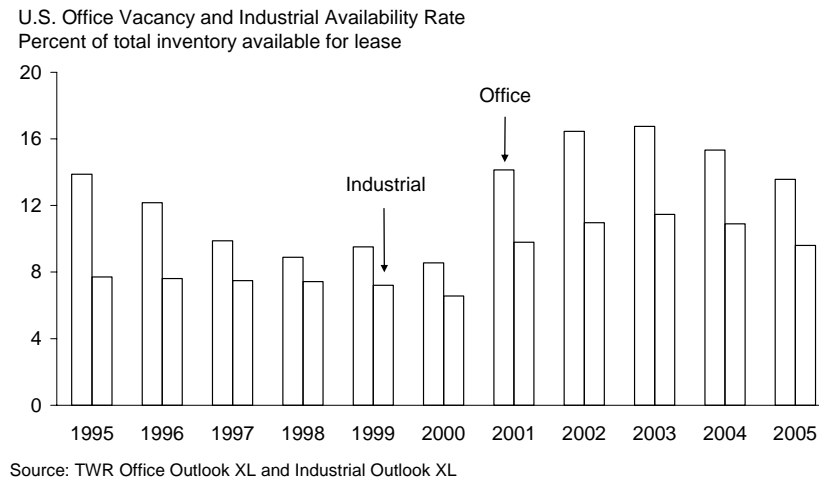
May 9, 2006

The prevalence of high commercial property concentrations to capital now exceeds levels of the late-1980s.



At present, CRE industry fundamentals are improving. Vacancy rates are generally declining and rents are rising. Poor industry fundamentals in recent years also were offset by low interest rates and strong investor demand; both of these factors acted to reduce cap rates. Lower cap rates in turn pushed up the sales prices of commercial properties, offering struggling owners an exit strategy of selling their properties to pay off delinquent loans.

Office vacancy and industrial availability rates continue to fall, but remain above the lows of 2000.



Nevertheless, increasing CRE concentrations raise concern should some unforeseen shock harm rents or sale prices, or result in sharply higher interest rates. A dollar collapse could result in a situation where weaker CRE fundamentals (rising vacancy rates, falling rents) occur in an environment of rising interest rates. This would simultaneously act to reduce cash flow, lower debt-service coverage ratios, lower property values, and raise leverage, thus limiting refinancing opportunities and reducing the ability to sell properties at prices sufficient to pay off any nonperforming loans. There are other potential shocks that could harm property values, and property cash flows simultaneously or in tandem, such as a pronounced energy price spike that leads to higher interest rates alongside rising inflation. It should be noted that the CRE market has evolved significantly since

Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
May 9, 2006

the early 1990s. Improved data on industry conditions, increased public funding from investment trusts, better pricing and underwriting standards, and increased levels of securitization have likely reduced and diversified CRE credit risk in recent years.

Proposed regulatory guidance intended to address emerging risks

Even though recent credit performance has been strong, regulators have proposed new guidance to financial institutions in response to increased growth in nontraditional mortgage products and rising CRE and construction concentrations. In addition to addressing the issue of negative amortization and possible payment shock for some borrowers, the proposed regulatory guidance on nontraditional mortgages seeks to mitigate the risks associated with reduced documentation loans, simultaneous second liens, and the combination of these factors with a nontraditional mortgage. The guidance seeks to ensure that consumers are properly informed of both the benefits and risks associated with complex mortgage products. Because of rising construction and CRE loan concentrations, regulators also have proposed guidance that encourages strong risk management practices, sound underwriting standards, and capital levels commensurate with the risk of these loans.

Impact of Hurricanes Katrina and Rita

The aftermath of hurricanes Katrina and Rita is not expected to have a significant overall effect on the deposit insurance funds. All institutions in the affected area are either well- or adequately capitalized for purposes of prompt corrective action as of year-end 2005. The FDIC has narrowed its focus from an initial group of 120 institutions in the affected area to a small group of institutions that we continue to monitor closely. The prospects for the financial institutions most affected will depend in large measure on efforts underway to rebuild and revitalize the communities these institutions serve. Many institutions have opened temporary branch offices since the disasters; 45 were in operation as of March 9, 2006. As displaced residents decide whether to return to their homes, bank managers will have to determine if their business models are still effective and make judgments about the many lingering uncertainties.

Long-Term Issues

Finally, this report briefly highlights a few key issues that will affect the economy and banking industry beyond the immediate 24-month timeframe of the preceding risk discussion. Some aspects of these issues could come to the forefront during the next two years in the event of a severe shock.

High consumer indebtedness

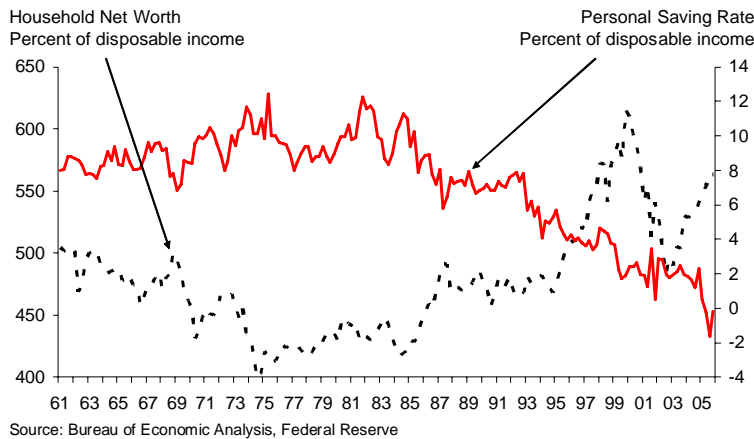
The United States has seen a secular decline in its personal saving rate over the past 25 years. The personal saving rate dipped into negative territory in 2005 for the first time since the Great Depression. This decline has been offset by, and may be a rational reaction to, growing household net worth, particularly in the form of housing equity.

Economic Conditions and Emerging Risks in Banking

A Report to the FDIC Board of Directors

May 9, 2006

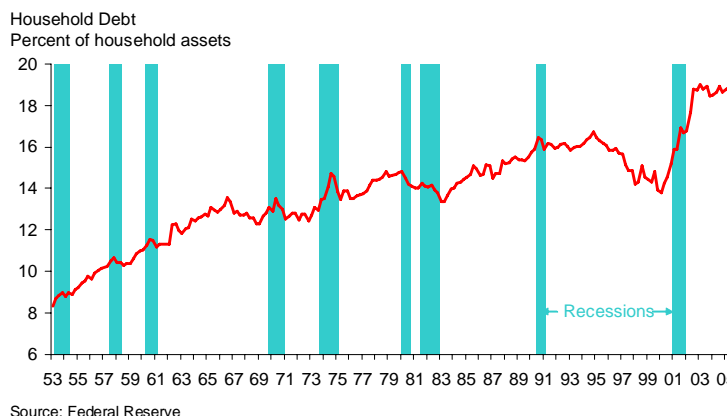
The sharp decline in the saving rate since the early 1990s was motivated by rising wealth.



However, because homeowners must borrow in order to use this equity, total U.S. consumer indebtedness has risen to historical highs in recent years. This increased leverage likely reduces the financial flexibility of the consumer sector overall. Should some event, such as a recession, significantly curtail job and income growth, the negative saving rate, coupled with a potential reduction in housing wealth, may result in significant credit stress for many households.

The widening, record U.S. trade deficit is a symptom of the strong growth in consumer spending in recent years. As more debt has been taken on, spending has been able to outpace domestic income and production growth, reinforcing the nation's rising structural emphasis on imported goods and services. This unprecedented trade deficit also increases the nation's reliance on funding from foreign investors and governments. Should foreign investment inflows be curtailed, especially in an abrupt way, then domestic interest rates and inflation could rise significantly. Such a spike in interest rates and inflation could potentially induce a recession.

Consumer leverage has been rising for decades, but surged in the past five years.



Economic Conditions and Emerging Risks in Banking

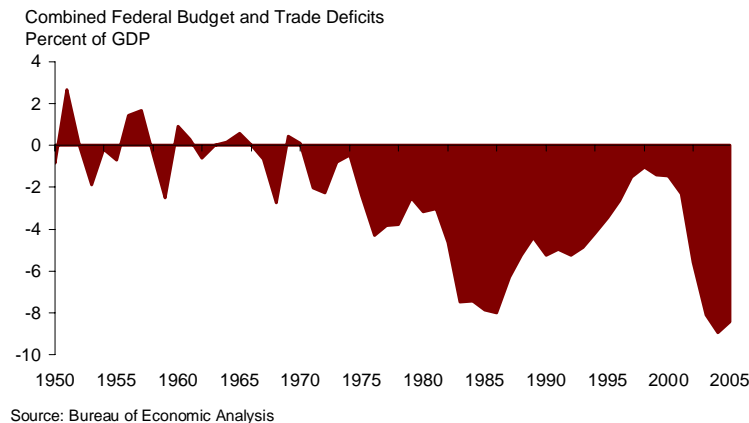
A Report to the FDIC Board of Directors

May 9, 2006

Evolving federal budget risks

The lack of personal saving is compounded by a lack of federal government saving, which is evident in the elevated U.S. government deficit. Combined, the “twin” trade and government budget deficits are near a record share of GDP. The twin deficits accounted for 8.4 percent of GDP in 2005, down modestly from the 8.9 percent record hit in 2004.¹² The decline last year was due to an easing in the federal budget deficit to 2.6 percent of GDP.

The near-record “twin deficits” reduce the financial flexibility of the United States.



The government budget deficit is particularly problematic over the long run, given the increasing burden of paying for federal entitlement programs. By some estimates, if no changes are made to current programs, Social Security, Medicare, and Medicaid, plus federal debt payments, could consume 100 percent of federal government revenues by 2040.¹³ Since this is an unlikely outcome, the coming years are likely to see a combination of lower entitlement benefits and higher taxes. This process of benefit reduction and higher taxes will raise the level of financial risk faced by U.S. citizens and businesses. This shift could elevate credit and interest rate risk for FDIC-insured institutions, but it should provide new business opportunities, as well. In the short run, ongoing budget deficits may limit the financial flexibility of the federal government in the event of a recession. Federal dissaving could impede the use of tax cuts alongside other counter-cyclical measures, such as unemployment benefits, designed to help stabilize the economy during a recession.

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A Report to the FDIC Board of Directors
May 9, 2006

Endnotes

1. The more conservative \$444 billion estimate is the sum of Freddie Mac's estimates for cash-out refinancings and increased loan balances from mortgage consolidation (\$279 billion in 2005) plus the \$165 billion gain in home equity lines of credit during 2005. The bigger estimate calculated by some analysts takes the \$1,067 billion growth in total residential mortgages in 2005 and subtracts the \$467 billion in new residential construction put in place last year.
2. For additional information, see <http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html> and <http://www.fdic.gov/bank/analytical/fyi/2005/050205fyi.html>.
3. Economy.com estimates that real GDP growth in 2005 was boosted by roughly 1 percentage point. Roughly one-half of this growth boost arose from high levels of residential construction and realtor commissions, while the other half was attributed to the consumer spending effects of increased housing wealth.
4. A recent LA Times/Bloomberg survey found that 40 percent of liquidated equity proceeds was re-invested in the house by funding improvements, 30 percent was used to pay down other debt, and the remaining 30 percent was spent.
5. Participants include Bank of America; Barclays Capital; Bear Stearns & Company, Inc.; Citigroup; Credit Suisse First Boston; Deutsche Bank; Goldman Sachs Group, Inc.; HSBC; JP Morgan Chase; Lehman Brothers Inc.; Merrill Lynch & Co.; Morgan Stanley; UBS; and Wachovia.
6. Federal Reserve Bank of New York, "Statement Regarding Progress in Credit Derivatives Markets: Second Industry Meeting Hosted by the Federal Reserve Bank of New York," news release, February 16, 2006.
7. For example, the April 1, 2006, Blue Chip Financial Forecasts publication shows a consensus view among economists that the federal funds rate should settle near 5 percent by the end of 2006 and ease slightly to 4.7 percent by late 2007. Meanwhile, the 10-year treasury note yield is forecast to stabilize at 5 percent through late 2007.
8. For more information, see "What the Yield Curve Does (and Doesn't) Tell Us," FYI: An Update on Emerging Issues in Banking, FDIC, February 22, 2006 at <http://www.fdic.gov/bank/analytical/fyi/2006/022206fyi.html>.
9. According to *Inside Mortgage Finance*, subprime loans accounted for 18.5 percent of all mortgage originations in 2004, versus 8.5 percent in 2003. Nonprime loan growth was 23 percent last year, according to SMR Research's Nonprime Mortgage Loans 2006 report. Data from LoanPerformance indicate that roughly one-third of nonprime mortgages securitized in 2005 were interest-only.
10. See "Mortgage Payment Resets: The Rumor and the Reality," Christopher L. Cagan, First American Real Estate Solutions, February 8, 2006.
11. Jodey Shenn, "Option ARMs: Disclosures And Balances Are Both & Up," *American Banker*, April 5, 2006.
12. Note: the budget deficit is calculated on an October to September fiscal-year basis, the trade deficit is calculated as of calendar year-end.
13. Office of Management and Budget, "The Nation's Fiscal Outlook," January 30, 2006, <http://www.whitehouse.gov/omb/budget/fy2007/outlook.html>.