Economic Conditions and Emerging Risks in Banking

April 11, 2002

Summary

Monitoring developments in the economy, the financial markets, and the banking industry is an essential part of risk management for the FDIC. This issue of FYI is based on a briefing delivered by staff to the FDIC Board of Directors on April 9, 2002.

The report describes recent signs of a consumer-led recovery in the U.S. economy that may have begun in the first quarter. Signs of recovery include: positive job growth, higher factory orders, rising consumer confidence, and an uptick in housing starts. However, there remains a list of negative factors that could dampen the economic recovery or even lead to another recession. Warning signs currently include: weakness in corporate profits, declining business investment, overcapacity in key industry sectors, rising commercial real estate vacancies, and high debt loads for consumers and businesses. The key to a robust economic recovery in 2002 would appear to be how households and businesses overcome these remaining difficulties (Chart 1).

Bank financial performance has remained generally strong during the recession despite higher losses on commercial and credit card loans. Going forward, the biggest single near-term risk to insured institutions appears to be subprime consumer lending. Longer-term risks involve the effects of a recent slowdown of formerly fast-growing metropolitan areas and interest-rate sensitivity at specialized residential mortgage lenders.

U.S. Economy Shows Signs of Recovery

The U.S. economy shows signs of emerging from the recession that began in April 2001. An aggressive program of monetary and fiscal stimulus during 2001 has helped to keep consumer spending strong despite the uncertainties posed by the September terrorist attacks and continued bad news from the U.S. corporate sector. Recent economic data—including job growth, manufacturing activity, housing starts, and consumer confidence—have been stronger than analysts' expectations, raising hopes for a synchronized global economic recovery led by the U.S (Chart 2). Fifty leading economists surveyed by the *Blue Chip Economic Indicators* have raised their consensus forecast for 2002 U.S. economic growth to 2.6 percent as of April 10, up from just 1.0 percent at the beginning of the year.

Obstacles Remain that Could Slow or Stop the Recovery

Amid the recent good news, however, there remain a number of factors that

call into question whether the U.S. economy will be able to generate a robust recovery in 2002. Much of the good news during the last six months has been related to consumer spending on housing and durable goods, such as autos. Personal consumption expenditures grew at an inflation-adjusted annual rate of over six percent in the fourth quarter of last year. However, this boom in consumer spending has been fueled largely by a combination of events—including the 2001 tax cut, low energy prices, and the opportunity to refinance mortgage debt at lower rates—that may not recur in the near term. In addition, consumers have incurred large amounts of new debt to maintain their spending. According to the Federal Reserve *Flow of Funds* data, the volume of mortgage and consumer debt outstanding rose by almost $1.2 trillion between year-end 1999 and 2001.

While price cutting by retailers apparently boosted sales in the fourth quarter of 2001, it did little to improve corporate earnings. Net income from continuing operations for the S&P 500 fell in the fourth quarter by 24 percent from a year ago. U.S. industries have slashed their inventories, setting the stage for higher orders later in 2002. However, industrial overcapacity and high corporate debt loads could discourage the type of large-scale recovery in investment spending that is characteristic of a strong economic recovery. U.S. factories, utilities and mines operated at less than 75 percent of capacity in the fourth quarter, the lowest ratio since 1983. Business fixed, nonresidential investment fell at an annualized rate of 13.4 percent during the fourth quarter.

There is concern that these obstacles to recovery could result in either: 1) a slow-growth recovery, or 2) a "double-dip" recession, either of which could result in a continuation of rising credit losses and slow loan growth that would impair the earnings of FDIC-insured institutions. Key ingredients of most plausible economic recovery scenarios would appear to include a recovery in corporate profits and business investment that would, in turn, help to support equity prices, job growth, and increases in consumer spending.

Banking Industry Performance Generally Solid Despite Rising Credit Losses

Bank earnings have continued to be solid in the recession. Commercial banks earned a record $74.3 billion in 2001, helped by securities gains and stable-to-rising interest margins in a falling interest rate environment. Loss provisions rose, particularly for large-bank C&I loans, helping to reduce return on assets for commercial banks to a still-healthy 1.16 percent. Credit card loan losses also rose in tandem with a record 1.45 million personal bankruptcy filings.

To the extent that credit problems tend to lag the business cycle, bank credit losses may continue to rise for a number of quarters in the future. However, at this time the industry overall appears to be well-positioned to weather the storm. Unlike the last recession, only very small number of institutions now report low ratios of capital to assets or high levels of nonperforming loans to total loans. For example, as of year-end 2001, only 55 FDIC-insured institutions reported equity capital and reserves less than six percent of their total assets, compared to 1,664 institutions at the end of 1990.

The FDIC provides a comprehensive report on bank and thrift financial performance in the Quarterly Banking Profile; the most recent issue covers the fourth quarter of 2001.

Regional Economic Weaknesses Spread During 2001

Weaknesses in bank and thrift credit quality during 2001 were generally concentrated in states along the upper and lower Mississippi Valley that rely heavily on manufacturing and that have experienced the longest period of economic weakness. However, during the second half of 2001 the economic slowdown began to spread to metropolitan areas outside the central U.S. that have higher employment concentrations in information technology and financial services. Commercial real estate markets in many of these metropolitan areas deteriorated rapidly during 2001. Bank credit exposures tend to be high in these formerly fast-growing metropolitan areas, which may well set the stage for higher credit losses in 2002.

Risks to FDIC-Insured Institutions in the Current Environment

The single most likely source of significant insurance losses related to the failure of FDIC-insured institutions in the near-term is subprime consumer lending. Some 160 FDIC-insured institutions with 6.3 percent of industry assets are currently identified by the FDIC as having subprime consumer or mortgage loans greater than 25 percent of Tier 1 capital. This group has contributed disproportionately to recent bank failures and additions to the FDIC Problem Bank List. The problems of subprime lenders have not been simply the result of loan losses that are much higher than those experienced with prime consumer loans. More troubling has been the tendency for the credit models used by subprime lenders to underpredict actual losses, as noted by FDIC examiners and other regulatory sources in recent months.[1]

Two issues represent intermediate-term risks that could materially affect industry earnings and insurance losses over the next one to three years. Early analysis of these intermediate term issues is useful in evaluating their potential for causing insurance losses and developing regulatory policies to reduce losses.

The first intermediate-term risk involves metropolitan areas that have exhibited both a significant slowdown in economic activity and where banks tend to have high concentrations of traditionally higher-risk commercial and industrial (C&I), commercial real estate (CRE), and construction loans (see Chart 3). Concentrations in these loan types increased industry-wide during the late 1990s, when rapid economic activity in a number of fast-growing metro areas included large volumes of commercial real estate and residential construction.

Why is this a concern? History shows that institutions with high concentrations of C&I, CRE, and construction loans have tended to fail at a significantly higher rate than other insured institutions.[2] These loan types tend to represent a higher degree of credit risk that can lead to higher losses when economic conditions do not meet lenders' expectations.

Thus far, the slowdown has not had a material effect on bank earnings in these markets. With the benefit of high capital levels and generally modest levels of past due loans at present, there appears to be time for lenders to adjust strategies to new economic conditions, as needed.

The second intermediate-term risk involves specialized residential mortgage lenders that have developed concentrations of long-term assets as a result of two recent waves of mortgage origination and refinancing activity that peaked in 1998 and 2001, respectively. These concentrations developed largely as a result of a strong preference on the part of households for fixed-rate mortgages. Institutions with high concentrations of these loans that have not pursued effective hedging strategies may be vulnerable to shrinking interest margins in a rising interest rate environment. While large residential lenders are more likely to manage interest rate risk through the use of sophisticated hedging techniques, a significant percentage of mortgage lenders do not. Smaller institutions evidence the greatest increase in long-term asset concentrations and appear somewhat more vulnerable to rising interest rates.

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[1] For example, see Board of Governors of the Federal Reserve System, *Senior Loan Officer Survey on Bank Lending Practices*,
January 2002, Table 1: Summary of responses from U.S. banks, pp. 13-16.
http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200202/default.htm

[2] See "Economic Conditions and Emerging Risks in Banking," FDIC Regional Outlook, Second Quarter 2001, p. 6.
http://www.fdic.gov/bank/analytical/regional/ro20012q/na/index.html

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Chart 1: Recoveries in corporate profits and business investment will be essential elements of the next U.S. economic expansion.

Chart 1A:		
Year	**Quarter**	**Year-over-Year Change in Quarterly Net Income from Continuing Operations for All S&P 500 Firms**
1996	4	14.04%
1997	1	15.13%
1997	2	10.74%
1997	3	12.89%
1997	4	7.94%
1998	1	3.63%
1998	2	3.49%
1998	3	-1.78%
1998	4	4.82%
1999	1	10.61%
1999	2	16.18%
1999	3	21.34%
1999	4	22.34%
2000	1	20.39%
2000	2	19.76%
2000	3	17.50%
2000	4	5.22%
2001	1	-7.37%
2001	2	-19.18%
2001	3	-21.56%
2001	4	-24.24%

Source: Bloomberg

Chart 1B:		
Year	**Quarter**	**Year-over-Year Change in Business Investment in Equipment and Software, in Chained 1996 Dollars**
1996	4	10.37%
1997	1	9.46%
1997	2	8.92%
1997	3	10.16%

1997	4	9.69%
1998	1	12.23%
1998	2	12.23%
1998	3	9.49%
1998	4	11.70%
1999	1	8.86%
1999	2	7.57%
1999	3	8.44%
1999	4	6.40%
2000	1	8.03%
2000	2	8.62%
2000	3	7.41%
2000	4	6.28%
2001	1	3.38%
2001	2	-1.33%
2001	3	-3.38%
2001	4	-6.36%

Source: Bureau of Economic Analysis

Chart 2: A number of signs point to economic recovery in the U.S.

Chart 2A: Employment Growth

Year	Month	Annualized Growth in Payroll Employment
2001	January	0.6%
2001	February	1.5%
2001	March	0.5%
2001	April	-1.5%
2001	May	0.4%
2001	June	-0.9%
2001	July	0.2%
2001	August	-0.5%
2001	September	-1.5%
2001	October	-4.1%
2001	November	-3.2%
2001	December	-1.0%
2002	January	-1.2%
2002	February	0.6%

Source: Bureau of Labor Statistics

Chart 2B: Consumer Confidence

Year	Month	Consumer Confidence Index (1985=100)
2001	January	115.7
2001	February	109.2
2001	March	116.9
2001	April	109.9
2001	May	116.1
2001	June	118.9
2001	July	116.3
2001	August	114.0
2001	September	97.0
2001	October	85.3
2001	November	84.9

2001	December	94.6
2002	January	97.8
2002	February	94.1
2002	March	110

Source: The Conference Board

Chart 2C: Manufacturing

Year	Month	PMI Index (50+ Shows Expansion)
2001	January	41.7
2001	February	42.0
2001	March	43.2
2001	April	43.2
2001	May	42.3
2001	June	44.3
2001	July	43.9
2001	August	47.9
2001	September	46.2
2001	October	39.5
2001	November	44.7
2001	December	48.1
2002	January	49.9
2002	February	54.7

Source: National Association of Purchasing Management

Chart 2D: Housing Starts

Year	Month	Monthly Housing Starts, Annualized
2001	January	1,666
2001	February	1,623
2001	March	1,592
2001	April	1,626
2001	May	1,610
2001	June	1,634
2001	July	1,660

2001	August	1,559
2001	September	1,585
2001	October	1,518
2001	November	1,616
2001	December	1,602
2002	January	1,721
2002	February	1,769

Source: Bureau of the Census

Chart 3

High credit exposures and recent economic weakness could create challenges for lenders in certain metro areas

Metropolitan Area	High-Risk Loans* as a Percent of Tier 1 Capital (Median Value for Institutions Headquartered in Metrolpolitan Area), December 2001	Change In Metro Area Employment Growth Rate (from 1992-2000 Average to 4th Quarter 2001)
San Jose CA PMSA	6.14	-10.17%
Austin-San Marcos TX	2.99	-7.72%
Cedar Rapids IA	2.01	-7.27%
Phoenix-Mesa AZ	6.17	-6.58%
Orlando FL	4.88	-6.43%
Denver CO PMSA	5.47	-6.29%
Rockford IL	2.91	-6.28%
Seattle-Bellevue-Everett WA PMSA	5.55	-6.25%
Las Vegas NV-AZ	6.49	-6.15%
Atlanta GA	5.93	-5.89%
Portland-Vancouver OR-WA PMSA	7.13	-5.86%
Dallas/Ft. Worth (combined)	4.80	-5.06%
Grnsbro--Wnstn-Salem--High Pt NC	3.60	-5.16%
Salt Lake City-Ogden UT	5.36	-5.15%
Lawrence MA-NH PMSA	1.60	-5.08%
Charlotte-Gastonia-Rock Hill NC-SC	3.88	-4.70%
San Francisco/Oakland	6.36	-4.54%
New York NY PMSA	3.62	-4.45%
Boston MA-NH PMSA	2.01	-4.33%
Lexington KY	4.21	-4.20%

Louisville KY-IN	3.87	-4.12%
Minneapolis-St Paul MN-WI	4.28	-3.92%
Tampa-St Pete-Clearwater FL	5.36	-3.91%
Detroit MI	4.91	-3.91%
Decatur IL	1.46	-3.91%
Columbus OH	2.27	-3.87%
Youngstown-Warren OH	2.33	-3.85%
Ft Wayne IN	2.20	-3.83%
Duluth-Superior MN-WI	3.77	-3.83%
Parkersburg-Marietta WV-OH	2.13	-3.81%
Wilmington-Nwrk DE-MD PMSA	2.45	-3.76%
Gr Rapids-Muskegon-Holland MI	7.27	-3.72%
Stamford-Norwalk CT PMSA	4.17	-3.71%
Chicago IL PMSA	4.03	-3.60%
Indianapolis IN	3.26	-3.40%
St Cloud MN	2.69	-3.35%
Birmingham AL	4.36	-3.33%
W Palm Bch-Boca Raton FL	4.31	-3.22%
Appleton-Oshkosh-Neenah WI	3.05	-3.20%
Albuquerque NM	5.10	-3.10%
Springfield MO	3.96	-3.08%
Ft Smith AR-OK	3.64	-3.07%
Clvlnd-Lorain-Elyria OH PMSA	1.02	-3.07%
Oklahoma City OK	3.93	-3.06%
U.S.	3.37	-3.02%
Milwaukee-Waukesha WI PMSA	3.76	-3.00%

Cincinnati OH-KY-IN PMSA	2.26	-2.98%
Gary IN PMSA	1.79	-2.97%
Little Rock-N Little Rock AR	4.78	-2.96%
Lincoln NE	5.13	-2.92%
St Louis MO-IL	3.22	-2.91%
Dayton-Springfield OH	2.28	-2.89%
Memphis TN-AR-MS	3.95	-2.86%
Greenville-Spartanburg-Anderson SC	4.28	-2.85%
Nashville TN	4.22	-2.81%
Davenport-Moline-Rock Isl IA-IL	2.10	-2.80%
Ft Lauderdale FL PMSA	4.48	-2.72%
Longview-Marshall TX	2.30	-2.72%
Richmond-Petersburg VA	3.94	-2.70%
Washington DC-MD-VA-WV PMSA	3.38	-2.65%
Jacksonville FL	4.12	-2.60%
Peoria-Pekin IL	1.68	-2.58%
Tulsa OK	4.18	-2.53%
Des Moines IA	3.73	-2.53%
McAllen-Edinburg-Mission TX	5.07	-2.49%
Kansas City MO-KS	3.26	-2.49%
Houston TX PMSA	5.36	-2.49%
Wausau WI	4.16	-2.46%
Newark NJ PMSA	1.83	-2.40%
San Antonio TX	5.67	-2.39%
Bergen-Passaic NJ PMSA	2.30	-2.38%
Providence-Fall River-Warwick RI	2.31	-2.32%

Allentown-Bethlehem-Easton PA-NJ	1.36	-2.30%
Chattanooga TN-GA	4.45	-2.29%
Evansville-Henderson IN-KY	1.96	-2.28%
Ann Arbor MI PMSA	4.96	-2.26%
Norfolk-Virginia Bch-Newport News VA-NC	4.20	-2.24%
Omaha NE-IA	3.11	-2.14%
Hartford CT	1.77	-2.14%
Fargo-Moorhead ND-MN	3.32	-1.99%
Baltimore MD PMSA	1.47	-1.99%
Bloomington-Normal IL	2.17	-1.99%
Raleigh-Durham-Chapel Hill NC	4.27	-1.92%
Worcester MA-CT PMSA	1.30	-1.84%
Harrisburg-Lebanon-Carlisle PA	2.05	-1.79%
Wichita KS	2.71	-1.76%
Rochester NY	3.19	-1.73%
Pittsburgh PA	1.12	-1.73%
Philadelphia PA	2.27	-1.70%
Madison WI	4.70	-1.60%
Miami FL PMSA	4.66	-1.59%
Scranton--Wilkes-Barre--Hazelton PA	2.50	-1.58%
Huntington-Ashland WV-KY-OH	1.76	-1.58%
San Diego CA	7.19	-1.58%
Orange County CA PMSA	5.63	-1.42%
Sioux City IA-NE	3.35	-1.38%
LA-Long Beach CA PMSA	6.53	-1.38%

Springfield MA	2.05	-1.36%
Middlesex-Somerset-Hunterdon NJ PMSA (Thous	2.28	-1.36%
Sacramento CA PMSA	6.49	-1.31%
Jhnsn Cty-Kngsprt-Bristol TN-VA (Thous	4.06	-1.31%
Sarasota-Bradenton FL	5.32	-1.29%
New Orleans LA	2.68	-1.17%
Jersey City NJ PMSA	0.65	-1.16%
Albany-Schenectady-Troy NY	2.36	-1.12%
Monmouth-Ocean NJ PMSA	2.93	-0.96%
Syracuse NY	1.52	-0.92%
Springfield IL	1.95	-0.80%
Fayetteville-Springdale-Rogers AR	4.72	-0.78%
Lubbock TX	4.51	-0.71%
Macon GA	6.34	-0.66%
La Crosse WI-MN	2.97	-0.65%
Lafayette LA	1.85	-0.59%
Champaign-Urbana IL	3.25	-0.25%
Knoxville TN	3.72	-0.16%
Riverside-S Bernardino CA PMSA	6.85	0.22%
Dallas/Ft. Worth	4.80	-5.06%

* High-risk loans include: commercial, construction and commercial real estate.

Note: The universe excludes banks over $10 billion, credit card and other small specialty institutions.

Source: Bureau of Labor Statistics, Haver Analytics, Bank Call Reports; Thrift Financial Reports.