Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors

Division of Insurance and Research, Risk Analysis Branch
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Executive Summary

The U.S. economy grew at its fastest pace in five years during 2004, boosted by a rebound in business investment and a resilient consumer sector. Economic growth is expected to moderate during 2005 and 2006, but should still remain at or above its two-decade average of 3.3 percent. While consumers are highly leveraged and face rising interest rates, a steady job market is starting to boost wage and salary incomes. We expect that inflationary pressures will become more of a concern during 2005, thus prompting the Federal Reserve to continue to raise interest rates at an unhurried, but deliberate pace. In short, the U.S. should remain an engine of global economic growth in 2005. However, downside risks include another surge in energy prices, high consumer indebtedness, the housing market, and large international financial imbalances.

While the bank earnings outlook remains positive, it may be hard to duplicate the record profits recorded in 2004. Two engines of marginal earnings growth—declining provision expenses and gains on the sale of securities—may not remain in place in 2005. Provision expenses are likely to stabilize or even increase given that loan performance may have already peaked for this cycle. Loan growth may also become a challenge, as reduced mortgage refinancing activity may not be fully offset by steadily increasing commercial loan demand. Also, anticipated increases in short-term interest rates could lead to a flattening of the yield curve and some compression in net interest margins, particularly if loan growth slows. Although systematic risks for banks remain well out on the horizon, near-term concerns include the possibility of faster-than-expected interest rate increases, uncertainties over high consumer debt levels, and settling of booming housing markets. In addition, operational risks at insured institutions appear to be increasing.

Outlook for the U.S. Economy

The U.S. economy expanded 4.4 percent during 2004, its fastest year of expansion since 1999. However, activity has slowed noticeably in the first quarter of 2005 to a preliminary rate of 3.1 percent. While consumer expenditures fell off modestly during the first quarter, a dropoff in the growth of investment spending and an expanding trade deficit were responsible for much of the slowdown. New orders for manufactured goods continued to expand during the quarter, but at a less exuberant pace than was evident at this time last year. Both consumers and businesses are feeling the effects of higher prices for energy and key industrial commodities in addition to modestly higher interest rates.

However, at this stage most economists are characterizing the first quarter slowdown as a "soft patch" in what has otherwise become a fairly well-balanced economic recovery. The consensus forecast of business economists calls for the expansion to remain solidly on track over the next two years. Wild cards that could disrupt the still-positive outlook include another spike in energy prices, volatility in interest rates, the repercussions of a highly indebted consumer, and reliance on foreign capital that is fast approaching $700 billion per year. A forecast provided by

Macroeconomic Advisers shows GDP growing by 4.0 percent in 2005, or somewhat more than the Blue Chip forecast of 3.7 percent growth. Economic growth of between 3.5 and 4.0 percent in 2005 would represent a moderate, but anticipated, slowdown from 2004.

Job Gains Are Expected to Remain Solid

Since reaching a trough in May 2003, payroll employment has increased by nearly 3.5 million jobs. During 2004, nonfarm payrolls increased an average of 183,000 per month. Despite a couple of weaker-than-expected months in the first quarter of 2005, job growth for the first four months of the year has actually accelerated, averaging 211,000 per month. Monthly average payroll gains between 170,000 and 190,000 are expected throughout 2005 as firms meet strong demand with increased investment in both capital and labor. A slowing pace of labor productivity growth should also support steady increases in employment this year. Ongoing improvement in the jobs picture will help keep the unemployment rate at or below its current level of 5.2 percent.

Indebted Consumers Are Likely to Keep Spending

Our conclusion at present is that, despite the weight of greater leverage, economic conditions are by and large favorable for consumer finances and spending. Job and income growth during 2005 will keep consumers spending and should successfully supplant the 2004 consumption catalysts of tax relief, mortgage refinancing, and rock-bottom interest rates.

However, a key assumption for the 2005 outlook is the ability of an increasingly indebted consumer sector to keep spending. Consumer spending has been strong since the 2001 recession despite a below average recovery in the job market, thanks to low interest rates and two large tax cuts. Meanwhile, robust home price appreciation allowed homeowners to extract (and spend) significant homeowner equity. However, there are some signs that the wealth effect from home price appreciation has eased. Fourth quarter data showed some small signs that wealth accumulation is shifting from homes to equities: while net worth grew to a record high, the quarter-to-quarter gains in corporate equities and mutual funds were much larger contributors than real estate gains, reversing the pattern of the previous three quarters.

Some analysts expect that a personal saving rate near historical lows and a highly leveraged consumer sector could weigh on the pace of household spending and borrowing, potentially detracting from overall economic growth. Household spending currently accounts for over 70 percent of GDP, versus an average of 65 percent over the past five decades. Given the importance of the consumer sector and the uncertainties that linger for households, analysts will continue to follow consumer trends closely.

Consumers have become accustomed to gasoline prices hovering in the $1.80 to $2.00 range, so the psychological impact of gas costing in excess of $2.00 seems to have weakened. However, the national average of unleaded gasoline spiked up to $2.24 per gallon in April, and the Energy Information Agency expects gasoline prices to average $2.28 this summer, 38 cents higher than in 2004. There could be an adverse impact on consumer confidence and spending if prices move significantly above current levels and if other consumer goods prices are affected.

Bankruptcy Reform May Contribute to a Temporary Surge in Bankruptcy Filings

The recent passage of bankruptcy reform (the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005) could create a rush to file in the six months prior to the law's enactment. This could temporarily increase consumer-related losses at financial institutions. In the longer run, however, the impact is less clear. Consumers may see the new bankruptcy provisions as incentive to save more and borrow less to prevent financial distress. However, if lenders, feeling heightened protection from losses, react by extending even more credit, households might find themselves even more financially stretched.

High-Cost Housing Markets Poised to Level Off, While Price Declines Remain a Risk

Despite indicators that suggest a slowdown in housing for 2005, the housing price boom is still continuing. Annual price increases accelerated in 2004, led by 20-plus percent increases in many California metro areas, Las Vegas, Boston, greater New York City, and in several coastal cities in Florida. In all, 55 of the 361 metro markets we are following were in the midst of a housing price boom in 2004, up from 33 boom markets as of year-end 2003.[1]

Our analysis indicates that, over the long run, home prices tend to increase roughly in line with personal income. Historically, most housing price booms have not ended in a bust, but rather with a period of price stagnation that has relatively mild economic effects. However, the widespread adoption of new, innovative mortgage market products may increase the current risk to home prices. For example, subprime mortgages more than doubled as a percent of originations in 2004, to nearly 20 percent of the market. Meanwhile, interest-only adjustable rate mortgages have proliferated in recent years, particularly as a means to qualify borrowers in high-priced housing markets.

As in times past, the health of local economies will play an important part in the future path of home prices. Markets that continue to experience job and personal income growth will be more likely to see a "soft landing" rather than price declines. Should price declines occur in any market, they may be amplified to the extent that a market has concentrations of financially vulnerable homeowners. Such homeowners could include those with limited financial resources, volatile job and credit histories, and those who obtained low-rate adjustable mortgages for more manageable mortgage payments. Also, real-estate investors who depend on double-digit home price increases could be vulnerable.

The broadening of the U.S. housing boom during 2004 may imply a growing role for national factors–including the availability, price, and terms of mortgage credit–in explaining home price trends. To the extent that credit conditions are in fact driving home price trends, the implication would be that a reversal in mortgage market conditions could contribute to an end of the housing boom. Additional analysis is being undertaken to further explore the role, if any, changes in the cost and availability of mortgage credit played in the expansion of the U.S. housing boom in 2004 and how these changes could affect home price dynamics going forward.

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[1] See: "U.S. Home Prices: Does Bust Always Follow Boom?," *FYI*, Federal Deposit Insurance Corporation, http://www.fdic.gov/bank/analytical/fyi/2005/050205fyi.html

Business Sector Poised for a Strong Year

Corporate profit growth eased during the second half of 2004, as firms exhausted recent labor productivity gains and higher commodity prices pressured margins. Macroeconomic Advisers expects corporate profits to rise 11.7 percent in 2005 and 6.3 percent in 2006, an easing from the 16.8 percent growth rate for 2004. However, the slowdown in corporate earnings growth does not so much reflect any particular problems for the corporate sector, but rather appears to be a sign of a maturing business cycle.

Year-over-year growth in business investment exceeded 10 percent during 2004, a pace that compares favorably to the mid-to-late 1990s. Business capital equipment outlays should stay healthy in 2005, rising somewhere between 8 and 10 percent. Expenditures on equipment and software drove much of the gain in business investment during 2003 and 2004. However, the pace of IT investment has slowed recently as the current technology replacement cycle seems to be winding down. At the same time, business investment activity has now widened well beyond technology, to areas such as long-lived industrial equipment. This is evident in the solid pace of growth in new orders for capital goods excluding defense equipment and aircraft.

Many companies added to their inventories during 2004 as economic growth began to accelerate. Most business surveys indicate that firms should continue to build inventories in 2005, although the pace of inventory building will likely slow. And while advances in labor productivity have lowered corporate cost structures and boosted margins, labor productivity gains may ease a bit during 2005.[2] Slower productivity growth, in turn, will be a mixed bag for the U.S. economy. Corporate margins may be pressured somewhat, but workers could see greater demand for their services and bigger increases in their wages. Another implication of slower productivity growth would be upward pressure on inflation, a trend that will bear watching over the course of the year.

Oil Prices Likely to Remain Elevated

In our last semi-annual report to the FDIC Board, we expressed the view that “energy prices may not retreat soon,” based on the confluence of growing global demand and tight supplies. However, the price of crude oil (West Texas Intermediate, or WTI) fell from $55.17 per barrel in October 2004 to less than $50 in January 2005. At that time, WTI futures contracts were priced to reflect the expectation that the price would decline further to the low-to-mid-$40s during 2005. Since then, however, there have been a resurgence in concerns regarding the ability of OPEC to meet global demand, which has shown few signs of easing. China’s economic boom is having a profound effect on the prices of all types of commodities, including energy. As a result, oil prices have moved back above $50 per barrell, and WTI futures indicate that the market expects oil prices to continue to rise through the summer months and into early fall.

There has been continuing concern that higher energy prices will translate into rising consumer price inflation. However, the structure of the U.S. economy is fundamentally different than that of the 1970s. For example, there is greater labor productivity among industries, which has allowed the U.S. economy to be more efficient in the way it uses energy. Increased global price competition has also prevented firms from directly passing along increases in the price of inputs.

[2] Recent data indicate that nonfarm productivity (output per hour) rose at a still-healthy annualized rate of 2.7 percent in the first quarter of 2005.

Finally, long-term inflation expectations have remained stable despite increased volatility in crude oil prices. Therefore, we expect that overall consumer price inflation will remain relatively stable over the next year despite above-average energy prices.

Inflation Appears Likely to Remain Under Control; But Higher Inflation a Risk

Consumer price inflation (CPI) has remained in check over the past three months. As of March 2005, top-line CPI inflation was running at 3.2 percent year-over-year, a slowdown from the 3.6 percent pace in November 2004. Meanwhile, the "core" measure of CPI inflation (that is, less food and energy) increased 2.4 percent. While this rate of core inflation does not yet raise major concerns, we note that it is a full percentage point higher than where it was last year. Another "core" measure closely followed by the Federal Reserve is the market-based personal consumption expenditure (PCE) deflator. By this measure, core inflation as of March was running at just 1.7 percent from a year ago, but even that was up from about 1.2 percent year-on-year growth in early 2004.

The March Federal Reserve Beige Book and recently-released minutes of the Federal Open Market Committee (FOMC) show that more firms, particularly manufacturers, indicated they were finding some ability to make price increases stick. These signs of increased pricing power were enough to cause the FOMC to change its policy statement at the March 2005 meeting. The committee noted that "though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident." This is the first time in four years that the FOMC has acknowledged concerns about inflation. Since the March meeting, Federal Reserve members have provided reinforcement that the FOMC is closely watching inflationary pressures.

Continued Moderate Interest Rate Increases Expected

The Federal Reserve has widely advertised a long-term program of slow and steady interest rate increases, and all signs indicate it will continue to deliver on this promise. However, the FOMC noted in its May statement that appropriate monetary policy action would be needed to balance (or manage) the risks to economic growth and price stability. This essentially leaves the door open for the FOMC to raise rates at a faster pace if inflationary pressures rise at an unwelcome pace, or to cease raising rates if there is an undesirable slow down in economic growth. This multi-directional tone has contributed to a recent increase in volatility in expectations about interest rates. Prices of federal funds futures currently imply an expectation that the FOMC will raise interest rates by 25 basis points at three of its next four scheduled meetings, leaving the federal funds rate in the range of 3.75 to 4 percent by year end.

The yield on 10-year Treasury notes has fluctuated between 4.0 percent and 4.6 percent during the first four months of 2005, before settling near the mid-point of that range in early May. This yield appears to reflect market expectations for a respectable pace of economic growth, a modest acceleration in inflation, and a continuation of interest rate increases by the FOMC through the remainder of 2005. Meanwhile, successive increases in the federal funds rate have helped to shrink the yield spread between the 10-year Treasury note and the 3-month Treasury bill to 142 basis points, or only slightly above the long-run average of 130 basis points. Private analysts expect the yield curve to flatten to the long-run average by year-end, with the 3-month yield reaching 3.7 percent and the 10-year yield reaching 5.0 percent. Thus, while a flattening yield curve will probably cut into bank net interest margins (NIMs) this year, it is not expected to flatten so much as to forecast significantly slower economic growth in 2006.

Changes in the level and shape of the yield curve during 2005 will be a key challenge facing bank performance in the FDIC's New York Region, where 30 percent of banks are mortgage lenders. Rising interest rates also are a key factor in the risk outlook for FDIC's San Francisco Region. Higher rates could dampen recently robust rates of home construction and price appreciation. The San Francisco Region is home to many of the most rapidly appreciating U.S. housing markets. While a slower pace of home price growth might ease strains on affordability, a potential decline in home prices remains a downside risk for the Region this year.

A Mixed Outlook for Asset Markets

Stocks ended 2004 on an up note after faltering during the first half of the year. The S&P 500 rose 8.9 percent while the NASDAQ lagged slightly with an 8.2 percent gain. At the beginning of the year, Wall Street analysts were forecasting 2005 stock market gains generally ranging from zero to 10 percent. Stock buybacks, increased dividend payouts, and snappy leveraged-buyout activity helped equities to some degree during 2004, a trend that was expected to continue in 2005. Despite sanguine expectations for the year, equity performance has been weak in the first four months of the year. Through the end of April, the Dow Jones Industrials Average and the S&P 500 were both down over 4 percent for the year, while the NASDAQ was down over 11 percent.

The dollar depreciated further against the euro and the British pound in 2004. Even so, the dollar recently has been buoyed by expectations that U.S. interest rates will rise faster than comparable foreign rates and that U.S. economic growth will be strong relative to many other nations. Current 2005 forecasts for the dollar against most European currencies are mixed. Some analysts believe the euro has become overvalued relative to the U.S. dollar, especially since the European Central Bank continues to hold their target interest rate at 2 percent while the Fed raises U.S. rates. On the other hand, the Bank of England has been raising rates in a fashion similar to the Fed, which suggests a more neutral outlook for the dollar exchange rate with the pound.

Meanwhile, the dollar continues to depreciate only marginally against many Asian currencies because of active exchange rate management policies and outright currency pegs. As a result, many analysts are calling for more pronounced dollar depreciation against Asian currencies over the next two years. However, as the value of the dollar against these currencies remains a matter of policy for many Asian nations, it is difficult to predict when or how a currency adjustment may ultimately take place. Chinese officials in recent weeks have sent mixed signals regarding their intentions on possibly removing their currency peg with the dollar. Furthermore, the dollar has recently gained against the yen as there are signs the Japanese economy may not grow as fast as expected during 2005. Therefore, it is likely that short-run changes in the dollar will be determined more so by interest rate and growth differentials than by trade flows or exchange rate policy.

U.S. Economy Will Remain a Global Engine of Growth in 2005

The size and path of the U.S. deficits in its foreign trade and federal budget also represent a modest risk to the 2005 outlook. Growth in imports again outpaced that of exports last year, widening the current account deficit and weighing on net GDP growth. One factor in the widening of the foreign trade deficit was a generally slower pace of growth abroad (particularly in Europe). Macroeconomic Advisers forecasts foreign economic growth to accelerate to 3.5 percent during 2005, which should help narrow the economic growth gap between the United States and its trading partners. As a result, U.S. export growth is expected to begin to eclipse that of imports in the coming quarters, helping to stabilize the widening current account deficit.

But a more important long-term factor may be the inability of the dollar to depreciate against many Asian currencies. Because China, Japan, and some other Asian countries either manage or peg the value of their currencies against the dollar, most of the recent downward adjustment in the dollar has occurred vis-à-vis the euro and the pound. Some analysts contend that setting foreign exchange rates as a matter of policy, as opposed to letting market forces define their proper value, may have distorted recent trends in trade and investment flows between the United States and its Asian trading partners. Finding a way to correct these imbalances without destabilizing the global financial system represents one of the most important economic challenges of the next few years.

Longer-Term Challenges for the U.S. Economy

FDIC analysts have noted what they see as a contrast between the clearly positive short-term outlook for the banking industry and the presence of longer-term concerns that could dim the outlook for the industry at some point in the future. They have categoriezed these longer-term concerns into four main categories: 1) a disruption in the housing market booms currently underway in dozens of U.S. metro areas, 2) a significant decline in the value of the dollar, with a related increase in U.S. inflation and interest rates, 3) further energy market shocks that result in still higher prices for gasoline and fuel oil, and 4) an inability of consumers to service high levels of indebtedness at current levels of consumer spending.

All of these longer-term concerns relate in some way to the upheavals caused in recent years by the accelerating globalization of the world economy. The large inflows of global capital to the United States are the flip-side of large trade deficits being incurred with U.S. trading partners, particularly those in Asia. One effect of these capital inflows has been to help keep U.S. interest rates low—a contributing factor to the five-year U.S. housing boom. Taking advantage of historically low interest rates, U.S. households have increased their mortgage indebtedness by $1.6 trillion in the last two years alone. In turn, the spending of U.S. households continues to fuel the growth of export-oriented emerging markets such as India and China. And it is the high rates of growth and rapid industrialization of these emerging markets that is helping to push up the prices of oil and other industrial commodities to historic highs.

Taken together, these trends represent a set of interrelated financial imbalances that may or may not, at some point, result in disruptive market adjustments that could derail the U.S. economic expansion and contribute to a much more difficult economic environment for FDIC-insured institutions. For example, one such disruptive market adjustment would be a move away from dollar-denominated assets by international investors. Such a development, which is by no means unprecedented in the modern history of financial markets, could not only push down the value of the dollar, but could result in sharply higher U.S. inflaton and interest rates. While FDIC-insured institutions employ a variety of strategies to manage their exposure to higher interest rates, there is no question that a large increase in rates (300-400 basis points in one year) could pose a risk to certain classes of institutions.[3] No small part of the fallout from such an event might be the credit stress placed on interest-sensitive household and business borrowers.

The evaluation of these long-term adverse scenarios by FDIC analysts remains preliminary at this stage. Work is ongoing to monitor the financial trends associated with these scenarios and to formulate stress tests of FDIC-insured institutions so as to estimate the degree to which the banking industry and the insurance funds might be vulnerable to these "low-probability-high impact" risks.

2005 Outlook for Banks and Thrifts: Expect Another Good Year

At present, the financial condition and performance of the banking industry continues to be a picture of stability. Capital ratios remain near all-time highs, earnings remain strong, and credit problems continue to decline toward cyclical lows. The numbers of problem, unprofitable, and undercapitalized banks and thrifts also remain at historically low levels. The vigor in consumer lending in residential mortgages, home equity loans, and mortgage-backed securities continues, and this sector accounted for more than 70 percent of the total growth in interest-bearing assets in the fourth quarter of 2004. Given the expectation of continued rising interest rates, however, banks and thrifts may not be able to rely on growth in consumer and mortgage portfolios to such a large degree in coming quarters. Although commercial and industrial (C&I) loan demand is growing, it is not yet strong enough to compensate for a slowdown in consumer loan growth.

Chief near-term risks for insured institutions include: the relaxation of credit underwriting standards in commercial lending; the proliferation of both hybrid credit products in consumer and motgage loan portfolios and rapid growth in portfolios of home equity lines of credit (HELOCs); uncertainties over future developments in consumer finances and housing markets; and the potential for operational losses at institutions with internal control weaknesses. However, given the industry's current strong loan performance, earnings performance, and capitalization, any financial difficulties that arise from these sources would appear unlikely to cause significant distress for the industry in the near-term.

Bank Earnings Remain Strong

Net income for 2004 of $123 billion continued a four-year string of record annual earnings for FDIC-insured institutions. Industry earnings have also set new quarterly records in ten of the last twelve quarters. This strong earnings performance is primarily attributable to growth in net interest income, reductions in provision expenses, and repeated gains on the sale of securities. However, even though none of these factors are expected to reverse themselves altogether in coming quarters, it does appear likely that the contribution of declining provisions and continued gains on sale will dwindle over the course of 2005.

Thanks to robust loan growth, net interest income has shown strong gains even as margins have declined. Historically low interest rates have allowed institutions to realize large gains on their sales of fixed-rate securities, while the cyclical decline in loan-loss provisions also has contributed to increased profits. Asset quality at insured institutions remains solid as

[3] For a discussion of interest-rate risk management at FDIC-insured institutions, see the Spring 2005 issue of *FDIC Outlook* at: http://www.fdic.gov/bank/analytical/regional/ro20051q/na/index.html

nonperforming loans, provision expenses and net charge-offs all remain low. Return on assets declined for large banks in 2004 due to slower growth in noninterest income, higher noninterest expenses, and continuing narrowing of NIMs. The main areas of weakness in noninterest income have been lower market-sensitive revenues, especially trading profits, and lower gains on sales of loans and other assets. In contrast, growth in transaction-based fee income has been steady. Much of the increase in noninterest expenses reflects one-time charges by a few large banks, including $3 billion in provisions for litigation losses at two large banks and hefty merger-related restructuring charges at others.

Provision Expenses Should Stabilize While Overhead Expenses May Rise

Declining provision expenses have been a driver for earnings growth for the past two years, but the peaking of commercial and industrial (C&I) credit quality may cause provision expenses to stabilize or even rise slightly in 2005. Indeed, provision expenses declined by $8.3 billion in 2004, and net charge-offs have exceeded provision expenses for the past several quarters. Still, while provision expenses may not be able to drop further in 2005, any distress in overall loan quality is not expected in the next two years, making significant increases in provision expenses unlikely. Overhead expenses are likely to face upward pressure as well during 2005, given the increasing legal, accounting, and other operating costs associated with the Patriot Act, Bank Secrecy Act, Basel II, and the Sarbanes-Oxley Act.

NIMs to Remain Under Pressure

In 2005, NIMs can be expected to decline at many insured institutions because of recent and anticipated flattening of the yield curve, which affects abilities to profit from paying on short-term deposits and collecting on longer-term assets. Historically, flattening yield curves have resulted in compressing margins.

Since 2002, NIMs at larger institutions have been declining at a faster rate than at smaller institutions. This is primariliy the case because the cost of funds for large banks tends to be more sensitive to rising interest rates than that of smaller banks, which have more stable "core" deposits that they can reprice more slowly. Anticipated growth in C&I loans and home equity loans should offset some of the pressure from higher funding costs by helping banks increase their asset yields. The sale of liquid, long-term securities has provided an alternative source of funding for some institutions. This trend is expected to continue in 2005 unless rising long-term interest rates eliminate the unrealized gains in these securities.

Ability to Generate Quality Loan Growth a Key to 2005 Bank Earnings

Loan growth was particularly strong in 2004, led by tremendous growth in mortgage lending. Mortgage-related assets (including mortgage-backed securities) held by FDIC-insured institutions grew by $499 billion during the year, compard to an increase of $451 billion in all other interest-bearing asset classes combined.

Refinance mortgage originations fell during 2004, while purchase mortgages rose. The plunge in mortgage refinance volume should not be a significant negative factor for most smaller institutions because refinancing is more of a wholesale business performed by one-product lenders. However, growth in residential mortgage assets, excluding home equity loans, accounted for more than 30 percent of all asset growth for the banking industry over the past two years. This contribution is unlikely to be sustained as long-term interest rates rise, given that marginally higher rates have already dampended demand for mortgage refinancing.

Despite the dropoff in refinancing activity, other household loan categories are growing rapidly. Outstanding balances in HELOC portfolios grew by a whopping 42 percent in 2004, accounting for about 14 percent of total industry asset growth. Increased home values in many markets have left homeowners with considerable equity in their homes that they can tap via HELOC borrowing. Still, the rapid HELOC growth pace seen last year may not be sustainable, especially if interest rates rise as expected during 2005. As long as overall consumer loan demand grows this year, credit card debt and most other consumer loans should see rising volume. Auto lending activity may be somewhat weaker though, given the surge in auto sales in recent years and the apparent dropoff in the early months of 2005. Growth in subprime loans, particularly mortgage loans, rose markedly last year. Subprime mortgage originations reached a record $607 billion, a 56 percent increase from 2003, and subprime mortgage loans accounted for 22 percent of all residential production.

A slowdown in mortgage loan growth in 2005 could make it difficult for banks and thrifts to grow their earnings. While demand for C&I loans is clearly strengthening, C&I loan growth may not be sufficiently advanced to fill the void left by weakening mortgage demand.

The outlook for commercial lending activity improved markedly in 2004. After 13 quarters of decline, C&I lending grew during the last three quarters of 2004, and this growth trend is expected to accelerate over the next several quarters. Small and mid-sized business C&I demand remains steady, while liquidation of sizeable, impaired C&I loan positions appears to have run its course at the nation's biggest banks. Construction and development (C&D) and commercial real estate (CRE) lending also have remained strong.

Consumer Credit Quality: Certain Segments Could Weaken

In general, consumer credit quality should remain solid in 2005. The long-awaited pickup in job growth is now powering growth in disposable incomes in the aftermath of the 2003 tax cut. If interest rates continue to rise gradually, and if there is no significant disruption in residential real estate markets, consumer and mortgage portfolios in general shoud continue to perform well. However, certain segments of these portfolios could see losses rise. In particular, variable rate loans of all descriptions would figure to become more expensive to service during 2005. HELOCs are a primary concern in this regard. Newer, innovative HELOC structures, especially those with interest-only and high-leverage features, do not yet have a firm loss history in a rising interest-rate environment, making it difficult for lenders to estimate how rising rates may affect borrowers. This could be of particular concern for those borrowers who were only marginally qualified for credit in a historically low interest rate environment.

Subprime portfolios may also be vulnerable to rising interest rates. While many subprime lenders continue to earn large margins in this line of business, there is a history of problems among FDIC-insured "subprime institutions." These institutions, defined as having subprime loans greater than 25 percent of Tier 1 capital have accounted for a disproportionate number of failed institutions for the past several years. Of the 40 FDIC-insured institutions that have failed since the end of 1997, twelve (30 percent) have been subprime institutions. These institutions accounted for some 64 percent of the total assets of failed institutions during this period. In addition, there is evidence that subprime mortgage borrowers are much more exposed to rising interest rates than prime borrowers. A 2004 estimate by **Loan Performance** indicated that approximately two-thirds of subprime borrowers took out adjustable rate loans. In these instances, a vulnerability to rising interest rates only compunds what are pre-existing credit weaknesses on the part of the borrower.

Credit card loss rates have declined recently, even as personal bankruptcy filings remained historically high. Nevertheless, loss rates in credit card portfolios may rise relative to other consumer loan types going forward. Credit cards have seen high repayment rates as eligible consumers substituted home mortgage debt for their credit card debt. This may have left a larger proportion of non-home-owning, and potentially riskier, borrowers in bank credit card portfolios. Federal Reserve data suggest that renters have higher financial burdens and generally poorer credit scores than do homeowners. While the recently-enacted bankruptcy reform bill should benefit credit card portfolios in the long run, there is also the possibility that bankruptcy filings could rise prior to the effective date of the legislation, which could boost cedit card loss rates in the near term.

Commercial and CRE Credit Quality at or Near a Cyclical Peak

Commercial credit quality is likely at the peak of the credit cycle. Still, significant deterioration in loan quality is not expected in the near-term as, historically, losses following the peak of the credit cycle take several years to manifest. Rising interest rates in 2005 may place additional stress on CRE loans, while the recent trend of declining C&I credit losses is likely to begin to wind down this year.

Commercial and Industrial (C&I) Loans. After a multi-year hiatus, C&I loan growth returned during the past three quarters, and demand for C&I loans should begin to accelerate in response to stronger investment, increased inventory building, and heightened merger activity by U.S. businesses in 2005. Ultimately, moderate increases in delinquencies and provision expenses may occur, but, based on the typical credit cycle, significant loan losses are not expected in the near term.

Historically, C&I loan charge-off rates at FDIC insured institutions have been highly correlated with global speculative-grade bond default rates. Since Moody's forecasts corporate C&I speculative default rates to decline in the first quarter, but then rise through the remainder of 2005, it is likely that the recent trend in improving C&I loan quality will have run its course by the middle of 2005. However, C&I loan charge-off rates should not rise appreciably in 2005 or 2006 unless real corporate profits start to fall or the U.S. economy slips into a recession. Consensus forecasts do not call for either to occur.

Although C&I credit quality may peak this year, it is not likely to show any meaningful deterioration, given generally improving corporate credit quality measures. For example, only 84 public companies filed for Chapter 11 bankruptcy in 2004, down from 143 in the prior year and 257 when filings peaked in 2001. Asset values involved in Chapter 11 bankruptcies are also down sharply—falling to $45 billion in 2004 compared with $97 billion in 2003 and $383 billion at the 2002 peak. In addition, nearly all of the 50 industries for which Moody's KMV Company calculates a median EDF have seen their risk of default decline in the past six months. Industries displaying the highest median EDFs in February 2005 included computer software, air transportation, computer hardware, textiles and electronic equipment. The airline industry faces a continuing challenge due to excess capacity, fierce competition, and high fuel costs. However, the banking industry only has a relatively modest exposure to the airline industry.

Commercial Real Estate (CRE) Loans. U.S. office property markets continue to improve, with strengthening absorption and falling vacancy rates. Industrial property conditions also have advanced in the past year, with vacancies falling at year-end to 10.8 percent—though this level is still slightly higher than the peak in U.S. industrial property vacancies seen during the last cycle. The lodging and multifamily sectors are improving, while the retail sector maintained strong fundamentals throughout this cycle.

CRE lending grew at a 13.7 percent annual rate through year-end 2004, while C&D loan volume has been gaining momentum and grew at a 23.7 percent annual rate. Real estate developers may react to the recovery in CRE markets by ramping up construction activity this year. While this could result in oversupply in the future, it will likely spur demand for financing in the near-term.

Loan performance for the CRE sector, including nonfarm, nonresidential, multifamily, and C&D loans, remains strong at present. However, CRE loans remain vulnerable to rising interest rates, especially in sectors where rent recovery has been slow or nonexistent. As the economy expands in 2005, rising interest rates, which lift debt service costs and loan-to-value ratios, will be competing against potential gains in rental rates and absorption. CRE delinquency and charge-off rates over the next few quarters depend on how this race turns out.

A vulnerability for CRE exists in the potential for softening prices if investors choose to liquidate their CRE holdings. Throughout the recent downturn, investors have sought out CRE as returns for this sector often exceeded other alternatives. Recently, a **CalPERS** official was quoted as saying, "It's an opportune time to take advantage of the market, as it's pretty frothy." **CalPERS** has not declared that it is scaling back its allocation to the CRE sector. However, because **CalPERS** is such a large CRE investor, any signaling that might be interpreted as a permanent change to their investment strategy carries the potential to sway other investors to follow suit.

Rents have languished in the office sector. The national office rental survey performed by Property and Portfolio Management showed its rental-rate index declining from a high of 124 at year-end 2000 to 96 at year-end 2004. Although recent anecdotal information indicates that the office rents may have turned the corner in the first quarter of 2005, a long way remains to full recovery for this sector. Some markets have continued vulnerability as previously peak, market-written rents are rewritten to the lower, going rates in the current stage of the cycle.

Farm Loans. The agricultural industry is in good shape after a record net farm income year in 2004. While the U.S. Department of Agriculture expects net farm income to decline in 2005, the level should still be one of the highest on record. Near-term risk is centered on production, with drought in the West and Great Plains extending into a sixth year. In the longer term, there is significant concern that agricultural subsidies may be significantly reduced in the 2008 farm bill, which could have a dramatic effect on heavily subsidized farmers in the Midwest and South.

Operational Risks Are Rising in Importance

Even as credit concerns have waned for the moment, operational risk (OpRisk) appears to be increasing in relative importance among FDIC-insured institutions. OpRisk is defined as the risk of loss resulting from external events or from inadequate or failed internal processes, people, and systems. Of the four basic types of OpRisk losses—those related to Fraud, Process, Stakeholders and Systems—dollar losses occur somewhat evenly across all risk sources, while fraud and process-related events are the most frequently occuring types. OpRisks also include supervisory issues pertaining to compliance with the Bank Security Act (BSA) and anti-money laundering concerns. Several cases of large fines have made headlines, and BSA program weaknesses are turning into a significant diversion of management attention at a number of banks, both large and small. BSA compliance will remain a significant cost issue and strategic focus for 2005.

The potential effect of fraud on the banking industry and the deposit insurance funds is evidenced by the fact that 20 of 40 institutions that have failed since 1997 involved some element of fraud. Current estimates show that just over half of the $2.3 billion in losses to the FDIC insurance funds during this period were related to these cases where fraud played some role.

According to FBI reports, fraud is becoming more expensive for financial institutions over time. Following a four-year trend, even though the number of pending financial institution fraud cases declined by 12 percent from 2003 to 2004, the share of "major cases"—those over $100,000 in suspected losses—increased over the same period by 7 percent. An estimated 46 percent of all OpRisk loss events are related to fraud, and the average loss equals about $70 thousand per instance.

Mortgage Fraud. Of the categories of fraud that are perpetrated on financial institutions, mortgage fraud in particular has been on the rise. This area is prime for exploitation as credit quality is strong, profits are high, and technology is enhancing criminals' ability to access financial institution data. Warehouse lines are particularly vulnerable, with their 90-day window of "purchasing" mortgages and awaiting ultimate repayments from final investors. According to FBI statistics based on Suspicious Activity Report (SAR) filings, the number of reported mortgage fraud cases more than doubled from 6,890 in 2003 to 15,706 in 2004. The potential dollar amount of the universe exposed to mortgage fraud is shown by the sheer volume of U.S. annual mortgage originations—estimated to have reached $2.8 trillion in total volume in 2004, according to the Mortgage Bankers' Association.

With rapidly growing markets such as real estate along with the development of new technology associated with refinancing and computer-driven underwriting methods, the opportunity for mortgage fraud will continue to grow. Mortgage fraud is pervasive in the types of fraudulent acts perpetrated upon financial institutions, and the FBI reports that property flipping with the motive to remove equity along with fictitious properties are common techniques. This problem is compounded in instances where institution policies and procedures are ineffective due to their poor formulation or outdated nature.

The FBI estimates that 80 percent of all mortgage fraud involves collaboration or collusion by industry insiders. On an overall basis, though, according to the FBI Financial Institution Fraud and Failure Report for fiscal year ending September 2004, external fraud schemes are higher than those involving insiders as a result of the pervasiveness of check fraud and counterfeit negotiable instrument schemes, technological advances, as well as the availability of personal information through illicit information networks.

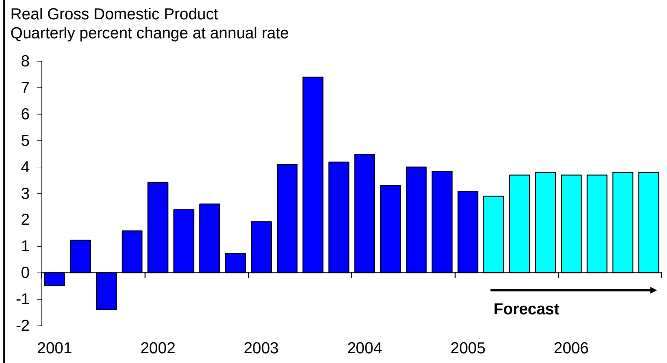
Data Security. The protection of valuable, confidential data from hackers is another area of increasing OpRisk for banks. From August 2004 to February 2005, the number of active sites used for "phishing"—creating fake websites to lure consumers to give up confidential information—is up by 261 percent, according to a February 2005 report by the Anti-Phishing Working Group. It is estimated that the financial services sector was the target of 78 percent of these attempts. FDIC examiners report that phishing attacks are becoming increasingly concentrated in regional and community banks.

Credit Derivatives at FDIC-Insured Institutions Experiencing Tremendous Growth

Another area of potential concern for FDIC-insured institutions is their ability to effectively manage growth in the use of derivative instruments, particularly credit derivatives. The notional value of derivative contracts held by FDIC-insured institutions increased 24 percent in 2004 to $88.3 trillion. Although most of this increase was the result of growth in interest rate derivatives, credit derivatives continue to grow more rapidly than any other type of derivative instrument. Credit derivatives held by FDIC-insured institutions grew by 134 percent in 2004, slightly faster than the 123 percent growth rate of credit derivatives worldwide. The notional amount of credit derivatives held by FDIC-insured institutions totaled $2.3 trillion as of year-end 2004. Although the number of FDIC–insured institutions holding credit derivatives has leveled off over the past few quarters, the majority of these instruments are held by the largest financial institutions who continue to be net buyers of credit protection. Risks include a significant decline in corporate credit quality, little information on counterparties, operational weaknesses that may result from the newness of these instruments, and a disincentive by managers to actively monitor portfolio credit risk.

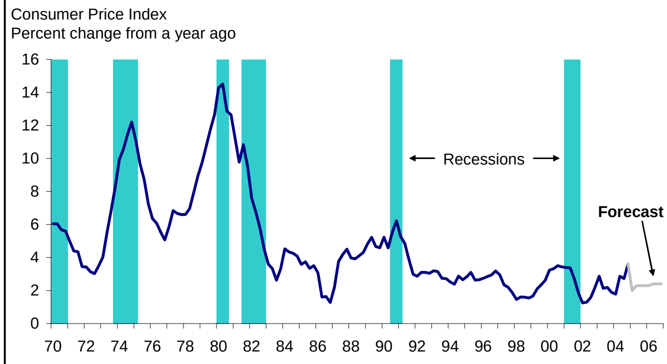
Economic Conditions and Emerging Risks in Banking Chart Book

Real U.S. economic growth is expected to average about 3.5 percent in 2005 and 2006, down from 4.4 percent in 2004.



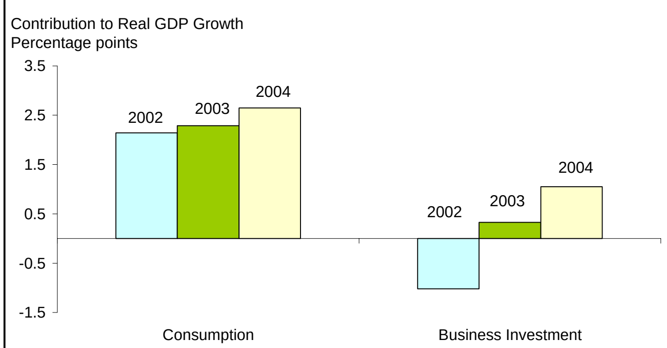
Source: Bureau of Economic Analysis, Macroeconomic Advisers forecast.

Consumer price inflation is expected to remain contained through 2005 and 2006 as energy prices level off.



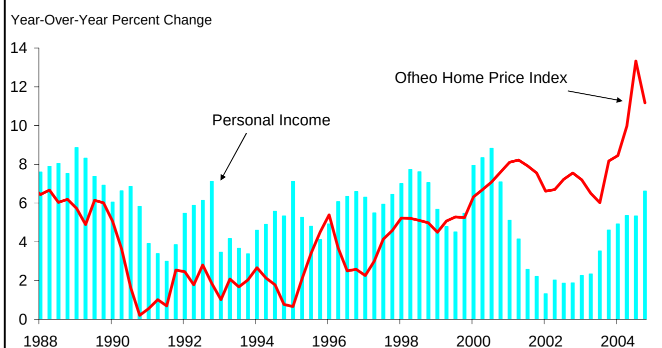
Source: Bureau of Labor Statistics, Macroeconomic Advisers.

Personal consumption continues to drive GDP gains, but business investment is playing a much larger supporting role.



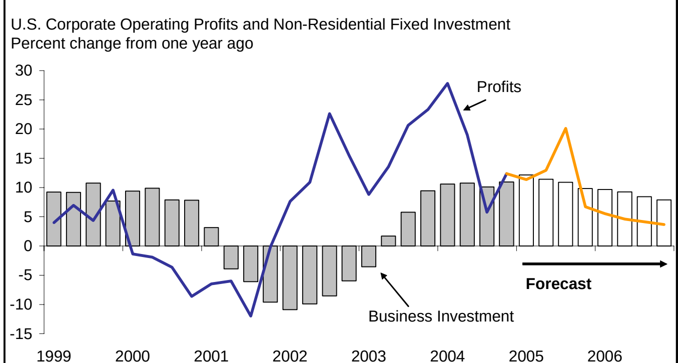
Source: Bureau of Economic Analysis

Consistent gains in personal incomes since 2002 have supported housing demand, but a slowdown in price growth is inevitable.



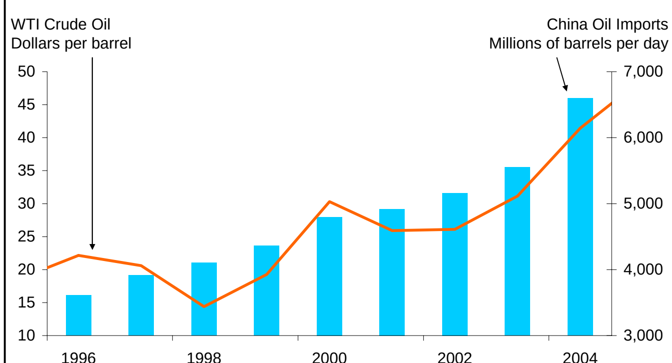
Source: Bureau of Economic Analysis; Office of Federal Home Enterprise Oversight.

Corporate profit growth is expected to moderate in 2005 and 2006 while business investment should remain healthy.



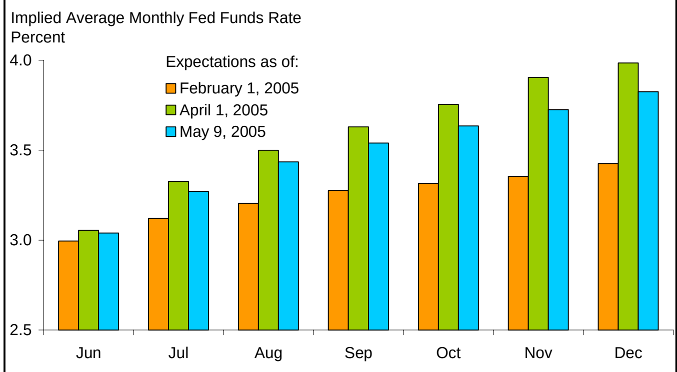
Source: Bureau of Economic Analysis, Macroeconomic Advisers.

China's oil demand has increased markedly in recent years, mirroring an increase in WTI crude oil prices.



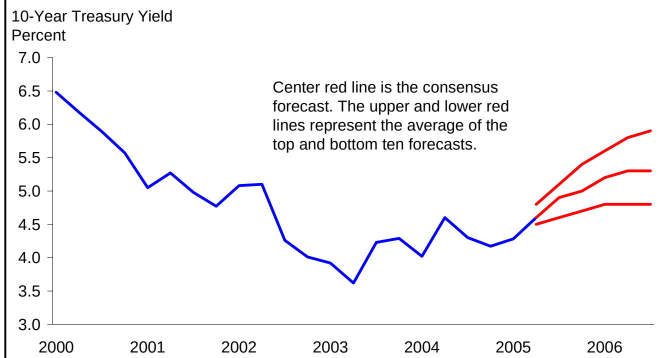
Source: Energy Information Agency.

Concerns about slowing growth and building inflation have created volatility in market expectations about the FOMC.



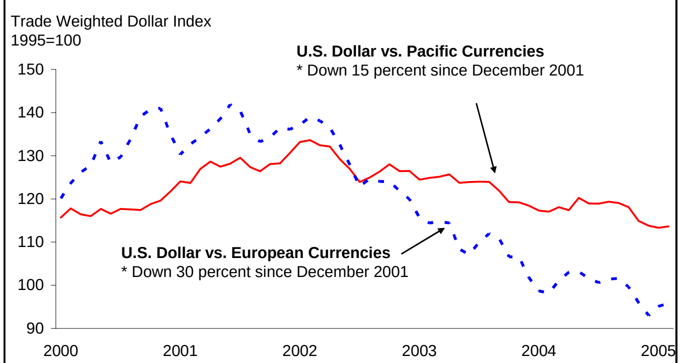
Source: Bloomberg, Chicago Mercantile Exchange.

Treasury yields are expected to reach 5.0 percent by year end, and then level off near 5.25 percent during 2006.



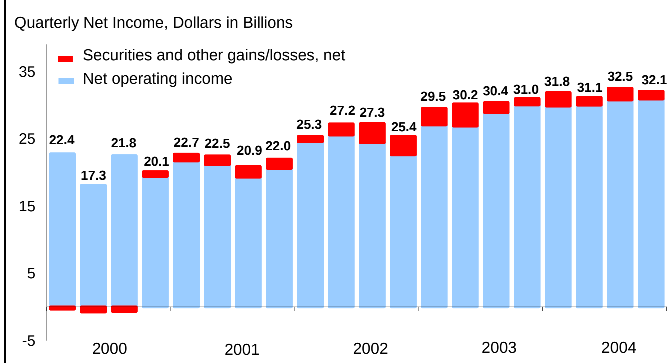
Source: Federal Reserve; Blue Chip Financial Forecast.

The U.S. dollar has depreciated most against European currencies while only modestly against Pacific currencies.



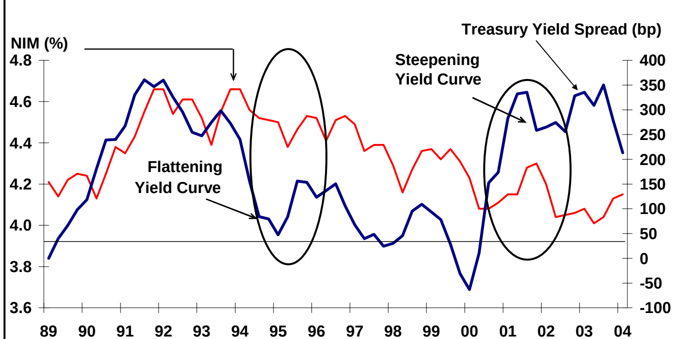
Source: Federal Reserve Bank of Atlanta.

FDIC-insured institutions have posted record earnings in each of the past four years.



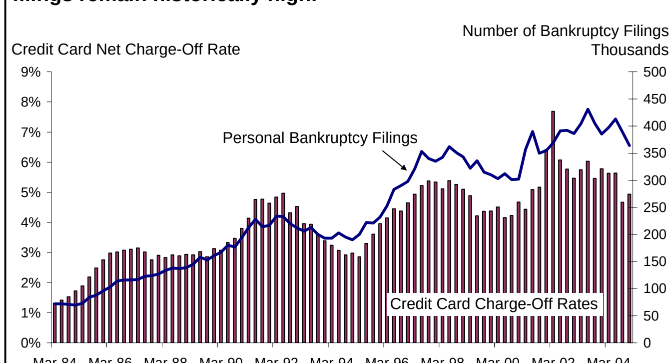
Source: FDIC

The steepness of the treasury yield curve influences bank NIM.



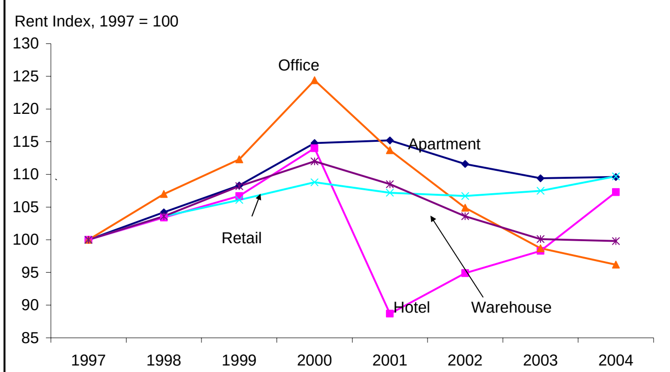
Source: Bank Call Reports, Federal Reserve Board. Median NIMs for banks with assets less than $10 billion excluding specialty banks. Spread data are difference between 10 year and 3 month Treasuries.

Credit card loss rates have eased, even as personal bankruptcy filings remain historically high.



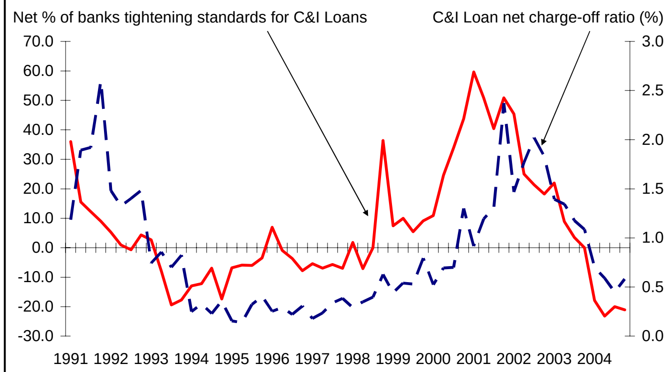
Source: Bankruptcies - Administrative Offices of the United States Courts

Office sector rents still have a long way to recovery, while the hotel sector is almost back to its former high.



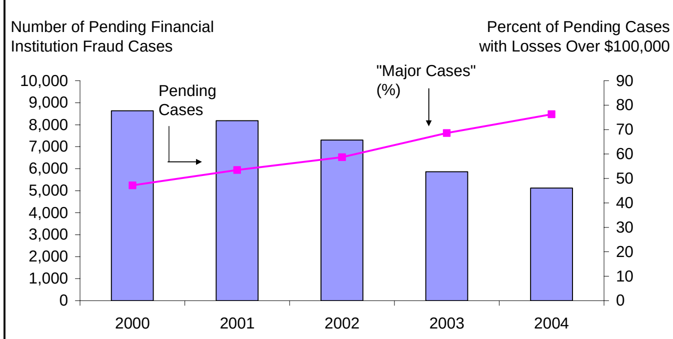
Source: PPR

Recent softening in C&I underwriting standards may ultimately lead to moderate increases in charge-off rates.



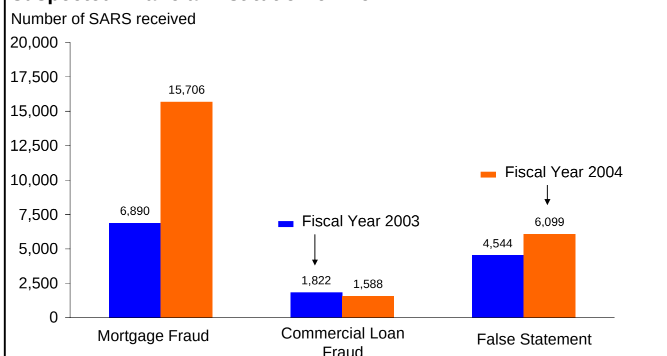
Source: Federal Reserve Board

Although the number of bank fraud cases has declined in recent years, the dollar losses in individual cases are rising.



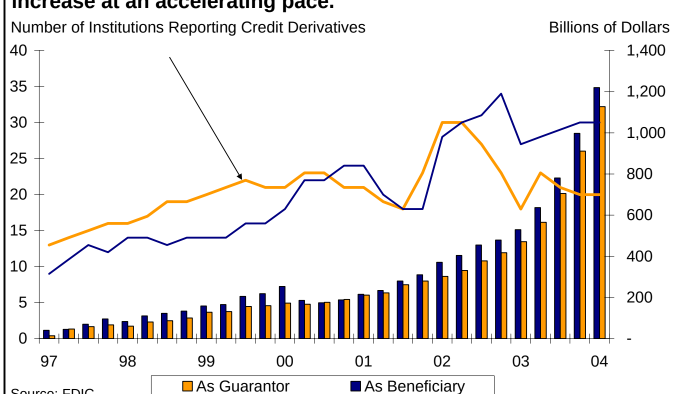
Note: The FBI defines a "major case" as one involving suspected fraud in excess of $100,000.
Source: FDIC, FBI.

Mortgage fraud is the most prevalent and fastest growing type of suspected financial institution crime.



Note: 2004 data through August 31, 2004
Source: FDIC, FBI

The notional value of credit derivative contracts continues to increase at an accelerating pace.



Source: FDIC

Economic Conditions and Emerging Risks in Banking
Supervisory Perspective
A Report to the FDIC Board of Directors

Division of Supervision and Consumer Protection
May 16, 2005

Overview of Risks Posed by Insured Institutions:

Insured institutions continue to report record profits, excellent credit quality, and sufficient capitalization. The industry's strong condition is attributable to a generally healthy domestic economy, a resilient but leveraged consumer, and effective risk management processes at most insured banks. The number of banks on the Problem Financial Institution List continues to be low. As of March 31, 2005, there were 81 institutions on the list with $28.6 billion in assets. Only three institutions, each with total assets of less than $125 million, are expected to fail in the next quarter.

Credit risk continues to be the predominant risk facing insured institutions. According to all measures (delinquency, loss rates, and classifications), credit quality is strong and no significant increase in problem loans should be anticipated for the next several quarters. Strong credit quality has allowed banks to reduce provision expenses, boosting profitability since 2003. However, there is increasing evidence (both publicly and among regulators) that lenders have eased underwriting standards and are accepting higher risks to expand revenues. Easing of underwriting standards indicates that we may be at or near a peak in this credit cycle.

The financial markets continue to have a reasonably positive view towards publicly traded insured banks; however, bank stocks have underperformed the S&P 500 during 2005 on concerns over competition, margin pressure, and reputation risk issues. Implied forward Treasury rates indicate a further flattening of the curve over the next twelve months, further straining net interest margins which have been declining for over a year. Competitive pressures on loan and deposit pricing/terms will also burden margins. The fixed income market has a positive view of the banking industry as evidenced by relatively tight spreads on bank subordinated debt and credit default swaps. The rating agencies have issued few downgrades of insured institutions so far in 2005 (Fitch reported only five downgrades since 2005).

Challenges Facing Insured Institutions in 2005:

Despite the banking industry's strong overall condition, the following will present notable challenges for insured institutions throughout 2005 and into 2006.

- *Credit Risk Selection* – Competition and low interest rates have led to slow revenue growth at insured institutions. Banks have responded by broadening their product mix, seeking merger partners, and reducing overhead expenses. Another response to this competitive environment has been to cut loan pricing and relax credit terms in both commercial and consumer lending fields. Examiners indicate that some institutions pressured by competition are lowering loan rates, extending maturities, imposing less stringent loan covenants, and making more frequent policy exceptions. Moreover, several larger institutions have increased or are planning to increase originations of subprime, near-prime, or Alt-A (low or no doc) loans to maintain loan growth targets.

It is uncertain how credits originated with relaxed terms will perform prospectively. Our supervisory experience shows that liberal underwriting terms and an increasing appetite for credit risk may cause higher delinquency and charge-off levels once credits season. There is not an immediate threat from these observations; however, our attentiveness to credit performance has and will increase, particularly as recent originations begin to season in 2006.

- *Achieving Net Interest Margin Stability* – Insured institutions continue to struggle with compressing net interest margins as the low interest rate environment and intense competition has resulted in pricing pressure. Net interest margins for all insured institutions declined from 3.75 percent as of the fourth quarter 2003, to 3.63% for the fourth quarter of 2004. Rising short term rates in 2004 provided little short term benefit for earning asset yields, which grew only eight basis points from the fourth quarter of 2003 to the fourth quarter of 2004. Indications from first quarter earnings release data shows that margin pressure has continued in 2005.

  The Treasury market implies that the yield curve will continue flattening over the next four quarters. A flatter yield curve will present a difficult environment for banks because a steep yield curve is generally more advantageous for traditional banking business. Significant competition for loans and deposits is expected to persist. Accordingly, stability in net interest margins will remain a challenge for insured banks for the remainder of 2005.

- *Bank Secrecy and Anti-Money Laundering (BSA/AML) Compliance* – Significant industry and regulatory attention over the past year has focused on the effectiveness of insured institutions' anti-money laundering programs. Several high-profile cases have intensified bankers' efforts to ensure that appropriate policies, controls, and detection processes are in place.

- *Information Technology Risk* - Insured institutions continue to struggle with operational risks associated with identity theft even when strong GLBA 501(b) information security programs are in place. Technology incidents such as "phishing," "pharming," and Internet account-takeover indicate the need for continued electronic authentication, monitoring, and detection by financial institutions.

- *Reputation Risk* – Large insured institutions continue to be regularly featured in negative headlines about questionable transactions, consumer complaints, foreign office debacles, and failure to protect customer information. While few of these matters threaten banks' earnings or capital positions, they mar the industry's image and erode confidence in insured institutions. Several large banks have posted significant charges related to widely-publicized corporate governance or transactional missteps. We expect the media to continue reporting on banking "scandals" as they come to light. These scandals are not only costly to earnings; they are also a significant diversion of management's attention.