Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
November 1, 2005

Background

This report provides a summary view of emerging risks in the banking and thrift industries. It is intended to serve as background for the Board's consideration of the deposit insurance premium rate case that follows. The report combines the perspectives of FDIC economists, risk analysts, examiners, and case managers working through the FDIC Risk Analysis Center. A previous version of this report was presented to the FDIC National Risk Committee on October 25.

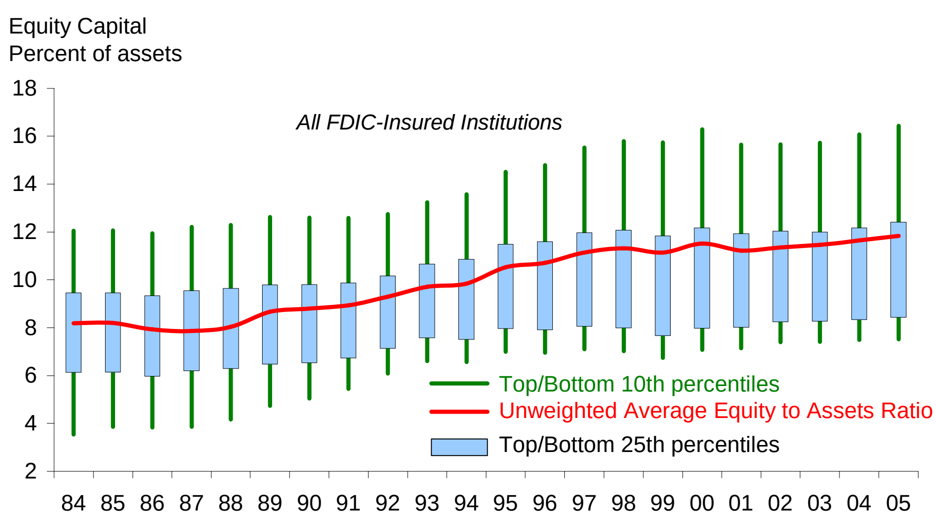
Performance of the U.S. Economy and Banking Industry Remains Strong

The four-year U.S. economic expansion continues to support strong loan performance and mortgage-led loan growth at FDIC-insured institutions. Banks have reported four consecutive years of record earnings, and have recently enjoyed earnings growth derived from securities gains, reduced loan loss provision expenses, and improved overhead efficiency. Continued strength in credit quality appears likely to translate into record industry earnings again in 2005, despite weakness in net interest margins (NIMs) related to a flattening yield curve.

Overall, the industry remains healthy, with strong credit quality, stable earnings, and capital ratios at historic highs (Chart 1). The number of banks on the Problem Financial Institution List also remains low. As of October 1, 2005, there were 67 institutions on the list with $7.86 billion in assets. There have been no bank or thrift failures since June 25, 2004.

Chart 1

Strong banking industry capital offers a buffer against future increases in credit losses.



Source: FDIC 2005 data point as of June 30

Despite this robust financial performance, FDIC analysts and examiners continue to monitor economic conditions and emerging risks in banking that could lead to deteriorating financial performance in future quarters.

Recent Hurricanes Pose Challenges for Banks and Economy

The most immediate identifiable sources of concern at this time are the intermediate-term effects of Hurricanes Rita and, especially, Katrina. The large-scale destruction of property and business activity in the Gulf Coast region, along with the displacement of hundreds of thousands of people, have created stresses for some local financial institutions.

Table 1

Bank headquarters and branches are located throughout the designated Katrina disaster zone.

Number of Offices as of June 30, 2005 in FEMA-Designated Counties

"Red" Counties and Parishes*	Main Offices	Branches	Total Offices	Office Deposits ($000)
Alabama (3 Counties)	9	173	182	8,480,851
Louisiana (30 Parishes)	92	919	1,011	42,453,378
Mississippi (15 Counties)	19	193	212	6,683,617
Total 48 Counties and Parishes	120	1,285	1,405	57,617,846
"Yellow" Counties and Parishes*				
Alabama (3 Counties)	3	23	26	759,353
Louisiana (34 Parishes)	70	491	561	15,752,837
Mississippi (37 Counties)	43	513	556	18,099,504
Total 78 Counties and Parishes	116	1,027	1,143	34,611,694
Total 122 "Red" and "Yellow" Counties and Parishes*	236	2,312	2,548	92,229,540

* "Red" counties and parishes are those initially designated by FEMA as eligible for both public and individual assistance. "Yellow" counties and parishes are those initially designated as eligible for public assistance only.

Sources: Federal Emergency Management Agency (FEMA), FDIC Call/Thrift Financial Reports, Summary of Deposits Survey

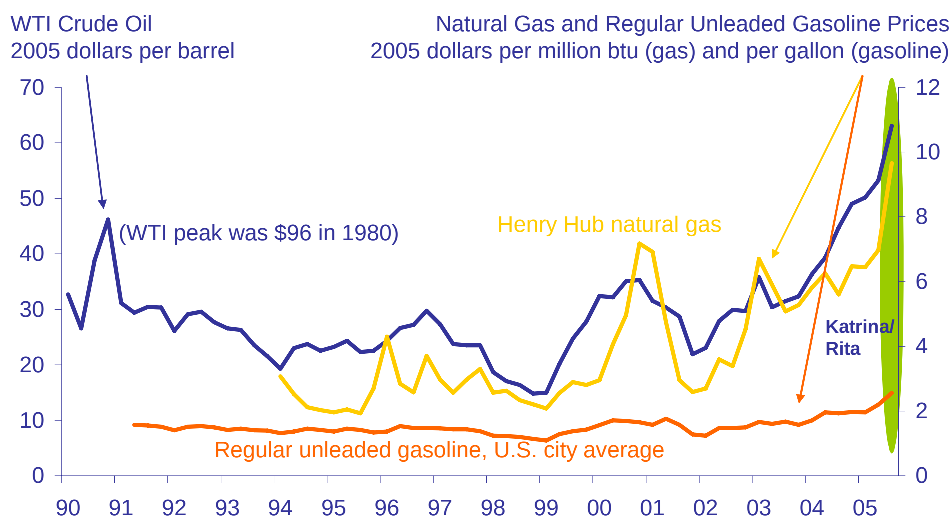
The FDIC has been working closely with other regulators and government officials to overcome the immediate operational challenges faced by the hardest hit institutions. Some institutions in areas affected by hurricanes have already reported the impact on earnings, while others are still assessing their exposure. The longer term effects on credit quality and franchise value will take time to fully evaluate. FDIC Regional and Field Office personnel are in regular contact with the affected institutions as they work with their borrowers.

The hurricanes have also altered the U.S. economic outlook. Energy prices, which had already risen significantly during the first eight months of 2005, rose briefly to record levels in the immediate aftermath of the hurricanes (Chart 2). High prices for natural gas are expected to persist through much of the winter and could adversely affect consumer spending. Higher energy prices are also contributing to the re-emergence of inflationary pressures as a policy concern, prompting market expectations that short-term interest rates will continue to rise in coming quarters. Federal spending on disaster assistance and rebuilding is expected to provide as much as $100 billion in aid to the Gulf Coast region;

however, this spending could create pressure to reduce other federal expenditures or expand the federal budget deficit.

Chart 2

Real energy prices spiked after Katrina and Rita, and may remain elevated through the spring.



Source: Haver, prices adjusted for general inflation using CPI *less energy* deflator

Outlook for U.S. Economy Calls for Stable—Though Moderating—Growth

While these shocks to the economic picture will continue to merit our attention, they are unfolding against a backdrop of an otherwise strong U.S. economy. Corporate profits have been somewhat higher than expected in recent quarters, while growth in jobs and disposable incomes have also been relatively strong.

Prior to the hurricanes, forecasters had been projecting that the U.S. economy would grow at a pace of about 4 percent in the second half of 2005. The expected net effect of these shocks has been that the pace of growth would slow to between 3 and 3.5 percent for the second half. However, preliminary estimates show that the economy continued to expand at a rate of 3.8 percent in the third quarter. While higher interest rates and energy prices are expected to moderate growth going into next year, rebuilding along the Gulf Coast is also expected to boost economic activity at the margin and help to maintain the pace of economic growth near its current level.

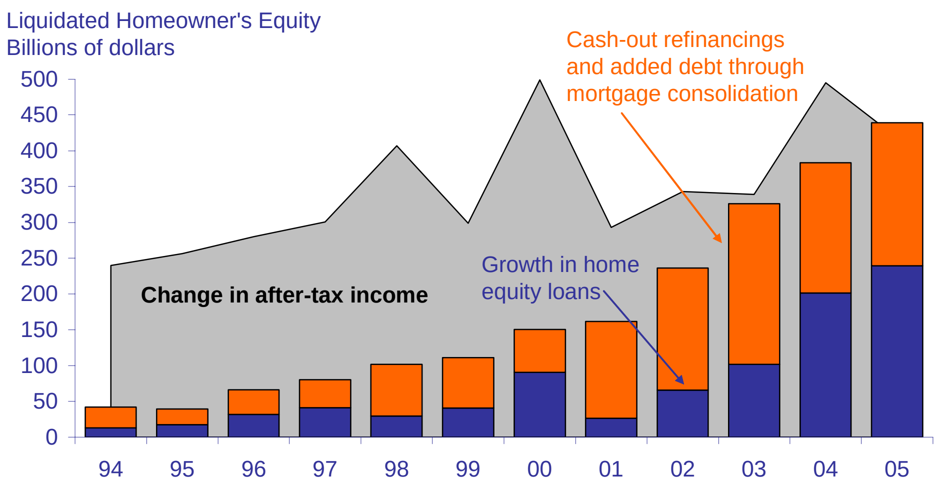
Risks to the Economic Outlook

Intermediate-term risks to the economic outlook generally revolve around the boom in home prices and continued U.S. dependence on inflows of foreign capital.

Housing Boom. Home prices have risen sharply in many markets along the east and west coasts in recent years, particularly in 2004 and 2005. While the increase in housing prices has not been uniform across the nation, low interest rates and non-traditional mortgage financing vehicles have allowed more borrowers to be active in markets experiencing rapid price increases. U.S. homeowners have taken on some $1.7 trillion in new mortgage debt over the past two years through home purchases and by extracting equity from homes they already own. Early estimates suggest that the amount of equity extracted from U.S. homes in 2005 could actually exceed growth in disposable incomes (Chart 3).

<u>Chart 3</u>

Cashed-out home equity may exceed growth in disposable income this year.



Source: Federal Reserve and Freddie Mac

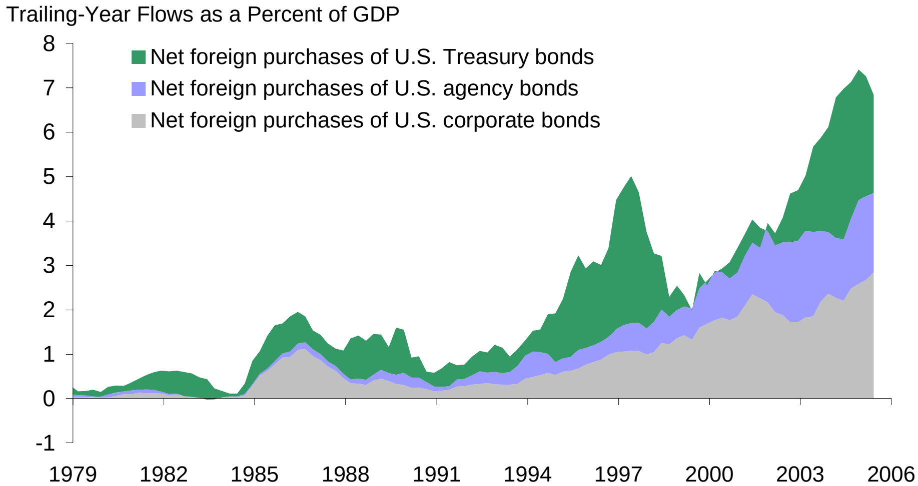
'05 is Freddie Mac forecast and equity and income estimates based on first half data

Rising interest rates and declining affordability will likely slow the pace of home price increases in current boom markets. It is not unlikely that some local markets could experience home price declines. One effect of a home price slowdown would be to limit the ability of homeowners to trade up or extract equity from their homes, thereby slowing housing market activity, mortgage lending volumes, and consumer spending. Another effect could be to boost levels of problem mortgage loans from current, historically low levels.

Dependence on Foreign Sources of Capital. Increased borrowing by the U.S. household and government sectors in recent years has been facilitated by large inflows of capital from overseas investors. The U.S. current account deficit totaled $668 billion in 2004 and appears likely to exceed that level in 2005. In one sense, the popularity of U.S. Treasury and agency securities among foreign official and private investors reflects their confidence in the ongoing stability of the U.S. economy and financial markets (Chart 4). However, the sheer volume of these global financial imbalances creates concerns that foreign investors will eventually seek to rebalance their portfolios toward non-dollar assets, thereby placing downward pressure on the dollar and upward pressure on U.S. inflation and interest rates. Given the strong and reasonably balanced growth the U.S. economy is enjoying at present, analysts continue to look to such shocks as potential sources of instability in the intermediate-term outlook.

Chart 4

Foreign investors have recently shown strong interest in U.S. bonds – Treasuries in particular.



Source: U.S. Department of the Treasury.

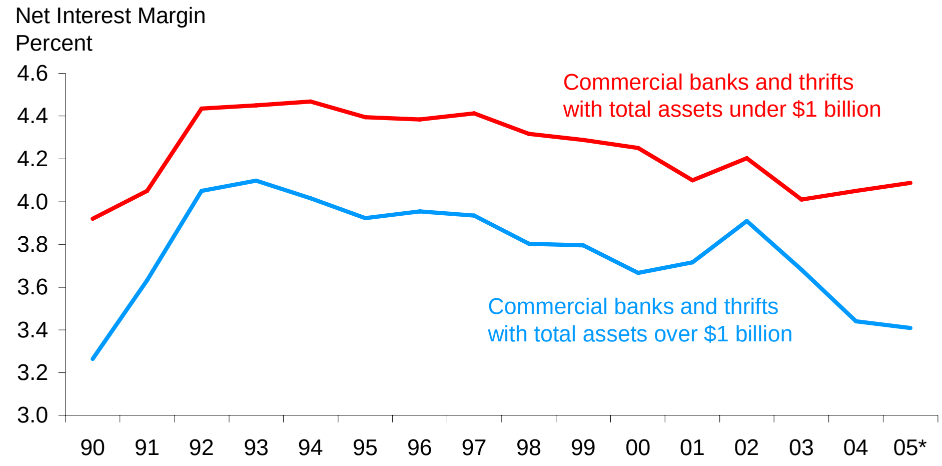
A Flattening Yield Curve Has Pressured Bank Net Interest Margins

After the U.S. economic expansion began producing consistent growth in jobs and business investment in early 2004, the Federal Reserve undertook a program of gradually raising short-term interest rates. Since June 2004, the federal funds rate target has been raised 12 times, by a total of 300 basis points. However, in part because of continued strong demand for U.S. Treasury and agency debt by foreign investors, long-term U.S. interest rates have been slower to rise. The result has been a significant flattening of the Treasury yield curve. The average spread between 10-year U.S. Treasury yields and the federal funds rate has shrunk from 3.72 percent as recently as May 2004 to just 0.58 percent in September 2005.

The flattening yield curve, along with heightened competition for loans and deposits, has put downward pressure on the average net interest margin of FDIC-insured institutions. The industry's average NIM during the second quarter of 2005 was 3.51 percent, down from 3.73 percent in the fourth quarter of 2003 and the lowest level recorded since 1990 (Chart 5). Recent earnings releases by public banking companies indicate the expectation of continued margin pressure during the third quarter of 2005 and beyond. Although larger institutions have been affected to a greater degree by the narrowing of margins, we note that their earnings are supplemented by higher levels of non-interest income and that they continue to perform very well in general.

Chart 5

Large institutions, in particular, have seen narrowing net interest margins as the yield curve has flattened.



Source: FDIC

Credit Losses Remain Low, But Competition Has Led to a Greater Appetite for Risk

Credit quality remained very strong through mid-2005, as delinquency and loss rates remain low across nearly every lending category. Noncurrent loans measured just 0.71 percent of total loans in the second quarter, the lowest level since the inception of that data series in 1984.[1] Notwithstanding this strong loan performance at present, FDIC analysts and examiners are monitoring a number of areas where there is potential for higher loan losses in future quarters.

The challenges associated with relatively slow revenue growth, intense competition among financial services providers, and historically low interest rates have led a number of banks to become more aggressive with their products in both commercial and consumer lending (Chart 6). Examiners continue to indicate that some institutions are responding to competitive pressure by lowering loan rates, loosening underwriting standards, and making more frequent policy exceptions. While these trends do not necessarily indicate the presence of excessive risk exposures, they merit continued supervisory monitoring—particularly as recently originated loans begin to season in 2006.

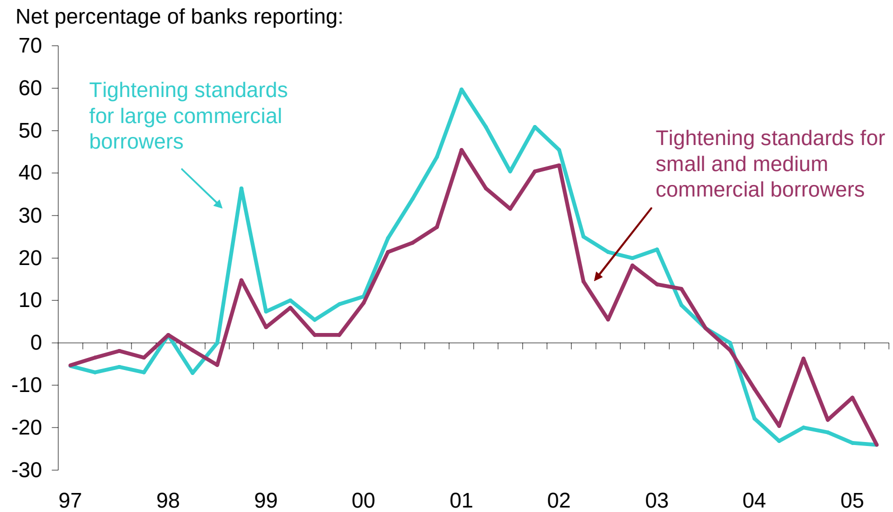
Commercial Lending. During 2001 and 2002, large banks saw the performance of their commercial loan portfolios deteriorate during a wave of corporate bankruptcies. Beginning in 2003, the performance of these portfolios improved markedly due to the economic recovery, aggressive loss recognition and loan restructuring, and a paring back of risk exposures to the corporate sector. The improvement in loan performance within

[1] Noncurrent loans include loans 90 days or more past due or in nonaccrual status.

large-bank commercial portfolios has been one of the single largest sources of earnings improvement for the industry during the past three years.

Chart 6

After an extended period of tightening, C&I lenders have begun to loosen standards in recent quarters.

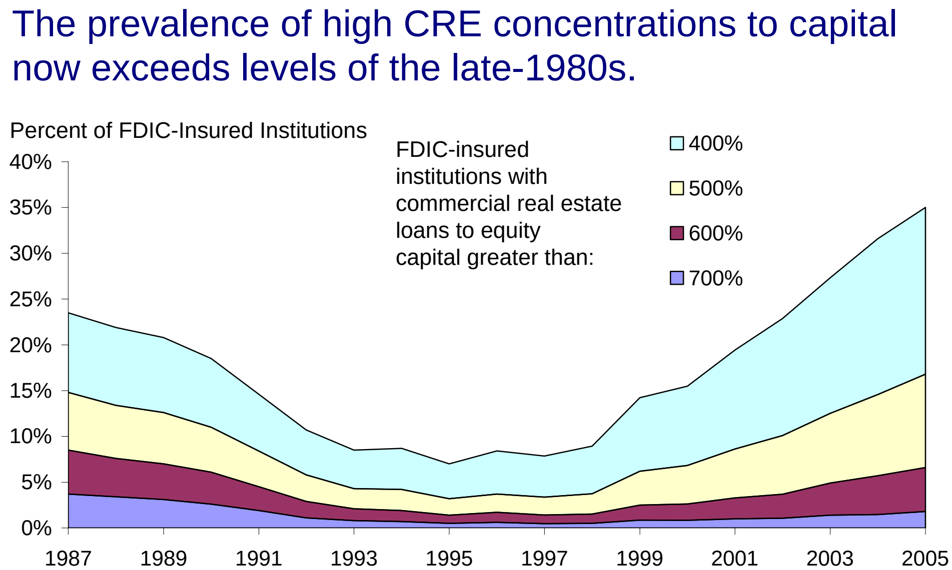


Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

The near-term outlook for commercial credit remains neutral to positive. While we note significant credit distress in certain industries, such as autos and airlines, those weaknesses must be balanced against the high profit margins that many other sectors currently enjoy. That said, the noticeable decline in commercial loan underwriting standards in recent quarters points to the likelihood that C&I credit losses will move higher in the intermediate to long term.

Commercial Real Estate Lending. Since the beginning of this decade, FDIC analysts have pointed to a long-term rise in the number of insured institutions with high concentrations of commercial real estate loans (CRE) to equity capital (Chart 7). This trend continued through mid-2005. While the rising prevalence of such concentrations raises some credit risk concerns, we also note that risk selection and underwriting in this cycle appear to be markedly improved from the late-1980s cycle, when commercial real estate losses contributed to a number of bank and thrift failures. As in other loan categories, credit losses in commercial real estate remain at historically low levels at present. While analysts note generally improving conditions in many CRE markets, they also note that rising interest rates will increase debt service costs for borrowers and could also have an adverse effect on property valuations as market cap rates rise. These factors will warrant continued monitoring of CRE concentrations, loan performance, and market conditions by FDIC analysts and examiners.

Chart 7



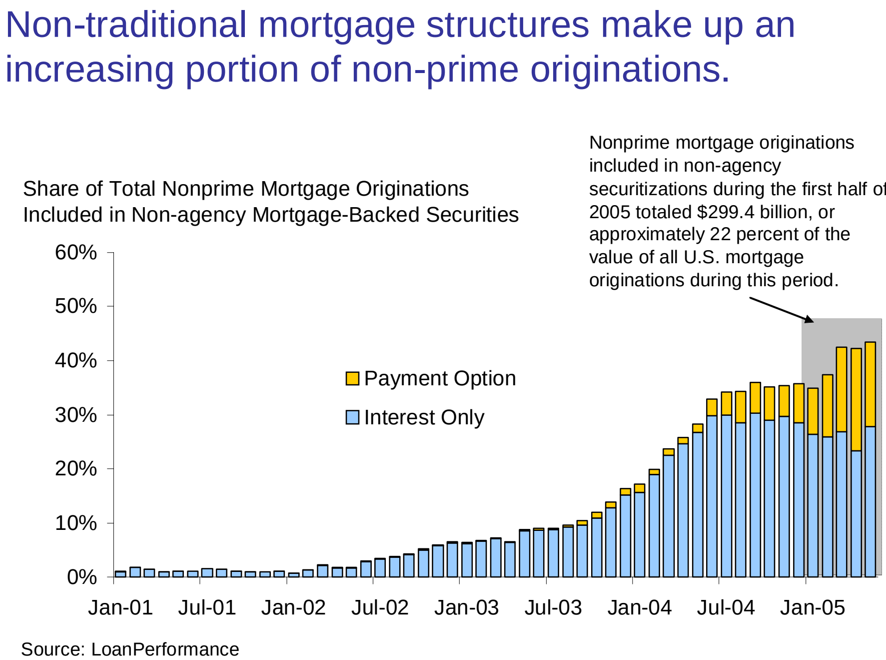
Source: FDIC. Includes FSLIC-insured institutions prior to 1989. All data reflect year-end totals except 2005, which represents mid-year totals. CRE loans include: loans secured by non-farm non-residential properties, by multifamily properties, and construction loans.

Mortgage and Consumer Lending. Despite the fact that mortgage credit losses at FDIC-insured institutions remain near historic lows at present, innovations in mortgage lending products are receiving greater attention from a risk management perspective. Analysts and examiners have noted a significant shift toward non-traditional mortgage loan products in 2004 and 2005 as lenders have sought to meet volume and revenue growth targets. Among these fast-growing loan products are subprime and low-documentation loans, interest-only loans designed to minimize monthly payments, and "payment option" mortgages that also give borrowers the option of skipping payments and adding accrued interest to their loan balances. Chart 8 depicts the rapid increase in interest-only and payment option mortgages included in private mortgage-backed securitizations, reflecting the general trend among most classes of mortgage lenders during the last two years.

While these structures have been useful in helping borrowers cope with rising home prices, they raise concerns that credit losses on poorly underwritten loans could increase significantly as interest rates rise and the home price boom eventually cools. Any such increase in mortgage loan losses is not likely to materialize until recently originated loans begin to season in 2006 and 2007. In addition, the ultimate impact of higher mortgage loan losses, should they materialize, will be mitigated to the extent that securitization has helped to spread mortgage credit risks across many diverse holders throughout the financial system.

The FDIC has been working on an interdivisional basis (through its Risk Analysis Center) and interagency basis to evaluate the risks posed by these products to individual institutions, and to provide supervisory guidance to the industry.

Chart 8



Consumer lending specialists have also experienced relatively strong loan performance and financial results in recent quarters, reflecting the effects of low interest rates and growth in disposable incomes. We note, however, that consumer lenders expect higher losses in the near-term due to an observed spike in personal bankruptcy filings that took place just ahead of the mid-October implementation of the bankruptcy reform legislation. Over the longer term, the effects of rising interest rates and energy prices could adversely affect consumer loan performance. However, as with mortgage risks, the prevalence of consumer loan securitization will help to limit the exposure of individual institutions to the possibility of higher consumer loan losses.

Financial Market View of Banking Sector is Generally Favorable

Although bank stocks have underperformed the S&P 500 thus far in 2005, price indications from the financial markets indicate a reasonably positive view towards publicly traded FDIC-insured banks. Among the concerns cited by analysts about the sector are heightened competition, limited revenue growth, margin pressure, and reputation risk. Moreover, analysts do not expect that banks will be able to sustain strong credit quality indefinitely. 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 (Moody's has issued only 23 downgrades of 837 banks and bank holding company issuers this year).

<u>Other Supervisory Issues</u>
FDIC examiners also note a number of other operational issues that continue to merit supervisory attention.

Bank Secrecy and Anti-Money Laundering (BSA/AML) Compliance. Significant industry and regulatory attention continues to focus on the industry's anti-money laundering programs. High-profile cases have intensified bankers' efforts to ensure that appropriate policies, controls, and detection processes are in place. The FDIC is working with other bank supervisors and government agencies to facilitate consistent approaches to policy development, examination coverage, training, and outreach.

Settlement of Credit Derivatives Trades. Accepted market practice up to the present time has allowed the booking assignments for credit derivatives without the prior written consent of the originating counterparty. As the number of credit derivatives trades has expanded rapidly in recent years, so has the backlog of trades in which the originating counterparty has not been notified. This backlog is thought to have the potential to impair the ability of participants to manage counterparty credit risk, and could also raise concerns with the ultimate legality of the contracts. Should an increase in defaults spark a wave of credit events, this uncertainty could contribute to a heightened potential for financial instability.

The Federal Reserve Bank of New York convened a meeting on September 15th with financial services regulators from the U.S., UK, and Switzerland, as well as 14 major investment and commercial banks, to discuss concerns relating to the dramatic growth in unconfirmed credit derivatives trades. This meeting set in motion the development of a protocol to simplify the process of transferring trades as well as a process for measuring and reporting unconfirmed transactions.

Information Technology Risk. Insured institutions are challenged to manage 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 featured in negative headlines about fraudulent transactions, consumer complaints, foreign debacles, and failure to protect customer information. These reports can be damaging to the industry's image and potentially erode confidence in insured institutions. They can also be costly to earnings and a significant diversion of management's attention.