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## FDIC REPORT EVALUATES PROSPECTS FOR COMMERCIAL CREDIT QUALITY

Continuing increases in problem commercial loans are focusing a spotlight on declining conditions in business lending, according to the Federal Deposit Insurance Corporation (FDIC). On September 30, 2000, commercial banks reported noncurrent commercial loans of 1.52 percent of total commercial loans, the highest level in the past six years.

Although worsening business loan quality is a concern, FDIC analysts point out that, in relative terms, current indicators of business loan problems do not approach the experience of banks during the economic downturn of the early 1990s. "Signs of a slowdown in the economy raise concerns about the possible severity of commercial loan problems, a situation we will be watching closely in the coming months," said FDIC Chairman Donna Tanoue. "However, it is important to note that continued strong earnings and capital provide a significant buffer for banks to weather the effects of higher levels of nonperforming business loans and business loan losses."

In the first quarter edition of the ***Regional Outlook***, analysts cited a rise in leverage at domestic corporations, as well as heightened tolerance for risk and relaxed underwriting standards at insured depository institutions from 1996 to 1999 as reasons for the decline in business credit quality. More recently, an apparent slowdown in economic growth coupled with weakness in certain industry sectors -- for example, telecommunications, healthcare services, and textiles-- have increased prospects for further deterioration in business credit conditions.

Certain regional trends described below reflect an increasing exposure to credit risk among insured institutions at the same time commercial credit quality is showing signs of deterioration.

- **Boston Region.** The credit risk profile of the Region's commercial banks appears to be rising as evidenced by a steep increase in commercial loans as a percentage of the total loan portfolio during the past three years.

- **New York Region.** As the economy has slowed, the Region's community banks have reported a shift into traditionally higher risk, higher yielding loan categories. The credit risk profile of the Region's new banks also appears to be increasing as evidenced by growing commercial real estate loan portfolios and increased use of noncore funding.

- **Memphis Region.** Rising funding costs, particularly in the Region's metropolitan areas, likely are pressuring banks to accept additional credit risk to bolster declining net interest margins. In areas where competitive pressures appear the highest, such as in Memphis, banks are reporting greater increases in credit exposure.

- **Chicago Region.** The Region's insured institutions have reported rising exposure to commercial and industrial (C&I) credits, a loan category that historically has experienced higher loss rates than other loan types. Although the strongest C&I loan growth has occurred among the largest insured institutions, increased C&I exposure is evident at many other institutions as well. In addition, the percentage of the Region's community institutions with significant commercial real estate portfolios continues to increase.

- **Atlanta Region.** The majority of the workforce in nearly one-fourth of all counties in the Atlanta Region is employed in industries that, according to an analysis of economic indicators, could be more vulnerable in the event of an economic downturn. The ripple effect from layoffs in two or more of these industries could adversely affect income levels and weaken consumer and business credit quality.

- **Kansas City Region.** A review of the Region's community banks prior to the 1980s agricultural crisis shows that the relationship between the loan-to-asset (LTA) ratio and the net interest margin (NIM) frequently was an indicator of increased potential for failure. Although banking conditions have changed since then, the results of this review suggest that banks reporting high LTA ratios and high NIMs appear to have a higher tolerance for risk.

- **Dallas Region.** Rising oil prices should, on balance, benefit the Dallas Region, although reliance on oil as an economic driver has declined dramatically over the past 20 years. Oil and gas output as a share of the Region's gross regional product declined from 17 percent in 1982 to 5 percent in 1998.

- **San Francisco Region**. Personal bankruptcy filing rates and household debt service burdens likely will increase in a slowing regional economy and challenge the Region's insured institutions. Subprime and specialty credit card lenders, which manage most of the Region's consumer credit, would likely be disproportionately affected by consumer credit quality deterioration.