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More on Banking …

CREDIT CONDITIONS page 9
Some snap and crackle, but no pop.

DISTRICT VOICES page 11
How have current credit conditions affected your business, community or industry?

AG BANKS: A WALK DOWN (BAD) MEMORY LANE? page 12
Are conditions ripe for another farm crisis?

GOING FOR BROKE page 15
Personal bankruptcies are up, but still low by historical standards.

DISTRICT DATA

Outlook 17
Forecast 18
Data map 20

A spanking in banking

District banks struggled last year and face tough conditions going forward, but they continue to show good fundamentals to weather the storm

By RONALD A. WIRTZ
Editor

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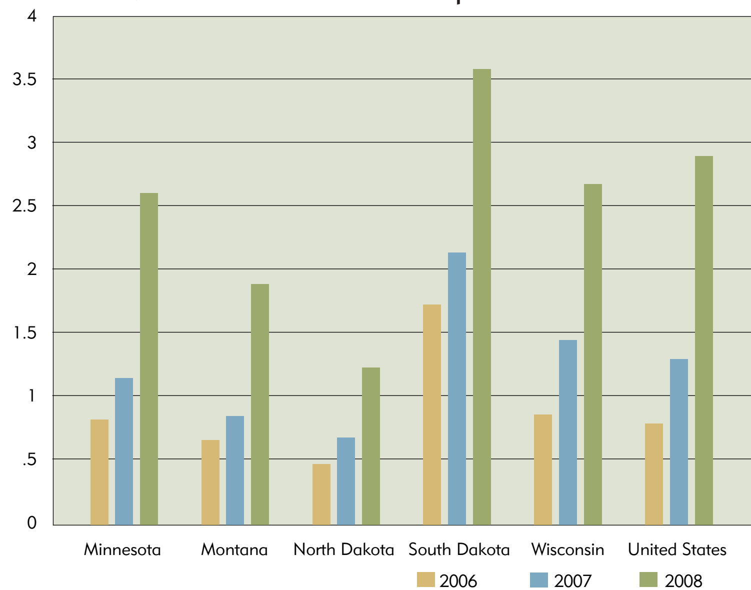
Financial Analyst

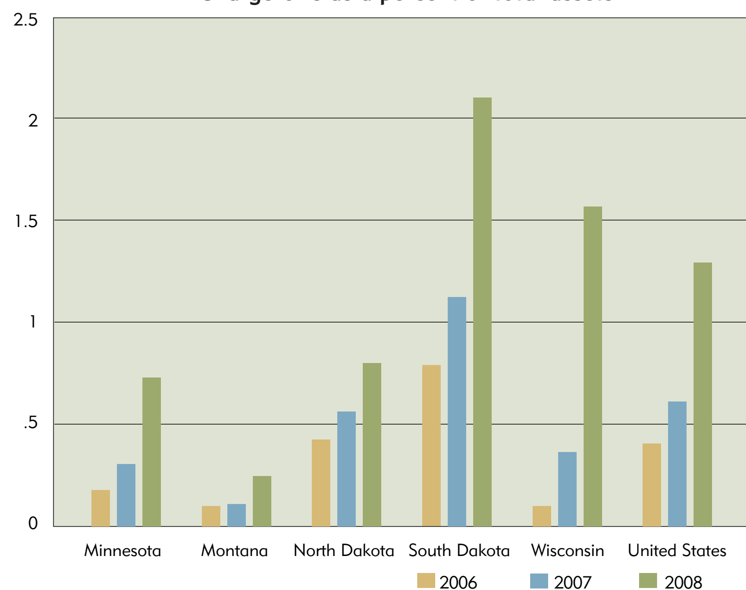
With somewhat ironic deference to the Grateful Dead, what a long, strange trip it's been for banks.

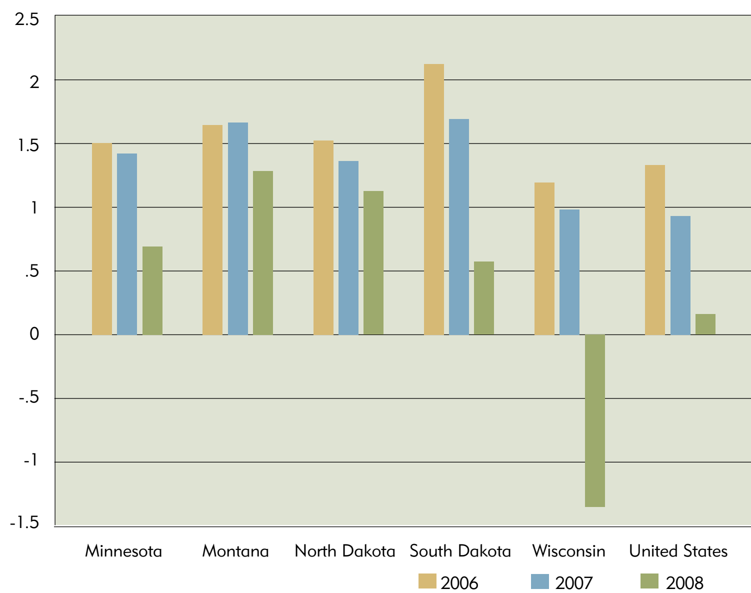
By now, most people are intimately familiar with the banking crisis, even if they'd prefer not to be. The matter is ubiquitous, whether it concerns bailouts, stress tests, toxic assets, stock prices, credit crunches, you name it—in the newspapers, on the airwaves, on the Web, at cocktail parties and backyard barbecues.

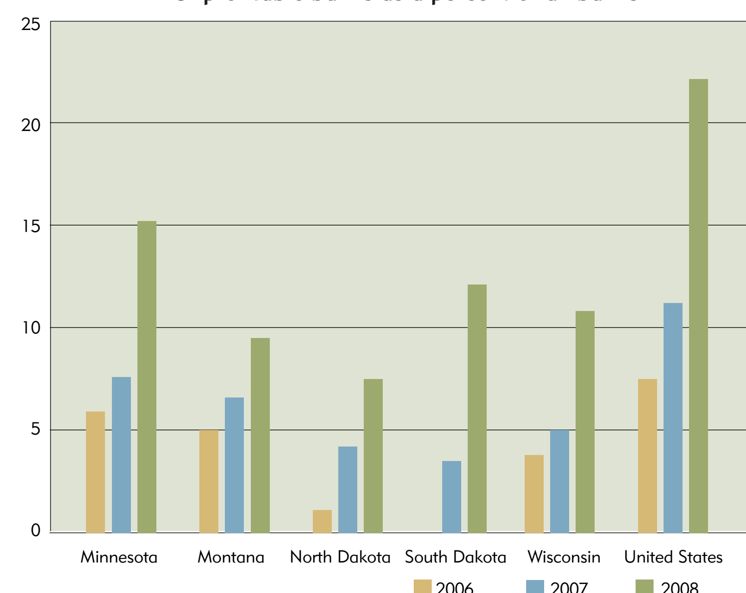
Lost amid the chatter and hand-wringing, however, is the fact that banks in the Ninth District are still in comparatively good shape despite major upheaval in financial markets and the broader economy. Whether that holds is difficult to predict; trend data going back to the 1980s suggest that performance by district

Continued on page 2









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One of the Minneapolis Fed's congressionally mandated responsibilities is to gather information on the Ninth District economy. The *fedgazette* is published bimonthly to share that information with the district, which includes Montana, North and South Dakota, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

The opinions expressed in the *fedgazette* are expressly those of the authors or of attributed sources and are not intended to represent a formal position of this bank or the Federal Reserve System.

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Banking from page 1

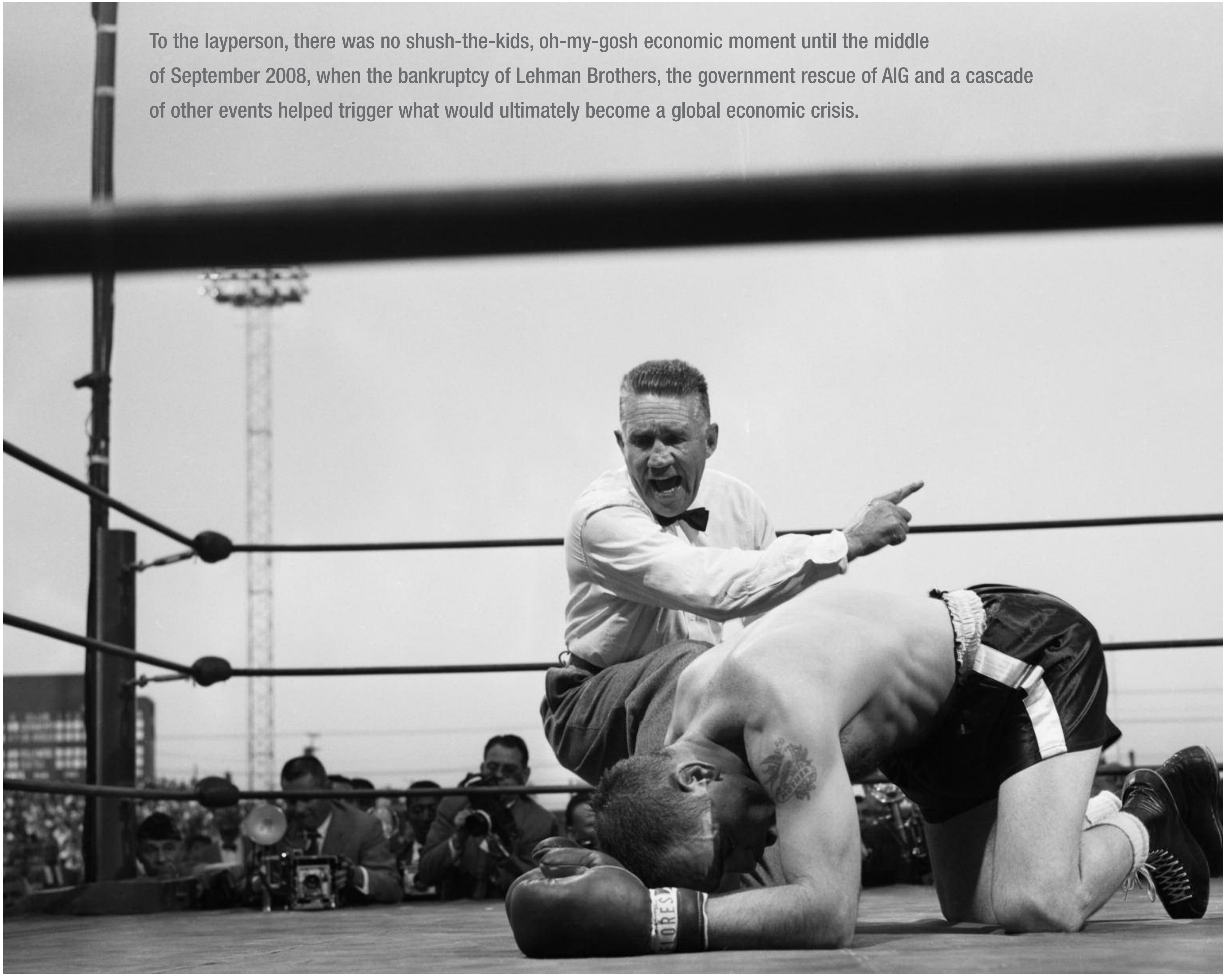
banks, on average, is likely to get worse before it gets better.

Yet as future bank performance rolls out, it's useful to retrace the path from whence it came. In some respects, it's difficult to grasp just how quickly things have gone off course. Indeed, the trip has been strange, but not necessarily that long.

By the middle of 2007, there was concern among bankers and economy watchers as the subprime mortgage debacle started to unfold, and even clearer signs of trouble became apparent by the end of the year, when a national recession officially began. By early 2008, the Federal Reserve was aggressively cutting interest rates and had implemented new programs to provide liquidity in the financial sector. For many, a tipping point came in March 2008, when the Federal Reserve invoked emergency powers and helped to arrange a fire sale of Bear Stearns to JPMorgan.

Still, even by last summer, the recession had not severely affected employment or output, and runaway commodity prices and $4 gas dominated the business news. To the layperson, there was no shush-the-kids, oh-my-gosh economic moment until the middle of September 2008, when the bankruptcy of Lehman Brothers, the government rescue of AIG and a cascade of other events helped trigger what would ultimately become a global economic crisis.

So much has happened since last September that it almost feels like a time warp: Doesn't the now-comparative calm



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of 12 months ago feel like 12 *years* ago?

All recessions hit the financial services sector eventually. But problems in the financial sector have been the defining elements of this recession, from its beginnings in the subprime mortgage market to the extraordinary bailouts and policy measures of the past 12 months. Rather than follow other sectors into an economic slowdown, banks and other financial institutions have led the way into this recession. But it wasn't a group effort, at least not at first. The implosion of the financial services sector—everything from banks to investment firms to rating agencies—mainly snared the biggest conglomerate banks that were involved in troubling investments such as subprime mortgages, collateralized debt obligations and credit default swaps.

The ensuing melee has put banking in the public spotlight, which also means the industry gets painted with broad strokes. If the big banks are seemingly a congressional whim away from failure, how close are the rest to the abyss?

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In fact, regional and community banks have been largely unaffected by the so-called toxic asset controversy surrounding subprime mortgages. But over time—a fairly short time, in reality—plunging bank profitability suggests that the industry has come to feel the effects of the broader recession. Thanks to this simultaneous top-down and bottom-up pressure, 2008 will go down as a scarlet-red-letter year for banks across the country and the Ninth District. However, despite obvious signs of decline and stress, most district banks today still appear healthy, particularly compared with the nation's banks as a whole.

For broader perspective, it helps to take a comparative look at history. The last full-blown banking crisis took place in the 1980s and hit particularly hard in Minnesota and many rural agricultural areas of the district. This time, although health indicators have worsened considerably in the past 18 months or so, and appear likely to decline further, banks in the Ninth District have some financial strength remaining to help them withstand this bout of economic flu.

Let's not do this again, hmm?

The best thing that might be said about 2008 is that at least it lasted only 12 months, as banks watched the economy and their own health metrics take a nosedive, particularly in the last three months of 2008.

Continued on page 4

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Net income, for example, plunged 80 percent at banks nationwide in 2008, and by 60 percent in both Minnesota and South Dakota, according to data from the Federal Deposit Insurance Corp. ... Not surprisingly, return on assets took a similar beating compared with a year earlier for banks in most district states, and the number of unprofitable banks also surged.

Banking from page 3

Net income, for example, plunged 80 percent at banks nationwide in 2008, and by 60 percent in both Minnesota and South Dakota, according to data from the Federal Deposit Insurance Corp. (FDIC). In Wisconsin, net income swung from a $1.2 billion profit to a $1.5 billion loss, mostly on the heels of large losses at Marshall & Ilsley Corp., parent of M&I Bank, the state's largest bank. The amount of past-due loans and loans written off by banks as uncollectible also rose steeply in all district states, though more in some than others; certain states like Montana still have rates for these important measures that are relatively low (see Charts 1 and 2 on page 2). (Note: For comparison purposes, the accompanying charts include all commercial banks in Wisconsin, some of which are not in the Ninth District.)

Not surprisingly, return on assets (ROA) took a similar beating in 2008 compared with a year earlier for banks in most district states, and the number of unprofitable banks also surged. On both of these measures, however, district banks in general fared much better than those nationwide (see Charts 3 and 4 on page 2).

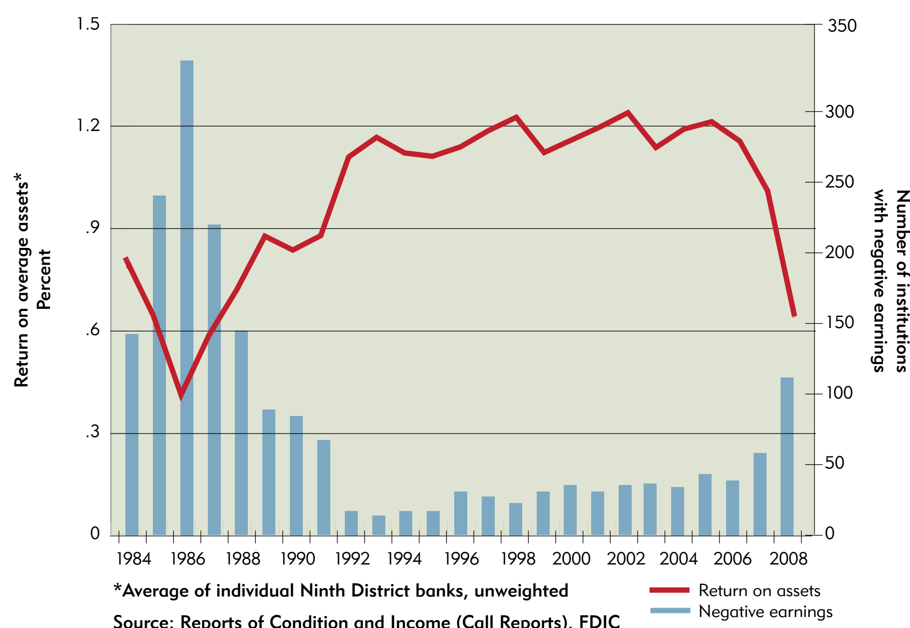
More disconcerting is the fact that bank losses accelerated steeply over the course of the year. For example, nearly one-third of U.S. banks were unprofitable in the fourth quarter of last year, significantly worse than the nationwide annual rate of 22 percent in 2008. In Wisconsin, 11 percent of banks were unprofitable last year, but 28 percent lost money in the last quarter of 2008.

Though much of the carnage occurred in the fourth quarter of last year, 2008 was not in line to be a banner year even before the financial collapse last fall. Indeed, a close look at the data shows that virtually all of the indicators mentioned above had worsened across the board in 2007, though mostly by fairly small amounts.

Among district states, Minnesota and Wisconsin banks have probably fared the worst of late. (South Dakota's performance has also been poor, but is a special case as discussed below.) The two states have seen some of the steepest declines among the various performance measures. Total bank employment, for example, has dropped two consecutive years in Minnesota, worse than the national trend, which saw employment drop only in 2008. The state was also on the low end of deposit growth in 2008 (at 4 percent), which doesn't include a $6.8 billion deposit migration when Wells Fargo Bank South Central of Faribault, Minn., a mortgage-related subsidiary of Wells

CHART 5

Return on assets plummeting; more negative earnings*



*Average of individual Ninth District banks, unweighted

Source: Reports of Condition and Income (Call Reports), FDIC

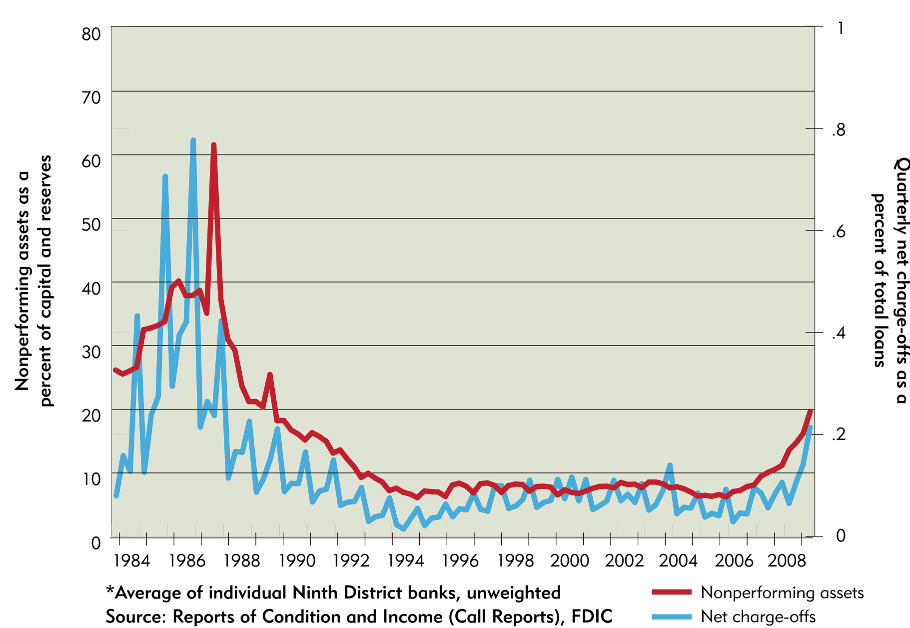
- **Trend**: Return on average assets (red line) has been declining for several years and has plummeted of late, driven in part by an increasing number of banks reporting negative earnings (blue bars).

- **Return on average assets (ROAA)** is a standard measure of bank earnings. It is the ratio of net income to annual average assets. **Earnings** are a measure of profitability (also referred to as net income or the "bottom line") and equal a bank's revenues minus operational costs, depreciation, interest, taxes and other expenses. **Assets** are the cumulative investments, loans and real property owned by a bank.

- **Why are these measures important?** Profits (a.k.a. earnings or net income) are ultimately what sustain all businesses, including banks. As they sag industrywide, it's likely that a growing number also become unprofitable and are more likely to go out of business.

CHART 6

Asset quality decent, but worsening*



*Average of individual Ninth District banks, unweighted

Source: Reports of Condition and Income (Call Reports), FDIC

- **Trend**: Since about 2006, there has been a notable uptick in the percentage of nonperforming assets (red line) and, with it, a related increase in net charge-offs (blue line).

- **Nonperforming assets** are loans that are 90 or more days past due, plus nonaccrual loans (loans not earning income because interest is overdue and full collection of principal is uncertain, usually because of borrower difficulties), plus "other real estate owned" (OREO), which is typically acquired through foreclosure and not generating income. **Net charge-offs** are the assumed losses from bad loans charged against a bank's loan portfolio, less any recoveries ultimately collected on those loans.

- **Why are these measures important?** Banks have a capital buffer to absorb losses. Nonperforming assets are a leading indicator for loan charge-offs, which reduce a bank's capital buffer and its ability to absorb future losses.

Fargo, relocated its offices to Alaska.

Banks in North Dakota and Montana have performed comparatively well to this point. Net income has dropped less than 10 percent since 2006 in the Peace Garden state, and the number of unprofitable banks remained in single digits in 2008 for both states. Banks in each state continue to have low levels of noncurrent loans and net charge-offs, probably due in part to the outsized effects of strong farm and energy sectors in both states last year. However, if this crisis has shown anything, it's that conditions can change, and quickly.

As might be expected given the circumstances, growth of new branch offices has slowed. In 2007, a total of 130 new bank offices were opened in the five district states and the Upper Peninsula of Michigan, according to the FDIC. That number fell to 88 last year, and only 11 opened after mid-September. Through early May of this year, just 14 new offices had opened in the five states; eight in Wisconsin and none in Montana, South Dakota or the U.P.

The total number of bank offices is still growing slowly nationwide, but has fallen in the district, which breaks a decades-long growth trend. From 2006 through 2008, U.S. banks added about 500 net new locations (about one-half of 1 percent). In the same period, the total number of bank offices in the Ninth District actually dropped a bit—by 58 locations, or about 1 percent—from a high in 2006. Though it has comparatively few bank offices, the Upper Peninsula saw a particularly large percentage drop of 17 percent over this period, and currently has 160. The slow-drip trend in district bank offices overall is likely to continue. AnchorBank of Madison, Wis., for example, announced in April that it would close three of its 76 branch offices in the state by the end of summer.

On the whole, however, Ninth District banks do not appear to have experienced the same level of difficulty as their peers nationwide. For example, 57 U.S. banks have failed from January 2008 through early May of this year; only one is in the Ninth District—First Integrity Bank of Staples, Minn., in May of 2008. Most annual performance metrics also give a decided edge to district banks.

There are some caveats, however, regarding district-to-nation comparisons. Nationwide figures for many stress indicators are skewed higher—by how much is not known exactly—by the disproportionate number of very large banks that are struggling. Though small in number, these banks hold a majority of bank assets, and their performance can have an outsized effect on cumulative bank performance if the sector is viewed as one large entity—everyone pooled together—rather than as the average performance of individual banks.

In fact, South Dakota offers just such an example in the district, because it is the charter home for Wells Fargo. By most measures, Wells Fargo has performed better to date than its goliath peers; though it lost money in the fourth quarter of last year, it was still profitable for the year and surprised the market with a $3 billion profit in the first quarter of this year.

Still, its 2008 performance lagged compared with 2007, and when Wells Fargo sneezes, the banking sector in

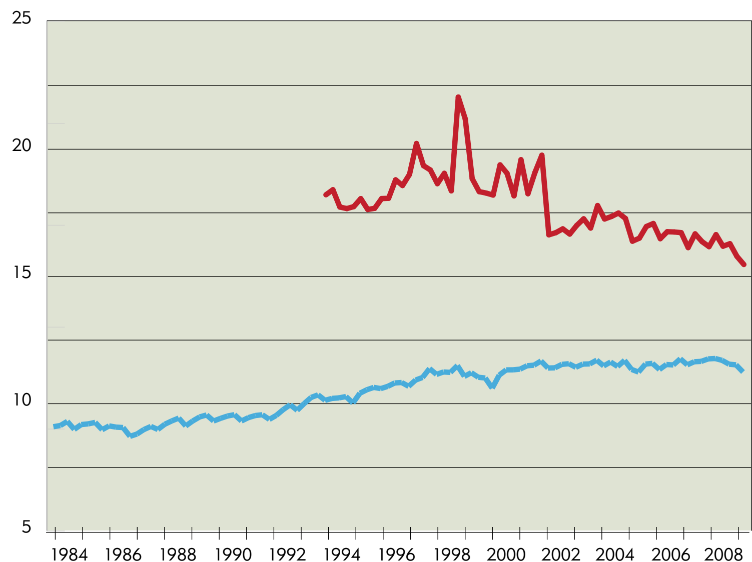
Continued on page 6

More disconcerting is the fact that bank losses accelerated steeply over the course of the year. For example, nearly one-third of U.S. banks were unprofitable in the fourth quarter of last year, significantly worse than the nationwide annual rate of 22 percent in 2008.

CHART 7

Capital ratios solid, but in retreat*

Percent



*Average of individual Ninth District banks, unweighted
Source: Reports of Condition and Income (Call Reports), FDIC

Total Risk-Based
Equity/Assets

- **Trend**: Two different capital ratios show that capital adequacy for banks has declined, particularly on a risk-adjusted basis; but on average, these ratios suggest that the banking sector in the Ninth District appears financially sound overall.

- **Capital ratios** are a key measure of a bank's financial stability. There are a variety of capital ratios, but they generally measure certain types of bank capital against certain types of assets. As a rule of thumb, the higher the ratio, the more sound the bank. **Equity capital to total assets** (blue line) simply compares the two main elements of a bank's balance sheet. The **total risk-based ratio** (red line) adjusts the assets for their underlying risk, which allows lower capital charges for less risky assets.

- **Why are these measures important?** Capital ratios represent a bank's buffer against losses. The closer that buffer gets to zero, the higher the chance of failure, all else equal. Bank supervisors group banks based on risk-based capital ratios. If this ratio is 10 percent or more (along with meeting certain targets on other select capital ratios), banks fall into the highest (safest) capital category and are considered "well capitalized," which means they do not necessarily face prespecified supervisory restrictions on their activities.

Add up these (and sundry other) performance indicators for most banks in the Ninth District, and you get a picture of a banking sector that is back on its heels, maybe a bit bloodied, but with enough stamina left to stay upright despite poor economic conditions.

Banking from page 5

South Dakota looks like it caught a cold, especially compared with other district states. For example, net income for Wells Fargo fell from $8 billion in 2007 to $2.8 billion last year—about 90 percent and 80 percent, respectively, of the net income of all South Dakota banks. Net charge-offs for Well Fargo doubled from 1 percent in 2007 to 2 percent last year; the bank wrote off $7.8 billion in loans last year, more than 90 percent of the $8.5 billion written off statewide; indeed, that represents about 70 percent of write-offs in all five district states. Results of the widely touted stress tests of the largest 19 U.S. banks by federal regulators showed Wells Fargo needed to raise $14 billion in additional capital.

Historical, or hysterical, comparisons?

The shock and trajectory of the current banking crisis has brought with it historical comparisons to the last banking crisis, which occupied much of the 1980s.

That collapse was really two separate crises among financial institutions. One involved commercial banks (and is the focus here). But there was a second, coincidental collapse among savings and loans, which stemmed from factors both similar and different from the commercial bank collapse. In all, about 2,000 banks and thrifts failed during the decade, including 1,400 commercial banks—about 25 times more than the tally from the current crisis through early May. The 1980s crisis spanned virtually the entire decade; the trajectory and length of the current crisis is unknown now that the banking sector has again become stressed.

Still, given today's economic and banking environment, it's useful to compare current banking indicators with those of banks during the 1980s to see what might be learned, and what path might lie ahead for the sector. So the Federal Reserve Bank of Minneapolis compiled historical data on a number of bank-health metrics, looking at average or median performance among all banks, rather than cumulative performance of banks as a single entity.

(Note: Much of the historical data on banks go back only to 1984, which is in the midst of the commercial banking crisis, but before the peaks in most indicators of weak performance. This analysis also covers only banks specifically within the Ninth District, which includes the Upper Peninsula of Michigan and 26 counties in northwestern Wisconsin.)

Broadly speaking, various indicators show that the banking sector is ailing. At the same time, a variety of measures suggest that overall, banks are considerably healthier than they were during the 1980s.

At first blush, the comparison with the 1980s looks unnerving. The first place most bankers look for trouble is their bottom line. Return on assets, a common benchmark in banking, has fallen steeply of late, reaching levels last seen during the 1980s (see Chart 5). This is due to a number of factors (discussed below), but reflected in the fact that the number of district banks with negative earnings has also risen significantly.

Another indicator of falling profitability is a decline in net interest margin (NIM). This is the difference or "spread" between what the bank pays for funding (like its deposits) and what it earns by lending that money to various borrowers. NIM is the business model upon which commercial banking is built—find cheap funding, and make money lending it to other people at higher interest rates. NIM tends to stay within a fairly tight range—roughly between 4 percent and 5.5 percent. But it has been gradually declining since the latter half of 2005, and the 4.1 percent average NIM reading in the fourth quarter 2008 was the lowest since 1987.

Banks also are seeing a higher rate of "nonperforming assets"—bankspeak for loans or other assets that are 90 days or more past due or otherwise in arrears, and often not earning the contractual rate of interest. Banks ultimately write off a certain number of bad loans that they believe are uncollectible. When this happens, the losses are charged against (or subtracted from) available capital. These charge-offs have risen fairly steeply of late (see Chart 6).

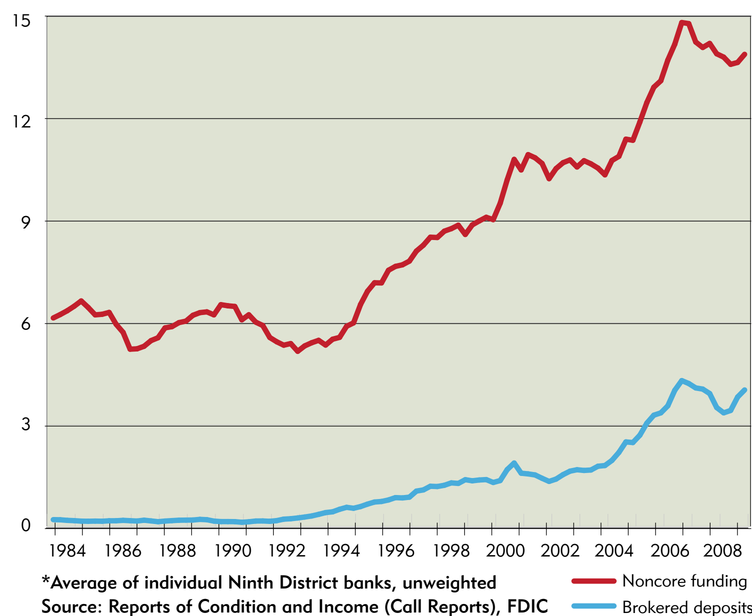
Banks must also "provision" against future losses. That is, after reviewing economic and loan-specific factors that help forecast loan losses, banks charge themselves an expense, which reduces earnings. The offset to the expense is a loan loss reserve. As might be expected in light of other indicators, provisions have jumped in the past year; from the first quarter of 2008 to its final quarter, total provisions as a percentage of loans have increased by about 250 percent in the district. Rising provisions can also be seen in the number of unprofitable banks (see Chart 5).

Despite the unflattering increases among all of these indicators, none is close to peak levels witnessed in the 1980s. Other metrics give a mixed report card on the health of district banks. For example, regulators also look at capital ratios—in essence, the amount of capital or equity compared with assets. On a basic level, over the past 25 years, banks have seen dramatic improvement in their

CHART 8

Alternative funding higher

Funding sources as a percent of total liabilities*



*Average of individual Ninth District banks, unweighted
Source: Reports of Condition and Income (Call Reports), FDIC

- **Trend**: Noncore (red line) and brokered deposits (blue line) can be relatively "footloose" sources of bank funding. Their overall share has increased significantly over the past two decades, but has dropped since about the start of 2007.

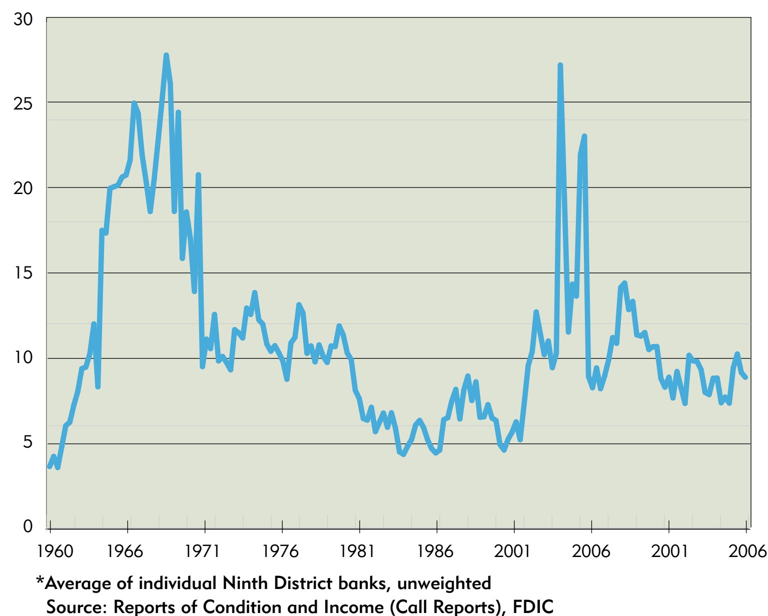
- **Core funding** is the deposits made by customers in the bank's general market area, who are usually considered to be the most consistent and loyal. **Noncore** funding is the deposits from outside the bank's general market area and include sources such as federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, and jumbo CDs (more than $100,000). A **brokered deposit** is a large-denomination deposit (similar to a certificate of deposit) that has been facilitated by a third-party broker who has pooled smaller deposits.

- **Why are these measures important?** Because noncore funds and some brokered deposits (those over $250,000 currently, but previously $100,000) are not insured by the federal government, the owners of these funds have reason to move such funds out of weak banks, which can further weaken a bank. As the funding share of noncore and brokered deposits increases, banks face potentially higher volatility in the shifting of these more mobile funds.

CHART 9

Asset growth stable of late

Percent growth in quarterly assets, year over year*



*Average of individual Ninth District banks, unweighted
Source: Reports of Condition and Income (Call Reports), FDIC

- **Trend**: Asset growth has seen considerable volatility over the years, but has been relatively stable during this decade.

- **Why is this measure important?** Rapid asset growth can increase the risk of loss for a bank. Though not a universal predictor, a bank might face increased risk if it takes on a large exposure before it has sufficient data, time or management capacity/controls to fully understand the potential risk it has assumed.

equity-to-asset ratio (see Chart 7). When assets are adjusted for underlying risk of repayment, however, the picture changes; after a notable drop in risk-adjusted capital ratios after the 2001 recession, these ratios have continued to slide slightly lower and recently fell below 16 percent. Still, regulators view a bank with a 10 percent ratio as well capitalized.

Adding to concerns, banks have seen a sizable increase in funding sources that are more footloose and potentially expensive. For example, the share of bank funding coming from so-called core deposits that the FDIC insures (and which, in some cases, may be more loyal to a bank) has been falling steadily since about the early 1990s, replaced by noncore funding and brokered deposits, which tend to seek out the best return (see Chart 8). Noncore deposits are more likely than core deposits to flee a weak bank because they may be larger than the FDIC insurance limit. Regardless of reason, when these funds leave, bank assets will have to shrink as well, and a smaller asset base can negatively affect profitability.

Beyond what you might think, bank assets have continued to grow even during the current crisis. In fact, total bank assets have not declined in any year going back at least to the 1950s. This naturally raises concerns given that a 1997 FDIC study of the 1980s crisis found that fast loan growth was an early indicator of problem banks. On this measure, asset growth has been comparatively stable for the past half dozen years or so—in the 8 percent to 10 percent range, well below the spikes seen in the 1980s, as well as during the boom years of the late 1990s (see Chart 9).

Add up these (and sundry other) performance indicators for most banks in the Ninth District, and you get a picture of a banking sector that is back on its heels, maybe a bit bloodied, but with enough stamina left to stay upright despite poor economic conditions.

At least that's the view of regulators, who continue to favorably rate the large majority of banks. Cumulative bank ratings (from all three federal regulatory agencies, as well as state bank regulators) are only available back to 1989—after the peak of the commercial banking crisis, when overall bank ratings were on the mend. Still, current bank ratings remain better overall than they were even then.

In the first quarter of 1989, for example, despite being on the tail end of the crisis, one in five district banks had a poor rating (3, 4 or 5, the last of which is considered an indication of imminent failure). The percentage of poor ratings subsequently plunged to the low single digits and remained there through about 2006, when it began to rise, slowly at first, before spiking in the last three quarters of 2008. Still, barely 14 percent of banks have a poor rating (see Chart 10).

At the same time, however, cumulative ratings are a lagging indicator because banks are typically examined every 12 to 18 months. This means ratings might decline further as examiners update ratings.

How far to the forest boundary?

The slope of virtually all the historical indicators suggests that the banking sector is not out of the woods yet. Almost certainly, conditions will worsen before they get better, and some banks will experience significant difficulty, even failure.

Aside from all of the data, there are also some contextual factors to consider regarding historical comparisons. For example, none of this discussion includes the carnage among savings and loans and other thrift institutions during the 1980s. From 1980 to 1988, there were 563 S&L failures nationwide, including 190 in 1988. There were also 333 supervisory mergers and almost 800 voluntary mergers, which the FDIC said were "technical failures," but didn't cost the federal government anything in terms of deposit insurance payouts. If S&L ratings and other performance data were included in this analysis, the current environment would likely look better compared with the 1980s.

In fairness, however, a large number of nonbank mortgage firms have also failed—MortageDaily.com puts the figure at more than 300 since 2006. They include the likes of New Century (at one point, the second-largest subprime lender in the country) and Fannie Mae and Freddie Mac, the mortgage behemoths that are now in government conservatorship.

Many people also point to much higher interest rates in the 1980s as an important difference compared with the current crisis. The federal funds rate, which is the target rate of interest for depository institutions lending their Federal Reserve balances to other institutions overnight, bobbed in double digits for much of the first half of 1980s, spiking as high as 20 percent as the Fed tried to rein in high inflation. Today, the rate is practically zero (technically, it's being targeted between zero and 0.25).

But from a banking standpoint, nominal interest rate levels aren't particularly important; rather, net interest margins are important—borrowing capital cheaply while lending high. The business model for banks is based on simply lend-

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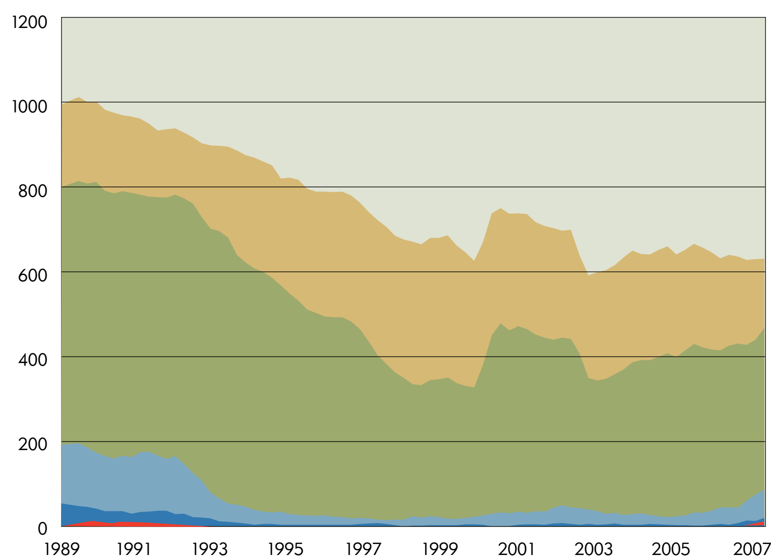
CHART 10

Bank ratings okay, but ratings are a lagging indicator

Number of Ninth District banks by bank rating



Source: National Information Center, Federal Reserve System

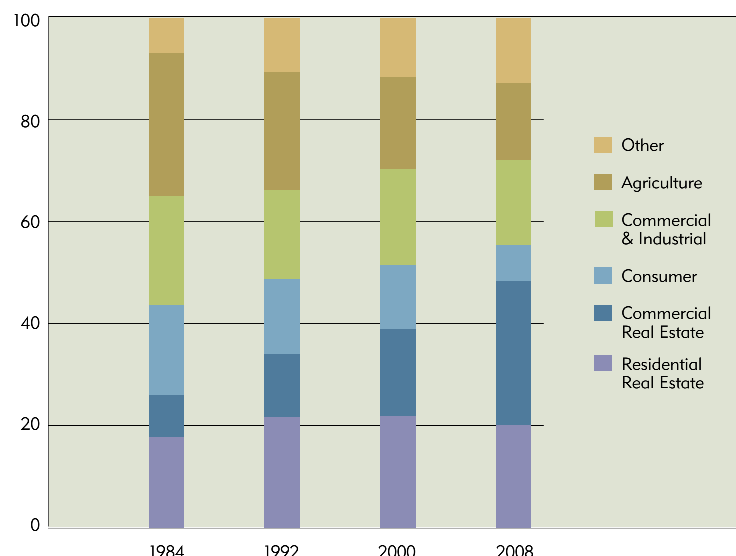
One Two Three Four Five

- **Trend**: Despite an uptick in the number of low-rated (or problem) banks, a very large majority of banks are still considered healthy.
- **Ratings** are evaluations of a bank's safety and soundness by the appropriate bank regulator. The rating is a composite measure, ranging from 1 (best) to 5 (worst, and considered a significant risk for failure).
- **Bank regulators**: The **Federal Reserve** supervises bank holding companies and state-chartered banks that are members of the Federal Reserve System; the **Federal Deposit Insurance Corp**. regulates state-chartered banks that are not part of the Federal Reserve System; the **Office of the Comptroller of the Currency** supervises nationally chartered banks; **state regulatory agencies** also supervise banks chartered in their state. Still other federal and state agencies regulate national and state-chartered thrifts (savings banks, savings and loan associations) and credit unions.
- **Why are these measures important?** Ratings are the best single measure available on bank health and safety—individually and as a sector—because they embody a summary analysis of the many measures of bank health and risk. At the same time, however, ratings are a lagging indicator because banks are typically examined every 12 to 18 months. This means ratings might decline further as examiners update ratings in the current environment.

CHART 11

More concentration in commercial real estate

Percent of total loans at year end*



*Average of individual Ninth District banks, unweighted
Source: Reports of Condition and Income (Call Reports), FDIC

- **Trend**: Commercial real estate has steadily grabbed a much larger share of overall bank lending, and all real estate is now responsible for almost half of all bank lending. The average bank has also significantly reduced its nonmortgage consumer and agricultural lending.
- **Commercial real estate loans** include those for multifamily residential properties, loans secured by nonfarm nonresidential property, construction and development loans, and unsecured loans to finance commercial real estate. **Residential real estate loans** include those for 1-unit to 4-unit family residential properties. **Consumer loans** include credit card loans, other revolving credit plans and other consumer loans. **Commercial and industrial** loans define their own category. **Agriculture loans** include loans secured by farmland, loans to finance agricultural productions and other loans to farmers.
- **Why is this measure important?** All else equal, concentrations of loans in a specific sector, geography or by loan type raise the risk of loss to the bank. An economic or other shock to the sector or within the local economy can create more losses to the bank if its exposure is similarly concentrated. However, banks can take steps to manage concentration risk, and bank supervisors have set up expectations for prudent management of concentrations.

Banking from page 7

ing money at higher rates than the bank is paying for its deposits. As mentioned earlier, despite much lower interest rates today, NIM is currently at levels last seen in the 1980s. (See charts of historical NIM online at minneapolisfed.org.)

Some similarities between the current and 1980s bank crises are worthy of attention. Both occurred in the midst of a deep recession, but have roots outside of those economic contractions. Prior to each recession, for example, there was a period of expanding credit and rapid real estate appreciation. The 1980s crisis was a series of rolling regional recessions predicated on an earlier boom in a particular sector. The first was in agriculture, and specifically farmland. But other busts followed in oil and commercial real estate, with each hitting a region of the country harder than others.

The Ninth District was witness to boom-and-bust cycles in oil and farmland. Oil prices, for example, generated immense activity in the oil-bearing areas of the district—mostly western North Dakota and eastern Montana—through the late 1970s and into the 1980s.

Because of farming's presence across the Ninth District, the bubble in farmland values had a greater effect on district banks. Between 1980 and 1993, 67 banks in the Ninth District failed, and two-thirds of them were ag banks. But ag banks accounted for less than one-quarter of bank failures nationwide during the 1980s. (For more discussion on the current health of ag banks in the Ninth District, see related article on page 12.)

The FDIC analysis of the 1980s crisis has found (as has other research) that concentrations of loans in a particular sector put a bank at higher risk of problems and possible failure. Agriculture's share of total loans among district banks reached about 25 percent at one point during the 1980s. But even that figure is understated, because banks in agricultural areas routinely had much higher concentrations of ag loans. So when the farm economy went south, the solvency slope for farmers and bankers got too slippery, too quickly.

Nationwide, a similar overinvestment occurred in commercial real estate loans in the 1980s, according to the FDIC study, and was responsible for a significant share of failures that decade, mainly outside the district. Now fast-forward to the current banking crisis: Over the past 25 years, district banks have steadily increased their exposure to commercial real estate (see Chart 11), and there are signs of trouble in the sector. For example, charge-offs on construction and land development loans in the five district states leapt from $212 million in 2007 to almost $1.5 billion in 2008, according to FDIC data, roughly two-thirds of it occurring in Wisconsin banks.

As the philosopher George Santayana said roughly a century ago, those who cannot remember the past are condemned to repeat it. Still, despite reams of data on current and past banking conditions, predicting the trajectory of the current banking crisis is guesswork. The exhaustive FDIC report on the 1980s bank crisis found "no single cause or short list of causes." Rather, it resulted from a concurrence of forces—economic, financial, legislative and regulatory—working together to produce a decade-long crisis among banks, many of which "gave few obvious signs that the competitive environment was becoming more demanding or that serious troubles lay ahead" for them.

Many of those forces are at work again in the banking sector. Few would have predicted such a uniquely memorable and forgettable 2008. With history as a conductor, the rhythm of this bank crisis might seem similar to others that have come before it. But try as you might, you're not likely to name that crisis tune until the song is over. f

For additional, historic performance indicators of Ninth District banks, go online to minneapolisfed.org.

Credit conditions: Some snap and crackle, but no pop

By RONALD A. WIRTZ
Editor

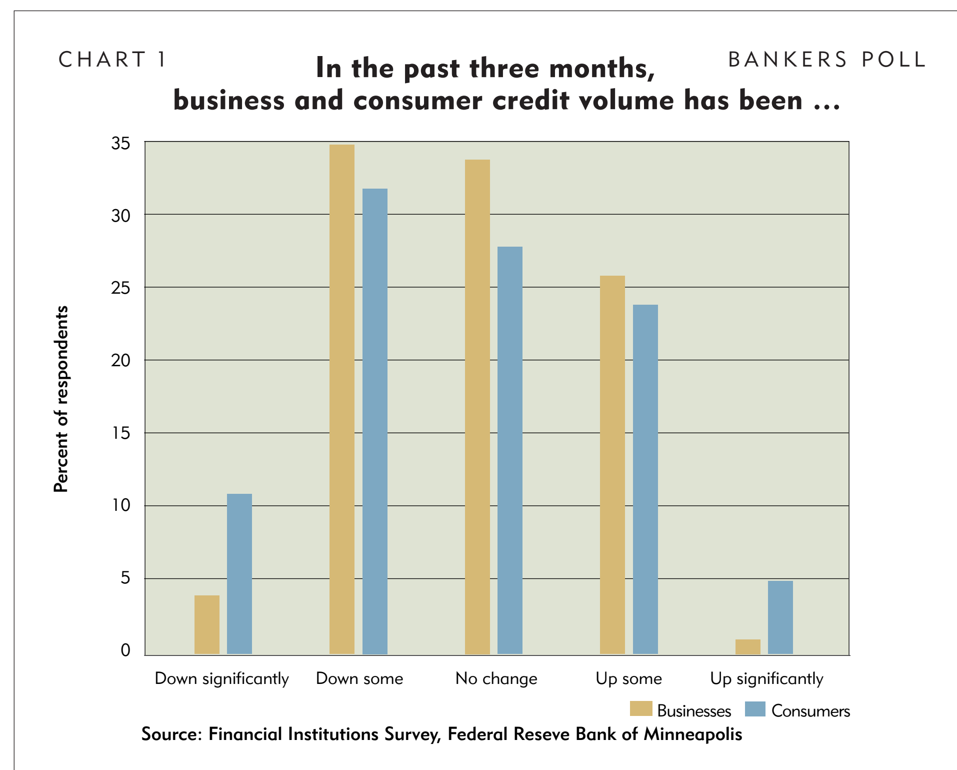
Hey, buddy, can you spare a dime of credit?

Back in October and November, financial markets teetered as they haven't for decades. Urgent claims of a credit crunch—that credit was simply not available, except at scandalous rates—were rampant. Though evidence of an actual credit crunch was sketchy, bankers and businesses alike were feeling a bit of credit vertigo: Easy credit conditions were replaced by credit standards that better reflected borrower risk, a matter complicated by an economic slowdown that pulled the plug on demand and besmirched borrowers' credit ratings in the process.

Fast-forward six months—has anything changed?

To get a glimpse into credit conditions in the Ninth District ahead of the release of official data, in late April the Federal Reserve Bank of Minneapolis conducted separate polls for financial institutions and businesses in the Ninth District. These are a follow-up to similar credit conditions polls conducted in November of last year (the results of which were published in the January 2009 *fedgazette*, available at minneapolis fed.org).

The results from the most recent polls show that credit conditions don't appear dramatically changed, save for the fact that people on both sides of credit transactions likely have a little better feel for and familiarity with the new credit environment. In general, credit volume to businesses and consumers continues to be weak, the result of tighter credit conditions and weaker credit quality among borrowers, but also because of weaker demand overall as borrowers wait out the recession.



Solitaire, anyone?

Banks and credit unions reported little problem with deposits; two of three respondents said insured deposits were up—about 20 percentage points higher than in the November poll. That finding jibes with national data showing a relatively sudden and positive shift in savings habits among U.S. consumers.

Despite the availability of credit, however, it's not flying out the door; over the previous three months, credit volume was down about 40 percent for both businesses and consumers (see Chart 1 above). A similar percentage of financial institutions said credit volume was down because both businesses and consumers were simply not seeking credit (see Chart 2 on page 10). That's not particularly surprising given the depth of the recession to date, though not a lot of attention is paid to the demand side of this supposed credit crunch.

A small Montana bank with $9 million in assets said, "Our (customers) are very conservative and have stopped asking for money. We have money to loan and very few applications."

A Minnesota regional bank with $145 million in assets echoed that theme. "Businesses we talk to are laying low," reducing short-term spending and investments, "which reduces their interest in borrowing." Consumers are worried about their jobs and retirement nest eggs "and are not borrowing for consumption purposes."

Another Montana financial institution with $45 million in assets noted that it was not seeing a significant economic slowdown in its region, "but our volumes indicate (borrowers) are trying to save more and spend and borrow less."

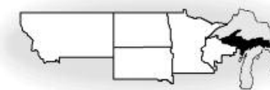
For those seeking credit, many were less qualified to receive it: More than half of respondents said that credit quality for both business and consumer credit applicants had declined in the previous three months; about one in five attributed the decline in credit volume at least in part to the fact that applicants could no longer qualify for loans.

The trifecta for weaker credit demand stems from the fact that banks and credit unions have continued raising the bar to qualify for credit. Banks have been tightening their credit standards across the board, and for some time, according to various quarterly Federal Reserve polls. That appears to be continuing, according to this poll: Over the previous three months, almost 60 percent of respondents said collateral requirements rose, and 44 percent said they required more documentation for credit approval.

Overall credit quality at a small Minnesota bank was still good, according to an official, in part because "less stable borrowers are deferring large purchases that require credit. It appears

Continued on page 10

MICHIGAN



Fair crier: Do I hear $1?

In light of a large state budget deficit, Michigan Gov. Jennifer Granholm eliminated state funding for two state fairs, one in the Upper Peninsula and a counterpart in Detroit.

The U.P. fair is held in Escanaba, roughly in the southern middle of the U.P. The fair will go on as planned in August, as it has for more than 80 years, but future fairs will be the responsibility of local or regional parties, who will also have to reconstitute the state-based board of managers, which is being abolished.

The state Legislature still has to officially approve the elimination of fair funding, but reinstating that funding will be tough given fiscal conditions. Long-time vendors at the fairs have reportedly been receiving termination notices from the fair.

Some officials have already started looking forward. One bill being considered will transfer the U.P. fairgrounds to Delta County for $1 on the condition that the land be used only for public purposes. Related proposals are in the works to reorganize the fair's board of managers with representatives from the U.P.'s 15 counties.

That's no ordinary brook trout

The coaster brook trout was once relatively widespread in the Great Lakes. But its presence has slowly narrowed to the point that environmental advocates believed it would end up on the endangered species list. But after a yearlong review, federal officials denied entry of the coaster to the list.

Once common in lakes Huron, Michigan and Superior, coasters today naturally reproduce in three lakes and 15 rivers, some of them in the U.P., and all of which feed into Superior. The fish gets its name from the fact that it likes to hug the shore. It also grows larger than its more common namesake.

The designation failure is a not-so-small matter for a proposed nickel and copper mine near Marquette by the mining company Kennecott. The mine would go under the Salmon River, which is home to the coaster. Opponents had hoped that designation on the endangered species list might require more burdensome habitat protection, which might force the mine to reconsider the project.

—Ronald A. Wirtz

MINNESOTA

With a stroke of the pen

The state's budget is in a world of hurt, and it appears many are going to share the pain, possibly via a scalpel wielded by Gov. Tim Pawlenty.

The state faced a $4.6 billion deficit even after $1.8 billion in federal stimulus funds came in. Lawmakers and the governor's office struggled to agree on cuts, and when all spending bills were in, a $2.7 billion deficit remained. State lawmakers approved last-minute measures to close the budget gap, including a hefty tax increase on high earners, which Pawlenty vetoed. He then invoked so-called unallotment powers, whereby he can take away any spending item that does not have funding—in essence, a line-item veto. The move is not unprecedented—it's the third time Pawlenty has used such powers—but the amount of money involved is.

In late June, Pawlenty announced reductions of almost $1 billion, including major cuts to local aid ($300 million), health and human services ($236 million) and higher education ($200 million), along with about $1.8 billion in an accounting shift that will push much of the problem to next year.

Shovel ready, and waiting

After a banner 2008 with record prices, the taconite industry is back in the proverbial hole, thanks to the global recession.

In May, most taconite mines had either slowed or shut down production as stockpiles lingered at Lake Superior loading docks. Last fall, Cliffs Natural Resources announced production cutbacks at mines in Silver Bay and Eveleth, and the company decided to stop all production from one mine until at least early July. In May, the Cliffs mine in Hibbing also began a 15-week shutdown. U.S. Steel closed its taconite mine in Keewatin in December, affecting 380 workers; after a first-quarter loss of $439 million, the company also cut back production at its mine in Virginia, laying off almost 600 workers in May. About half were called back in June on a short-term basis.

The industry received some good news in June, when a pilot program delivered 5,000 tons of crushed taconite for use as road aggregate. Taconite is harder than traditional dolomite and limestone and could extend the life span of highway and rail infrastructure, according to researchers.

—Ronald A. Wirtz

Fifty-nine percent said tighter credit came in the form of higher interest rates, almost half said their credit limits were lowered and about one-third said previously available credit was eliminated.

Credit from page 9

the people who don't qualify know it and are deferring credit requests."

Businesses down in the credit mouth

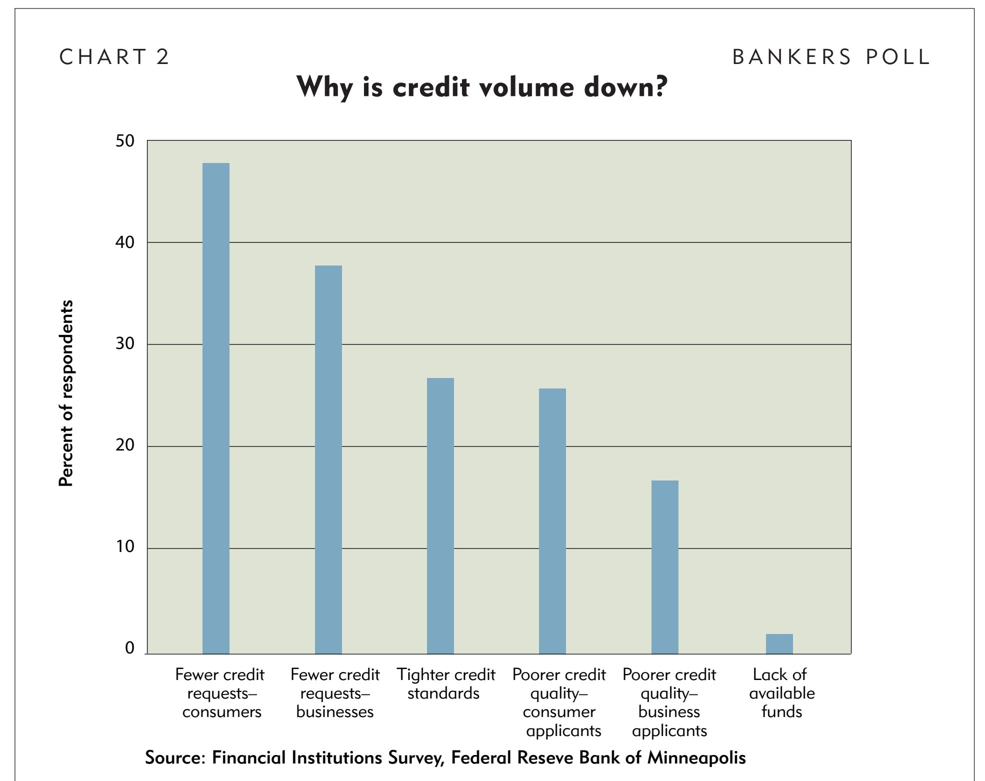
The main themes coming from bankers were largely reinforced, and amplified in some cases, by district businesses, according to a second poll conducted in partnership with state chambers of commerce.

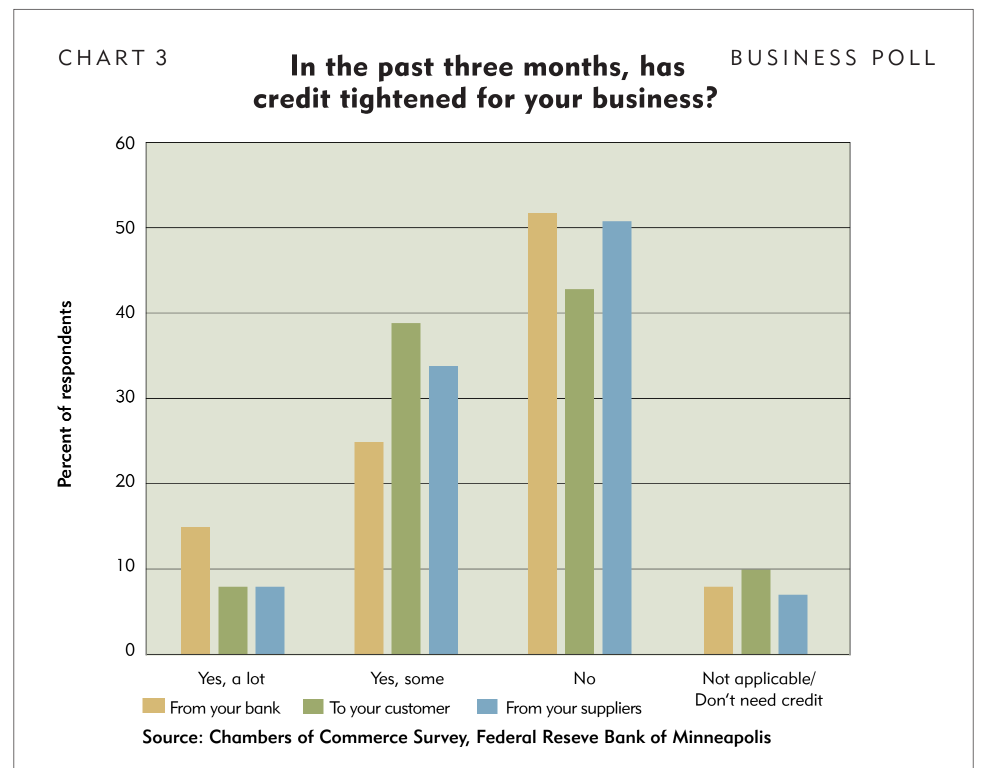
Forty percent of business respondents said their access to bank credit has tightened to some degree over the previous three months (see Chart 3 at right). For those experiencing tighter credit, it manifested in several ways. For example, 59 percent said tighter credit came in the form of higher interest rates, almost half said their credit limits were lowered and about one-third said previously available credit was eliminated.

There were several reasons for tighter credit, according to business respondents. Almost 80 percent cited poor credit market conditions overall as a culprit. But about one-third acknowledged that credit had tightened as a result of their firm's own poor financial condition. As might be expected, tight credit was also affecting business operations. For those seeing tighter credit, 43 percent said they were curtailing capital expenditures and 31 percent said it would affect hiring decisions.

A Minnesota manufacturer with 45 employees said it was not having trouble getting credit—because it was simply not looking for any. "We actually do not need as much credit because we have stopped our capital investments, and we have stopped all unnecessary expenditures." That might not be good news to local bankers with cash to lend, but it has helped stabilize the company's financial position despite lower sales, an official reported.

Many businesses also deal with upstream and downstream credit markets—what nonbankers call suppliers and customers—and credit has been tightening there as well, according to the poll (see Chart 3). Close to half of business respondents said they have tightened credit to their customers and are doing so on multiple fronts, such as limiting new credit accounts,





lowering credit ceilings and shortening pay periods.

A $65 million company in the oil and mining sector commented, "Customers want longer credit terms (and) suppliers want shorter terms. We are asking our suppliers and vendors for longer terms. All of our customers want price cuts of 10 to 30 percent, which is simply not realistic."

An official with a Minnesota manufacturer with $25 million in revenue said the firm was "very financially strong" and had very little debt. "This combination has allowed us to attract banks very willing to offer funding if we were to need it." At the same time, the company has had to take a "tougher stance" on credit to customers, stopping shipments for late payment and requiring advances from some customers that were in poor financial shape.

Firms in construction and manufac-

In the end, a familiar commentary among bankers and businesses was the current lack of confidence in the economy, and the role confidence plays going forward regarding the supply of and demand for credit.

turing were most likely to report difficulties accessing credit. A $30 million commercial real estate firm with sales in three states said it "is virtually impossible for developers to get financing. We have a national client with a solid business that we cannot move forward with because money is not available to build their building."

And it's not hard to see how credit problems for some firms cascade into other ones. A construction firm with 500 employees and $75 million in sales in five district states and Iowa said its own access to credit "has not been impacted, but our customers' access has been impacted severely." The company lost several contracts totaling approximately $10 million last year "due to financing issues facing our customers."

In the end, a familiar commentary among bankers and businesses was the current lack of confidence in the economy, and the role confidence plays going forward regarding the supply of and demand for credit. Even in areas not feeling the economic pinch so much, "there is a hunker-down mentality," said a small North Dakota bank. "Although the local economy remains reasonably strong, uncertainty about the national economy is impacting both borrowers and lenders."

A larger Montana bank with about $350 million in assets noted that "borrowers are being more conservative and waiting to see how the recession plays out. Loan volume will come back when borrowers are more confident in the economy." f

For information on the polls' methodology, go online at minneapolisfed.org.

Professional Services Survey

After tough times, professional services firms expect sluggish activity over the next year. Accountants, architects, engineers, market researchers and other firms that support businesses experienced a significant decrease in profits over the last year, according to the results of the annual survey of professional services firms, conducted in May and early June by the Federal Reserve Bank of Minneapolis and the Minnesota Department of Employment and Economic Development. See detailed survey results online at minneapolisfed.org.

District Voices *How have current credit conditions affected your business, community or industry?*

Upper Peninsula of Michigan

Consumers and businesses are both watching their money very closely. Loan volume is driven at its core by loan applications, which are down in both sectors.

—Bank with $192 million in assets

Minnesota

We are currently constructing a parking ramp ... and were planning to issue tax-exempt debt next week. That debt issue has been put off indefinitely due to high interest rates required by potential bondholders. We will have to internally finance or use an existing line of credit until rates and the markets begin to normalize. Additionally, we have a $60 million construction project that was planned to begin in May 2009 that will likely be put off months or a year.

—Engineering firm with 25 employees and $2 million in sales

Montana

Credit is taking longer to get than usual. More documentation is needed when it wasn't in the past; more of a down payment is needed, and my credit hasn't changed.

—Insurer with one employee and $135,000 in sales

North Dakota

Our bank keeps telling us that our credit availability has not changed over the last 12 months. We are, however, being more conservative on pulling the trigger on borrowing.

—Manufacturer with 380 employees and $52 million in sales

South Dakota

We provide government-relations services to businesses and business organizations, so we are impacted as businesses consolidate and fewer players are in the market for our services. The current credit market has accelerated this consolidation trend for several business types (financial services and auto dealerships, for example), decreasing both the number of businesses in the market and the number of businesses paying dues to an organization.

—Media company with 10 employees and $1 million in sales

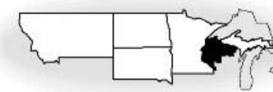
Wisconsin

Consumers, employees and businesses involved in the manufacturing sector seem to be the most affected. Consumer confidence of all others seems to be improving.

—Bank with $70 million in assets

(Note: Comments are from anonymous respondents to *fedgazette* surveys on credit conditions conducted in late April.)

WISCONSIN



Gotta light (up outside)?

Wisconsin joined the smokeless ranks when Gov. Jim Doyle signed legislation in May banning indoor smoking for most work places, including bars and restaurants.

There are a few exceptions to the smoking ban: Tribally run casinos are exempt from the ban because the state does not have regulatory authority over such places, thanks to tribal sovereignty; one other exemption includes cigar bars and tobacco shops.

The measure has been a priority for years for Democractic lawmakers, but past efforts were met with strong opposition, particularly from bar and restaurant lobbies. But over the past few years, about three dozen communities took matters into their own hands by passing local smoking bans. One bone being thrown to bars and restaurants: The ban will not go into effect until July 5, 2010, allowing establishment owners and patrons some time to prepare and adjust.

How do I get out of reverse?

The good news in Wisconsin these days is that things probably can't get a lot worse.

On top of a state budget deficit of $6.6 billion earlier this year, which required deep cuts and significant new fees, the state has watched unemployment continue to creep up. In the first quarter of 2009, the state saw more than 14,000 lose their jobs, more than twice the level from a year earlier. The state also experienced significantly more mass layoffs—events with 50 or more workers laid off for at least 31 days. In the first quarter of this year, there were 74 mass layoffs, almost triple the 27 that occurred in the same period of 2008.

Statewide job losses from April 2008 to this past April hit 128,000—the largest numerical decline in state history and the largest percentage drop in terms of total jobs since the late 1950s, according to the state Department of Workforce Development.

In hopes of helping workers, an effort is under way to consolidate and streamline the state's job creation programs. The Department of Commerce is collapsing five tax credit programs into a single, statewide program, thanks in part to a legislative audit that found a lack of accountability and coordination among the many state and regional economic development efforts.

—Ronald A. Wirtz