Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1997

FDIC
CHICAGO
REGION

DIVISION OF
INSURANCE

JOHN D. WEIER,
REGIONAL MANAGER

JOAN D. SCHNEIDER,
REGIONAL ECONOMIST

MICHAEL J. FEENEY,
FINANCIAL ANALYST

In Focus This Quarter

Regular Features

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Chicago Region's ***Regional Outlook,*** please call John Weier at (312) 382-7512 or send an e-mail to *jweier@fdic.gov.*

Chairman	Andrew C. Hove, Jr.
Director, Division of Insurance	Arthur J. Murton
Editor	George E. French
Managing Editor	Stephen Linehan
Associate Editor	Maureen E. Sweeney
Assistant Editors	Suzannah L. Susser John D. Weier
Publications Manager	Teresa J. Franks

Bank Earnings: Competitive Pressures and Cyclical Risks

- **Rapid loan growth, record low credit losses, vigorous expansion of income sources, and cost-cutting continue to propel bank earnings to record levels.**

- **Intense competition to preserve and attract business can lead to aggressive loan pricing, relaxed loan underwriting standards, increased portfolio concentrations, and other changes to risk-management practices that can reduce banks' ability to sustain earnings and capital through a downturn.**

- **As this economic expansion approaches an advanced age, prudent bankers will allow for the possibility of an adverse change in economic conditions.**

As the U.S. economic expansion continues through its seventh year, the banking industry continues to run at full throttle. Earnings climb to ever-higher levels, driven by rapid loan growth, record low credit losses, aggressive expansion of income sources, and vigorous cost-cutting. Some analysts argue that banking has entered a new era in which the development of non-interest income sources and new risk-management techniques will insulate banks from swings in the business cycle.

Yet banks face risks that should not be overlooked. Assertions that bank earnings will be less sensitive to business cycles remain untested. Meanwhile, competition to attract and maintain business can result in relaxed underwriting standards and easing of loan terms, or increased focus on business lines whose risks are difficult to manage. Policies that boost short-term shareholder returns, including high dividends and stock repurchase programs, can reduce banks' capacity to weather a future downturn. There is evidence that these things are occurring to varying degrees in banking today. Accordingly, as this expansion reaches an advanced age, prudent bankers will give careful regard to the quality and sustainability of the earnings generated by today's strategic decisions.

Credit Quality

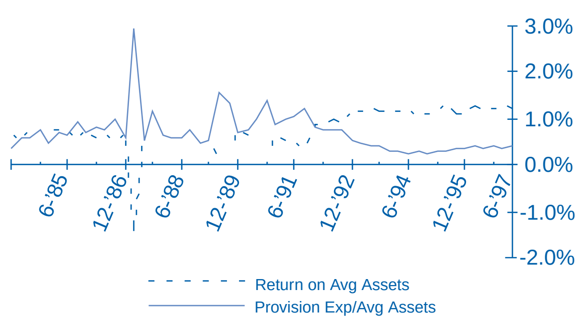
Variations in credit quality have been and are likely to remain for some time the primary source of large swings in bank earnings (see Chart 1). Banks manage the risks of large swings in credit quality by adjusting underwriting standards and loan terms, by diversifying loan portfolio exposures, and by supplying adequate amounts to the allowance for loan losses. In large part, the degree to which bank earnings can be sustained during a downturn will depend on decisions made about these factors during the expansion.

Some perspective on the cyclical nature of credit quality can be gleaned from Charts 2 and 3 (next page). As shown in Chart 2, bank loan growth has exceeded growth in gross domestic product (GDP) for ten of the past twelve quarters, even without considering the substantial volume of loans originated and sold in securitized pools. Moreover, Chart 3 shows that growth in loan losses has tended to follow episodes of rapid loan growth.

Credit standards are important tools for individual banks to manage these cyclical fluctuations in credit quality. According to the Federal Reserve's August 1997

CHART 1

Earnings Results Are Largely Driven by Provision Expenses



Source: Commercial Bank Call Reports

CHART 2

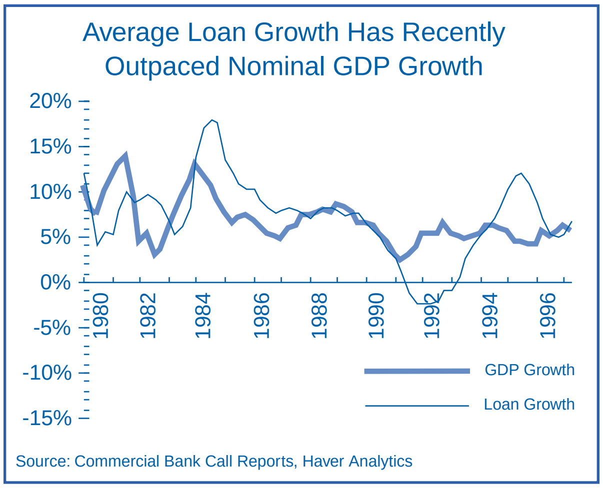
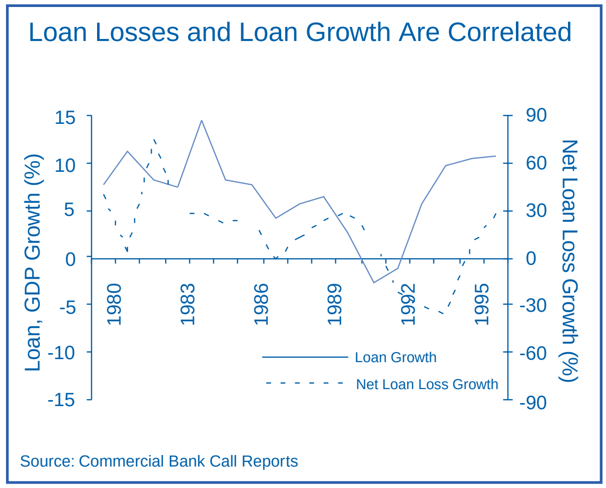


CHART 3



Senior Loan Officer Survey, during the preceding three months, a large percentage of banks had eased terms on commercial and commercial real estate loans, including reducing loan interest rates, increasing credit lines, and easing loan covenants and collateralization requirements. A "small but significant" share reported willingness to accept increased levels of risk on commercial real estate loans. In a similar vein, the Federal Deposit Insurance Corporation's (FDIC) ***Report on Underwriting Practices*** (second quarter 1997) did not note any widespread problems with underwriting practices but reported that about 24 percent of institutions examined that were actively involved in construction lending were "frequently or commonly" funding speculative construction projects. About 18 percent of institutions examined that were actively involved in business lending "frequently or commonly" made unsecured business loans that lack documentation of financial strength.

Maintaining an adequate allowance for loan losses is another important way for banks to sustain earnings and capital during downturns. The aggregate allowance held by commercial banks has decreased from 2.74 percent of total loans in the first quarter of 1992 to 1.90 percent in the second quarter of 1997; 166 banks reported negative loan loss provisions in the second quarter.

Although in the aggregate these reserve numbers remain high relative to the early to mid-1980s, when reserve levels ranged from 1.20 percent to 1.74 percent, the Office of the Comptroller of the Currency (OCC) recently issued an advisory letter expressing concern about declining reserve levels and the need to maintain an adequate allowance. This letter was a response to weakness in the credit card sector and to trends in the market for syndicated commercial loans, including increasing leverage, declining spreads, and a weakening in other underwriting terms, all stemming from increasing competitive pressures.

Diversifying loan portfolios is another way for banks to help reduce susceptibility to economic downturns. It has often been noted that the trend toward interstate banking and branching may improve loan diversification. It should also be noted, however, that many banks retain high concentrations of credit exposure to specific economic sectors. For example, commercial real estate lending and construction lending has been a source of volatility in bank earnings since the real estate investment trust (REIT) crisis of the 1970s. As discussed in ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***, banks are leading a resurgence in commercial real-estate lending. As Table 1 shows, 28 percent of FDIC-insured institutions grew their total commercial real estate and construction portfolios more than 30 percent from mid-1996 to mid-1997, and 16 percent had total commercial real estate and construction exposures[1] exceeding 200 percent of equity and reserves. Concentrations and rapid growth do not necessarily portend difficulties, but the greater the concentration of credit to a specific sector, the greater the importance of strict adherence to sound underwriting policies and standards and the maintenance of adequate loss reserves.

The most immediate concerns about credit quality have been expressed regarding credit cards and some other

[1] Includes loans secured by multifamily dwellings and nonfarm nonresidential structures, as well as construction loans.

consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 1991. Noncurrent rates on these loans are at near-historic highs of 1.94 percent, and some examiners are commenting that these rates would be even higher were it not for some of these balances being rolled over into home equity debt consolidation loans with loan-to-value ratios as high as 135 percent. Home equity lines are a rapidly growing business for some banks; 25 percent of banks and thrifts grew their home equity lines by more than 30 percent during the year ending mid-1997 (see Table 1).

Except for credit cards and some other consumer loans, loan losses are at historically low levels. Nevertheless, lending decisions that assume a continuation of favorable economic conditions should be closely examined this far into the expansion. Institutions that maintain strong underwriting standards, an adequate allowance for losses, and prudent diversification of the loan portfolio will be best positioned to sustain earnings and capital during a downturn in credit quality.

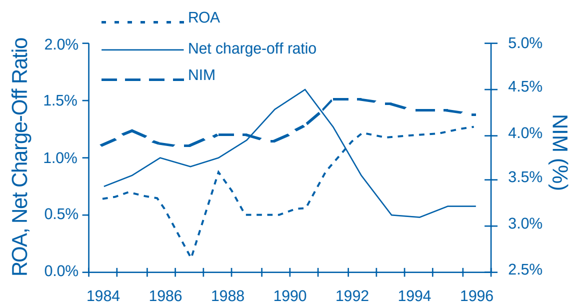
Net Interest Margin

Net interest margin (NIM) is another primary driver of bank earnings. Indeed, a sharp improvement in NIM helped lead the banking industry's dramatic recovery from the last recession (see Chart 4). Commercial banks' NIM has declined slightly in recent years, but at 4.23 percent still remains near the top of the range within which it has fluctuated since 1984 (see Table 2, next page).

The banking industry's rapid loan growth in recent years has been one of the factors supporting the current high NIM. (Since loans generally yield more than securities, a higher proportion of loans generally results in a higher yield on the total portfolio of earning assets.) Economic fundamentals cannot sustain rapid loan growth indefinitely, however. Accordingly, a

CHART 4

Rebound in ROA Since 1990 Fueled by Improved NIM and Asset Quality



Source: Commercial Bank Call Reports

TABLE 1

Rapid Loan Growth Is Occurring at a Significant Number of Institutions (4 qtrs growth ending 6/97)	Percentage of Institutions with Loan Category Growth Approximating		
	20% to 30%	30% or More	Total Over 20%
Total Loans and Leases	11	13	24
Construction Loans	4	36	40
Commercial Real Estate Loans	9	27	37
Total CRE	10	28	38
1-4 Family Residential Loans	11	17	29
Home Equity Lines	4	25	29
Total Residential	12	18	29
Credit Card Loans and Related Plans	4	17	21
Other Consumer Loans	9	18	27
Total Consumer Loans	9	18	27
Commercial Loans	9	26	35

Source: Bank & Thrift Call Reports

TABLE 2

1997 COMMERCIAL BANK PERFORMANCE COMPARED WITH HISTORICAL AVERAGES	6/30/97	INDUSTRY AVERAGES 1984-1996	
	ANNUALIZED (%)	LOW (%)	HIGH (%)
NET INTEREST INCOME/AVERAGE EARNING ASSETS	4.23	3.89	4.36
X AVERAGE EARNING ASSETS/AVERAGE ASSETS	86.50	86.21	88.42
= NET INTEREST INCOME/AVERAGE ASSETS	3.66	3.36	3.89
+ NONINTEREST INCOME/AVERAGE ASSETS	2.13	1.10	2.13
– NONINTEREST EXPENSE/AVERAGE ASSETS	3.50	3.05	3.90
– PROVISION EXPENSE/AVERAGE ASSETS	0.40	0.28	1.28
+ OTHER ITEMS/AVERAGE ASSETS	0.03	–0.02	0.15
– TAXES/AVERAGE ASSETS	0.68	0.18	0.64
= NET INCOME/AVERAGE ASSETS (ROA)	1.25	0.10	1.20

SOURCE: BANK & THRIFT CALL REPORTS

risk in the current environment is that in the effort to support their NIM by generating new lending, banks may make compromises in loan underwriting, pricing, and portfolio diversification.

Recent pricing trends have tended to weaken NIM, offsetting to a degree the effects of rapid loan growth. On the liability side, over the past six years, commercial banks' average annual deposit growth rate of 3.2 percent has been outpaced by the 4.9 percent average annual growth rate of earning assets. As a result, nondeposit borrowings have increased significantly in importance, rising from about 12.6 percent of earning assets in 1991 to 19.1 percent at mid-1997. Since the average cost of nondeposit borrowings has exceeded the average cost of deposits over the period by an average of 135 basis points, the greater use of relatively higher cost borrowings to fund earning asset growth has been an obstacle to wider margins. The slower deposit growth can perhaps be attributed to the increasing array of choices available to small savers; its effect is that bank funding is becoming more expensive and more interest-rate sensitive.

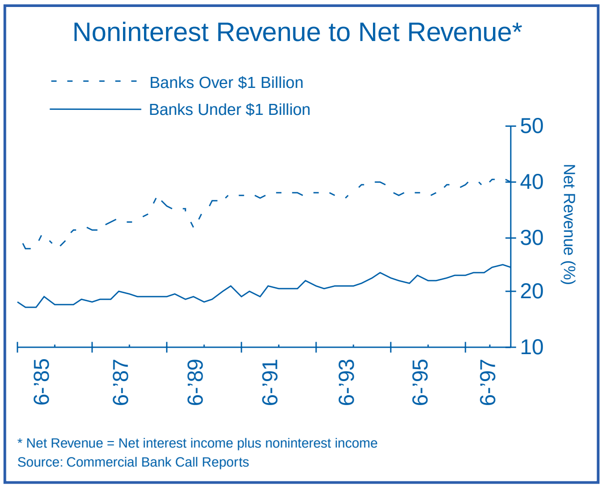
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads on investment-grade debt are at all-time lows. Reportedly, some deals are being done at minimal or no risk-adjusted spreads simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures on institutions not able to achieve the volumes necessary to efficiently utilize this new funding vehicle.

The thin spreads available from high-quality lending may tempt some institutions to finance higher yielding, riskier credits in an effort to preserve or boost profit margins. For example, recent forays by some banks into subprime lending (see ***Subprime Lending: A Time for Caution***, Third Quarter 1997) may be one indication of how competitive pressures on NIMs are affecting bank behavior. Over the long term, institutions that manage their NIMs with a prudent regard for how their newly booked business may fare during a cyclical downturn will have a better chance of sustaining earnings performance through the business cycle.

Growth in Noninterest Income

Industry analysts often cite the increasing contribution of fees and other sources of noninterest income as evidence of the evolution of the banking industry. As Chart 5 (next page) illustrates, for commercial banks with over $1 billion in assets, noninterest income now averages over 40 percent of net revenue (net interest income plus noninterest income). In contrast, banks

CHART 5



with under $1 billion show a profile of reliance on more traditional banking activities, with only 25 percent of revenue from these noninterest sources.

Noninterest income growth is being driven both by new business lines and higher deposit-related fees. Examples include fees from sales of mutual funds and other nondeposit products, investment banking activities such as securities underwriting and asset management, and increases in traditional fee sources such as from automated teller machines. Increasing securitization of assets, in which the accounting conventions convert interest income to noninterest income, has also affected the growth in reported noninterest income.

With the exception of trading revenue, noninterest income has historically shown a growth trend that has not been especially sensitive to economic cycles. However, newer fee-based businesses such as mortgage banking, mutual funds, and securities underwriting may ultimately share the same cyclical characteristics as traditional bank lines of business, and therefore may not reduce banks' historical exposure to economic cycles.

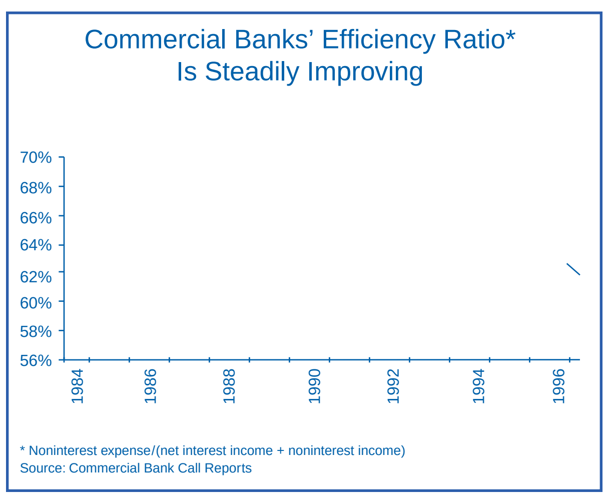
The Effect of Expense Control on Earnings Performance

Cost-cutting efforts in banking continue to show their effects. Since 1991, commercial banks' efficiency ratio,[2] a measure of an institution's effectiveness in generating revenue, has steadily improved (see Chart 6). Other measures of productivity have shown similar improvement. For example, commercial banking assets per employee doubled, from $1.5 million to $3 million, between 1984 and 1997.

Growth in overhead expense has been contained largely through consolidation, technological advances, and low levels of problem assets. Mergers have resulted in the wringing out of redundant expenses. Information technology (IT) has been deployed to trim underwriting expense, manage customer relationships, speed back-office processing, and facilitate the creation of new products and services. Favorable economic conditions have reduced costs associated with loan collection and asset workouts.

Whether the downward trend in overhead expenses will continue is an open question. Should problem loans increase from their cyclical lows, collection and workout costs will increase (evidence of this effect can be discerned for the late 1980s in Chart 6). The rapid change in information technology may prompt increasing expenditures. The 1996 Atlantic Data Services/Tower Group ***Survey of Information Technology Services in Banking*** noted that the banking industry is "faced with an aging IT infrastructure." The survey suggests that most technology-related expenses could increase at a 5.6 percent compounded growth rate until the year 2000 and that expenses for outside services could increase 11 percent over the same period. The ability to generate future revenue gains may depend on additional bank investment not only in technology but also in the development of new products and services.

CHART 6



[2] The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

In any event, cost-cutting is not without its risks. For example, reductions in personnel, or excessive reliance on automated underwriting procedures (see ***Will Credit Scoring Transform the Market for Small-Business Lending?*** Second Quarter 1997), may raise concerns about the effectiveness of internal administration and control processes. Cost-cutting that cuts too deeply into customer service can erode franchise value. Mergers can reduce redundant expense, but at some point there may be diseconomies to managing a large organization.

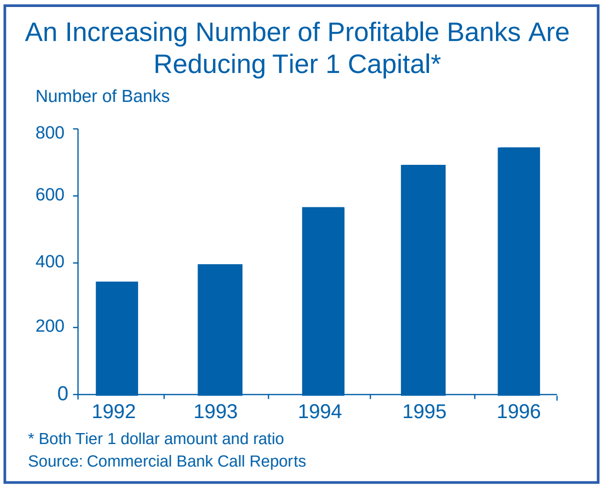
The Role of Capital in the Management of Earnings

Management, shareholders, and analysts often evaluate earnings in relation to the level of capital using measures such as return on equity (ROE) and earnings per share (EPS). One result has been pressure on banks to continue to grow ROE and EPS; these objectives have been made progressively more difficult to attain by the significant level of capital that has built up over the past five years.

Finding effective ways to deploy historically high capital levels appears to be one driving force behind the recent rash of mergers and acquisitions, high dividend payout ratios, increased stock repurchases, and the development of alternative types of hybrid capital such as trust preferred stock (see ***Financial Markets***). For example, during 1995 and 1996, major merger and acquisition deals included some $835 billion in bank and thrift assets. During 1996, commercial banks with over $1 billion in assets had an average dividend payout ratio over 89 percent, up significantly from the 67 percent payout rate of 1994. Banks with under $1 billion in assets averaged 55 percent for 1996 and 52 percent for 1994. In addition, banks and bank holding companies have issued some $21 billion in trust preferred stock during the last nine months, some of which has been used to fund the almost $42 billion in share repurchase programs announced by large banks during 1996 and early 1997.[3]

While the book value of equity and other capital ratios has increased at the aggregate industry level, a number of banks are reporting declines in equity capital and leverage capital ratios despite positive earnings (see Chart 7). For all institutions, the ability to actively man-

CHART 7



age capital accounts going forward will depend largely on having earnings available above the levels needed to fund dividends and growth, after assuming capital protection adequate for the level of business risk. Bankers and examiners will need to carefully review strategies that increase bank leverage or increase business risk without considering the potential effects of a downturn in credit quality or other weakening in the economy.

Summary

The most profitable period for U.S. banks in the post-World War II era is paradoxically occurring during a time when banks' traditional business lines are coming under greater competitive pressure than ever. While the industry as a whole is adapting well to these competitive pressures, there may be a tendency for some insured institutions to respond by accepting greater risks to preserve or gain business.

The nature of banking is to profit by taking calculated risks, and naturally more profits will be made during the expansionary phase of a cycle than during a downturn. Nevertheless, the institutions that are best able to sustain their earnings and capital over the complete cycle will be those that allow for the possibility of an adverse change in business conditions, and prudently balance the levels of risk taken with the expected returns.

Ronald Spieker, Chief, Depository Institutions Section
Steve Linehan, Assistant Director, Analysis Branch
George French, Deputy Director

[3] Salomon Brothers.

Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets

- **Commercial banks are leading a resurgence in commercial real estate financing; many metropolitan markets are experiencing rapidly rising rents and single-digit vacancy rates, suggesting the likelihood of further development.**

- **New funds directed toward commercial real estate are being increasingly supported by commercial mortgage-backed securities and real estate investment trusts.**

- **Some analysts have expressed concern that these financing vehicles may serve to heighten competitive pressures that will lead to more aggressive loan pricing.**

In the wake of declining values and the large losses of the late 1980s and early 1990s, commercial real estate is making a comeback. There are two stories here of interest to lenders. The first entails the remarkable resurgence in commercial real estate demand. The second involves the major changes taking place in how real estate is owned and paid for and—of greater interest to banks—who is financing this expanding activity.

Commercial Banks Show Renewed Interest in Commercial Real Estate

Strong evidence of commercial real estate's rebound can be seen in its renewed attractiveness to lenders. ***Federal Reserve*** figures show that nearly $58 billion of new commercial mortgage debt was added to the market in 1995 and 1996 (see Table 1). While this new net lending pales in comparison with that of the late 1980s—when nearly $74 billion in net new debt was added in 1987 alone—it positively shines when compared with the $89 billion *shrinkage* of commercial real estate loans from 1991 to 1994. Table 1 shows that commercial banks are leading this resurgence with a $37 billion net increase in mortgage lending during 1995 and 1996.

Perhaps the most convincing evidence of commercial real estate's recovery comes from the market itself. Rising prices and tightening supplies of space in most major markets and for most property types suggest a growing demand for new commercial property stock. Numerous indices and market studies support this notion:

- As measured by ***Koll/NREI*** national composites, prices and rents turned up sharply after 1993, with rents surpassing their 1988 to 1989 levels by 1995 (see Chart 1, next page). For office properties in particular, the ten fastest-growing cities in terms of rental rates saw increases exceeding 20 percent in 1996.[1]

[1] Those cities are, in order, Minneapolis, Columbus, Dallas, Portland, Salt Lake City, Atlanta, San Jose, Phoenix, San Francisco, and San Diego.

Table 1

Banks Are Increasing Their Flow of Funds into Commercial Real Estate ($ Billions)

	1991	1992	1993	1994	1995	1996
Net New Borrowing, All Sources	$ –15.6	$ –47.1	$ –21.5	$ –4.4	$ 22.6	$ 35.1
Commercial Banks	3.1	–8.4	–4.3	7.5	18.0	18.7
CMBSs	1.3	8.7	10.3	11.3	10.6	16.1
Savings Institutions	–22.4	–18.5	–7.5	–6.8	–1.8	0.8
Life Insurance Companies	–5.6	–15.1	–13.4	–10.5	–3.3	–2.5
All Other Sources	8.0	–13.5	–6.6	–5.9	–0.9	2.3
Equity Capital Flow, All Sources	$ 4.9	$ 3.1	$ 17.4	$ 21.6	$ 21.5	$ 30.3
REIT Equity Offerings	1.6	2.0	13.2	11.1	8.2	13.0
Pension Funds	–4.8	–4.3	–0.7	9.6	13.8	14.3
All Other Sources	8.1	5.4	5.0	0.9	–0.5	3.0

Sources: Federal Reserve, National Association of Real Estate Investment Trusts (NAREIT), LaSalle Advisors Investment Research

- Property capitalization rates, which measure the annual income generated by a property as a percentage of its purchase price, are falling (see Chart 2). These falling rates indicate that investors are paying higher prices for each dollar of current income generated by the property. Overall, however, prices have not yet caught up with rents, which now exceed their previous highs in some markets, suggesting that the current recovery is not yet peaking.

- Declining vacancy rates reflect strong demand for office properties, which ***Grubb & Ellis*** cast as the hottest sector in its 1997 forecast. Nationwide, office vacancies have fallen dramatically, by 5 to 10 percentage points during the last four years (see Chart 3). Moreover, ***Torto-Wheaton Research*** estimates that 21 of the 56 metropolitan areas it tracks had single-digit vacancy rates at the end of first quarter 1997. Not surprisingly, many of the tightest markets are those with the greatest rent inflation.

While the unrestrained commercial development of the 1980s continues to cast a shadow over the industry, that shadow is fading as declining vacancy rates and rising rental rates for existing properties fuel optimism among lenders and investors and strengthen the case for new development. Lenders, examiners, and analysts, however, must be diligent in monitoring commercial real estate markets to identify possible imbalances between supply and demand. It is particularly important that lending decisions be made on the basis of economic feasibility and realistic property cash flow projections rather than solely on the basis of competitive pressures.

Borrowers' Financing Options Expanding

Although banks are clearly the largest source of financing for resurgent commercial real estate markets, a broader and more competitive financing market has emerged. In this market, financing often bypasses banks, being funneled instead through entities that purchase and securitize commercial real-estate-secured debt or the properties themselves, parceling them into smaller, more standardized, and thus more liquid pieces that are attractive to institutional and individual investors alike. This trend is illustrated in Table 1, which shows the increasing roles commercial mortgage-backed securities (CMBSs) and real estate investment trusts (REITs) have played in funding commercial real estate over the past five years. This increase in public

Chart 1

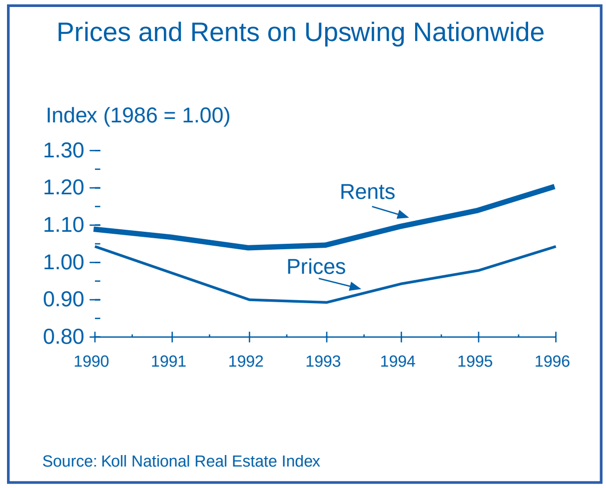


Chart 2

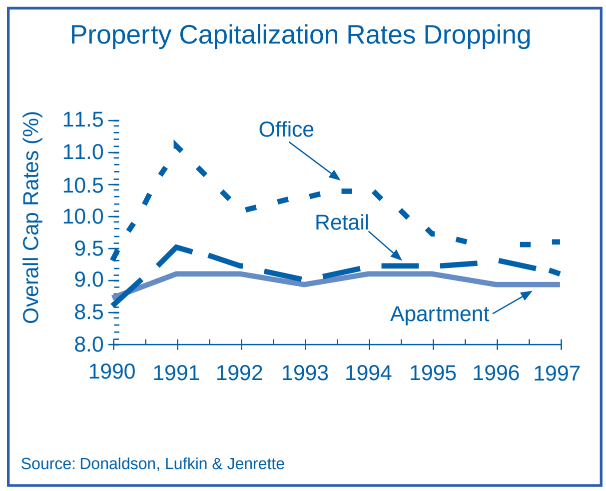
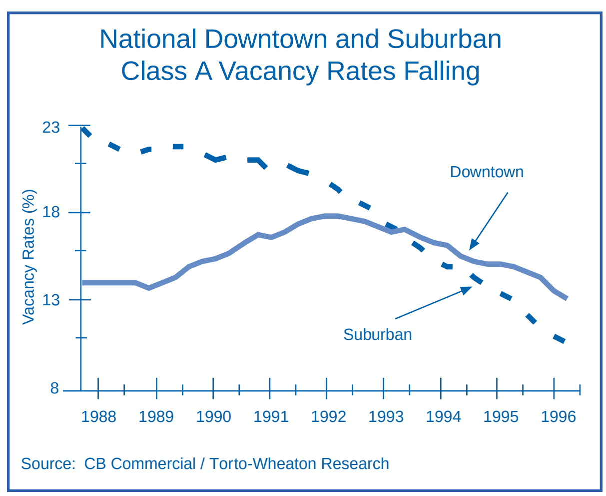


Chart 3



financing left financial institutions in 1996 with approximately a one-third share of all new net commercial real estate financing, down from well over half just a decade before.

From a lender's perspective, CMBSs offer several advantages over traditional portfolio lending. Most significantly, lenders can generate fee income from loan production and servicing activities while avoiding the excessive concentrations of credit risk that plagued lenders during the last real estate downturn.[2] According to ***Commercial Mortgage Alert***, outstanding CMBSs reached $125 billion in 1996 on a record $30 billion of new issuance. While outstanding volume is still dwarfed by the $3 *trillion* market for residential mortgage-backed securities (MBSs), the growth in CMBS volume has been remarkable considering that such securities were virtually nonexistent prior to 1991.

At present, most commercial banks are not active in issuing CMBSs, accounting for only $2.6 billion of CMBS issuance in 1996, according to ***E&Y Kenneth Leventhal Real Estate Group***. Rather, the primary source of these securities is investment banks, which generate substantial fees by converting existing loans into securities. CMBS issues also are being increasingly underwritten by *conduits*, which are entities created to originate mortgage loans for distribution to investors in the secondary market. ***Nomura Securities International*** estimates that such conduits accounted for over one-third of CMBS issuance in 1996, nearly double the volume of 1995. Only a handful of the largest commercial banks have set up conduit programs—the five largest banks accounted for $3.3 billion of the $10.2 billion in conduit issuance during 1996. Aside from this relatively small number of bank competitors, investment banks are among the largest and most active conduit issuers.

There is no fundamental reason why banks cannot take greater part in the rapidly growing CMBS market. In fact, they possess many distinct advantages over investment banks. Their distribution networks, lending experience, and back-office capabilities are naturally suited to facilitating loan demand, evaluating repayment risk, servicing loans, and monitoring a project's development. Obstacles of scale may preclude smaller institutions from directly issuing CMBSs ($500 million in volume is often cited as a minimum for efficiently assembling a deal). However, if the CMBS market develops like that for MBSs, standardized underwriting may enable small institutions to remain competitive either by cooperatively forming their own conduits or by selling their loans to existing conduits.

Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array of funding options. Moreover, the costs of public financing reflect efficiencies born of standardization and liquidity. In short, investors, including banks, can price, enter, and exit their positions in securitized debt more easily than could be done with whole loans. While improved efficiencies are a positive aspect of the growth in securitized investments, these efficiencies threaten to dictate bank pricing, thereby potentially reducing margins or driving institutions to lend on less economically feasible projects in an effort to preserve margins and market share.

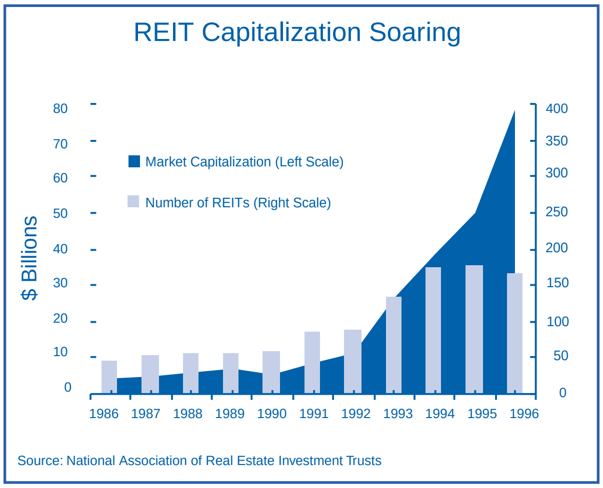
REITs: An Alternative to Traditional Capital Sources

Commercial real estate financing is evolving in other ways. REITs have become major players in the industry since 1993, accounting for fully one-fifth of funds flowing into real estate in 1996. REITs are much like mutual funds in that they allow indirect investment in real estate through purchases of equity in the REIT. The REIT itself holds title to the underlying properties and, provided it meets certain requirements, can directly pass through its earnings to investors without any intermediate tax. Although ***Moody's*** estimates place REIT holdings at less than 3 percent of all U.S. commercial real estate, outstanding REIT shares have grown considerably, with market capitalization doubling nearly three times in just four years (see Chart 4, next page). Accompanying this rise in capitalization has been an equally dramatic rise in bank lending to REITs. According to ***Loan Pricing Corporation***, bank lending to REITs surged to $12.8 billion in 1996, a 16 percent increase over 1995's then-record volume and more than a tenfold increase over the period 1990 to 1992.

The rise in REIT capitalization can be attributed in part to pent-up institutional demand for real estate. REITs

[2] While securitization of loans purports to shift credit risk to investors, many analysts and rating agencies have recently expressed concern over recourse arrangements, both contractual and voluntary, whereby the seller/servicer effectively assumes all or most of losses experienced by the security.

CHART 4



have a particular appeal to fund managers since they offer the benefits of investment diversification without the dual headaches of property management and asset illiquidity. Aside from the direct credit risk posed by lending to REITs, their rising popularity confronts banks with an indirect threat as well—the threat that banks could be crowded out of lending opportunities if investors find REIT funding structures more attractive from a cost and control standpoint. The degree to which this crowding out may occur is unclear, for according to ***Nomura Research***, REITs historically have borrowed 40 cents for each dollar of real estate held. However, well over half of this borrowing takes place through public offerings of secured and unsecured debt, leaving only a small portion to be financed by banks and other private lenders. Because REITs tend to focus on the highest quality projects, their increasing presence also creates concerns that banks may be driven to lend to less attractive or more risky properties to preserve market share.

Many analysts have also expressed unease over the rapid rise in the valuations of REITs, some of whose shares are priced at a considerable premium to the properties themselves. Anecdotal evidence suggests that premiums as high as 40 percent over market value have been paid for some REIT shares in recent months. Such market-based valuations create concern over the extent to which an REIT's capital structure allows it to pay more for properties than an investor who employs greater financial leverage. Accordingly, while REITs may make up a fairly nominal amount of overall real estate holdings, they may be quite influential in determining how commercial properties are being valued or appraised.

Commercial Real Estate Securitization: Some Broader Implications

Maturing CMBS markets could eventually improve the overall stability of commercial real estate markets not only by improving market liquidity but also by enabling investors to diversify and share their credit exposures among a greater number of participants. In addition, loan performance could become increasingly transparent to the general marketplace, thereby encouraging more uniform and prudent underwriting standards. However, concern naturally arises because CMBSs are a major source of commercial real estate market funding that has not been tested through a serious market downturn. This situation leads to questions concerning the impact they will have on property values and market liquidity and whether today's underwriting terms, driven largely by competitive factors, will stand up to tomorrow's market downturn. Another question is whether the standardized structures underlying these securities offer enough flexibility to borrowers to renegotiate loan terms—a critical workout tool during times of financial stress. The answers to these questions will ultimately determine the extent to which lenders and investors suffer as a result of the inevitable cyclical swings in commercial property values.

There are also questions about how REITs will affect commercial real estate markets. One argument is that the appetite for REIT investments, combined with the premiums that the trusts can pay for properties, will push the price of commercial space beyond sustainable levels. Those who hold this view see REITs, and other Wall Street innovations that increase the supply of funding, as potentially amplifying cyclical swings in real estate values. The contrary view holds that REITs will improve market efficiency by providing continuous pricing benchmarks through daily share price movements and thus enforce discipline upon developers and lenders. This discipline, it is argued, will prevent excessive development and dampen the severity of real estate cycles.

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estatebased instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose how best to compete against—or participate in—these new real estate financing strategies.

Steven Burton, Senior Banking Analyst
sburton@fdic.gov
Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

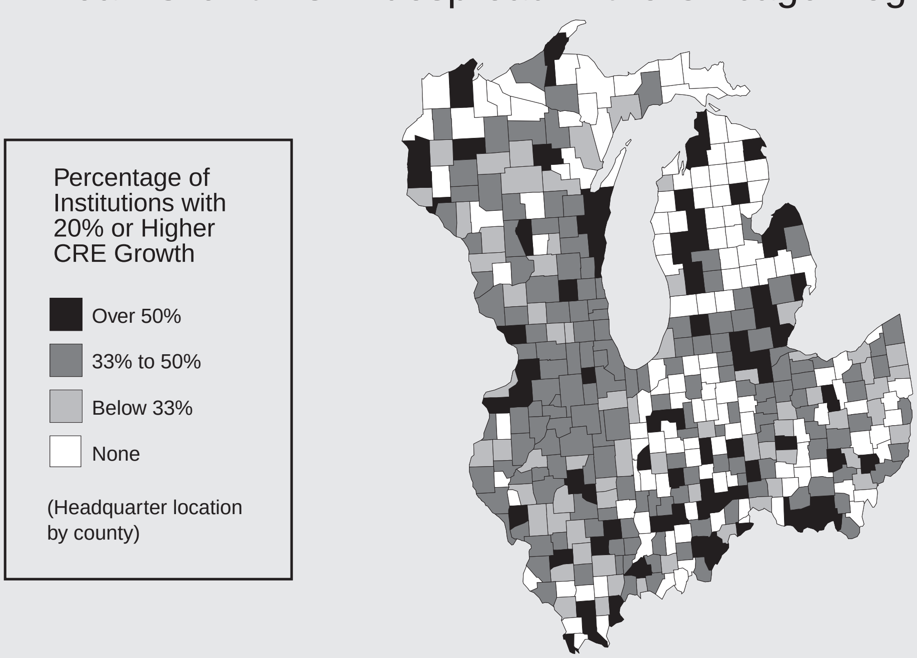
Chicago Region: Widespread and Rapid Growth in Real Estate Lending

Direct commercial real estate lending (construction and nonresidential) is important to many Chicago Region institutions. More than 40 percent of banks and thrifts in the Region reported aggregate exposures in this lending type exceeding Tier 1 capital at midyear 1997. In addition, some of these institutions, and others with less exposure, registered very strong commercial real estate (CRE) loan growth over the past year. About one-third of Chicago Region institutions had CRE loan growth of 20 percent or higher. These banks and thrifts are dispersed throughout the Region, in metropolitan and nonmetropolitan areas alike (see Chart 5).

Rapid growth rates are not necessarily precursors to future problems but can cause stress on insured institutions' management and control systems. In addition, competitive pressures caused, in part, by the financial innovations described in this article may be resulting in a slight increase of reports of liberalized underwriting practices. (See ***Regional Banking: Credit Quality Risk Management Becomes Even More Important as Economic Expansion Ages.***)

Chart 5

CRE Loan Growth Is Widespread in the Chicago Region



The Chicago Region's Economy in the Seventh Year of Expansion

- **The past year's slight decline in manufacturing employment within the Region reflects both moderating demand for some products and a tight labor market.**
- **Although the number of unemployed workers in the Region is the lowest in two decades, some insured institutions continue to cope with pockets of persistently high unemployment.**
- **The healthy market for single-family homes has spurred competition for residential lending, with some institutions liberalizing credit terms, especially on home equity lines.**
- **Ten years of appreciation have returned farmland prices in the Region to about 95 percent of their 1980 peak and thus improved the farm sector's debt-to-assets ratio. Continuation of these trends depends on both product prices and how well farmers manage their operations as government subsidies are phased out.**

Tight Labor Markets Limit Growth

Employment growth in the Chicago Region has been stalled at around a 1.5 percent pace since early 1996, when the Region's rate of job expansion started lagging the national pace (see Chart 1). *The deceleration in job growth is associated with both low unemployment in the Region and a long-lived cyclical expansion.* This expansion, now 79 months old, exceeds the post-World War II average of 50 months by a considerable span.

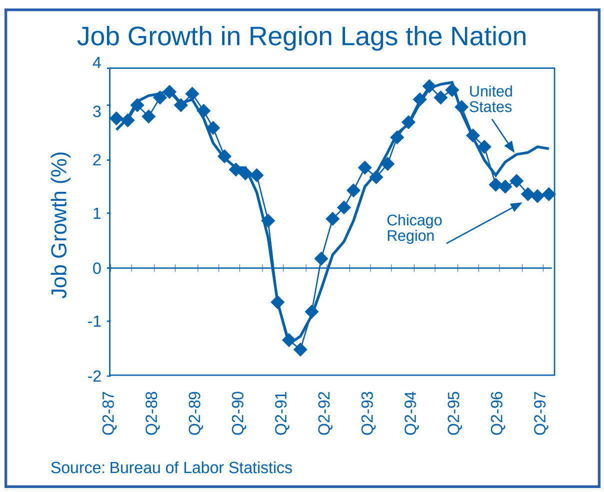
Another sign of the expansion's aging is that demand for such durable goods as light motor vehicles is high but has stopped growing. In this environment, productivity efforts by manufacturers and scattered strikes have actually trimmed the Region's employment among producers of vehicles and transportation equipment by about 2 percent (13,700 workers) over the past year. Overall, the only sectors with significant job gains recently are construction and services (see Table 1, next page).

This Region's low 4.1 percent unemployment rate highlights the lack of readily available workers for employers seeking to expand. *In fact, the 941,000 unemployed workers in the Region during the second quarter was the lowest level in the two decades for which data are available.* Meanwhile, Midwestern employers' ability to attract workers from other areas has weakened as economic conditions elsewhere, especially on the coasts, have improved.

Implications: In the seventh year of cyclical expansion, many factories and industries are operating near full capacity and labor markets are tight. Possible repercussions of this situation include the following:

- Firms lose business opportunities because of their inability to increase output in the short run.
- Labor costs rise and thus squeeze profit margins because firms cannot fully pass along higher costs in the form of higher output prices.
- Capacity constraints and inflationary pressures lead to rising interest rates, which affect the lending and earnings streams of financial institutions.

CHART 1



Pockets of High Unemployment Persist

The healthy economic environment represented by these statewide unemployment and job growth statistics, unfortunately, is not universal throughout the Region. In fact, 12 percent (52) of the Region's 437 counties experienced unemployment rates of 8 percent or higher in the second quarter of this year (see Chart 2). While current conditions represent an improvement relative to a year ago (see Table 2), the involved counties traditionally are rather insensitive to business cycles and thus have not actively participated in the expansion of recent years.

Within the Chicago Region, only **Indiana** had no counties with unemployment rates in the higher range. The pockets of higher unemployment are clustered in southern **Illinois**, northern **Michigan** and its Upper Peninsula, northern **Wisconsin**, and southeastern **Ohio**. Many high-unemployment counties lack significant diversity in their economic bases or reflect specific circumstances. For example:

- Seven counties in southern Illinois are heavily dependent on coal mining, which has been curbed in recent years by environmental regulations on the use of high-sulfur coal.

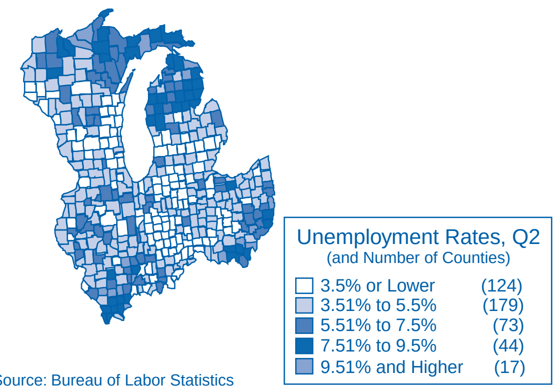
- The recent unemployment rate of 15.7 percent in Jefferson County, Ohio, largely reflected the effects of a lengthy steelworkers' strike. An August settlement is returning steelworkers to payrolls, but some of the damage to local businesses likely will be reversed very slowly.

- Employment in many Upper Peninsula communities is concentrated in such seasonal sectors as tourism or logging. Additionally, the closing of an Air Force base affected not only military employees but also service workers, retailers, and others who depended on business from the base.

Implications: *Banks and thrifts headquartered in counties with high unemployment rates do not show an elevated percentage of past-due loans relative to banks in the rest of the Region.* For the Region as a whole, slightly more than 9 percent of institutions had 5 percent or more of their loan portfolios past due in the second quarter. In high-unemployment counties, 7 percent of institutions had past-due ratios of 5 percent or higher. This comparability presumably reflects the ability of lending institutions in the high-unemployment areas to

Chart 2

Chicago Region Shows Scattered Pockets of High Unemployment



Source: Bureau of Labor Statistics

Table 1

Slowing Employment Growth Widespread in Chicago Region	% Change from 4 Quarters Earlier		
	Q2-95 (%)	Q2-96 (%)	Q2-97 (%)
Total Payrolls	3.0	1.5	1.4
Mining	–5.4	–5.6	–1.3
Construction	2.5	4.7	4.9
Manufacturing	3.2	–0.7	–0.4
Transportation, Public Utilities	3.1	1.3	1.5
Wholesale Trade	3.2	0.5	0.7
Retail Trade	3.7	1.2	1.5
Finance, Real Estate, Insurance	–1.0	1.8	1.8
Services	4.0	3.6	2.8
Government	1.6	0.9	0.2

Source: Bureau of Labor Statistics

Table 2

Pockets of High Unemployment Remain

Unemployment Rate of	Number of Counties in					
	Region	IL	IN	MI	OH	WI
Q2-97:						
8% and up	52	14	0	24	11	3
10% and up	14	5	0	5	3	1
Q2-96:						
8% and up	73	25	5	30	11	2
10% and up	30	10	1	13	5	1

Source: Bureau of Labor Statistics

plan for and adjust to unfavorable economic conditions, thus managing the quality of their credits at least as well as institutions in markets with more vibrant and diversified economies.

Single-Family Housing: High Demand but Modest Expansion

Relatively low interest rates and high employment levels are favorable for the housing market, but in the seventh year of cyclical expansion there is minimal pent-up demand. As a result, sales of single-family homes in the Midwest remain high but are expanding at a subdued pace. On the supply side, construction starts of single-family homes in the first half of this year were about 6.5 percent below the year-earlier pace, with some of the decline resulting from the lack of suitable building sites.

Around mid-year, prices of both new and existing homes in the Midwest were about 5 percent higher than a year earlier. However, they got there along different paths. Median prices of *new* homes in the Midwest have been on a modest rising trend since 1995. In contrast, price gains for *existing* homes have cooled recently after four quarters of 9 to 10 percent appreciation (at an annual rate), the most rapid in 10 years. Recent price changes in various metropolitan areas in the Region are shown in Table 3.

While the market for single-family homes is strong at present, some signs of vulnerability are appearing. For example, the rate of foreclosures started (on conventional loans) in the Midwest, as reported by the Mortgage Bankers Association, remains among the lowest in the nation but has risen over the past two years. *The sustained increase in the foreclosure rate joins rising credit card delinquencies in this Region as a signal that households' debt burdens are a concern at this stage of the business cycle, when job gains and income growth are slowing.*

Implications: The market for single-family housing in the Midwest has experienced moderate price appreciation and apparently avoided the boom mentality that often precedes a sharp reversal of fortunes. Even so, various potential developments could undermine current conditions and thus weaken the value of collateral behind real estate loans. Job growth could slow further or interest rates could start climbing, either of which would further aggravate debt payment problems among

TABLE 3

MEDIAN PRICE OF EXISTING SINGLE-FAMILY HOMES CLIMBS
(PERCENT CHANGE FROM A YEAR EARLIER)

Q4-95	Q4-96	Q2-97	Metro Area
12.9	3.4	3.7	Akron
5.7	–0.4	3.6	Appleton-Oshkosh-Neenah
6.0	2.3	0.5	Aurora-Elgin
8.1	2.7	4.1	Canton-Massillon
4.4	–1.0	5.0	Champaign-Urbana
3.8	0.9	4.9	Chicago
5.8	3.4	3.8	Cincinnati
10.6	3.6	3.9	Cleveland-Lorain-Elyria
–5.0	5.8	8.1	Columbus
10.8	3.2	7.7	Davenport-Moline-Rock Island
7.7	5.1	2.4	Dayton-Springfield
14.6	12.9	6.7	Detroit
6.8	–1.6	3.1	Gary
6.3	5.6	7.8	Grand Rapids-Muskegon-Holland
6.4	9.5	2.5	Green Bay
8.2	2.4	3.2	Indianapolis
13.8	7.4	10.5	Kalamazoo
10.2	6.7	7.2	Lake County, IL
6.4	4.4	10.7	Lansing-East Lansing
9.4	7.1	6.1	Louisville
9.9	–1.3	5.5	Madison
7.2	1.8	3.6	Milwaukee-Racine
6.8	4.7	–0.2	Minneapolis-St. Paul
6.0	5.2	7.0	Peoria-Pekin
4.8	–0.6	1.2	Rockford
15.1	3.4	5.6	Saginaw-Bay City-Midland
18.3	0.8	–5.1	South Bend
3.8	2.7	5.4	Springfield
6.0	3.3	7.6	St. Louis
9.7	8.2	2.9	Toledo
3.2	5.5	3.3	Youngstown-Warren

Source: National Association of Realtors some households. A downturn in the stock market could wipe out some of households' net worth and dent their optimism about economic conditions.

Over one-fourth of the Region's insured institutions experienced 20 percent or faster growth in 1 to 4 family residential loans over the past year. Home equity loans rose rapidly at a larger share of the Region's institutions, in part because some portfolios were fairly small initially. *Nearly 40 percent of banks and thrifts in the Region expanded their home equity lines by 20 percent or more in the past year.* Some of the home equity loans may be especially vulnerable to any softening in residential market values in light of anecdotal information that institutions' attempts to gain market share have, in some cases, resulted in loan-to-value ratios of 100 percent or more.

Agriculture: Appreciating Land Values and Volatile Prices

Ten years of appreciating land values have brought the current value of farm real estate in the Region to about 95 percent of its peak in 1980 (see Chart 3). The appreciation, in turn, has contributed to relatively low measures of debt loads (e.g., debt-to-assets ratio) among Chicago Region farmers (see Chart 4). It also has boosted the value of farm real estate holdings as a percentage of total farm assets to the highest level since 1983.

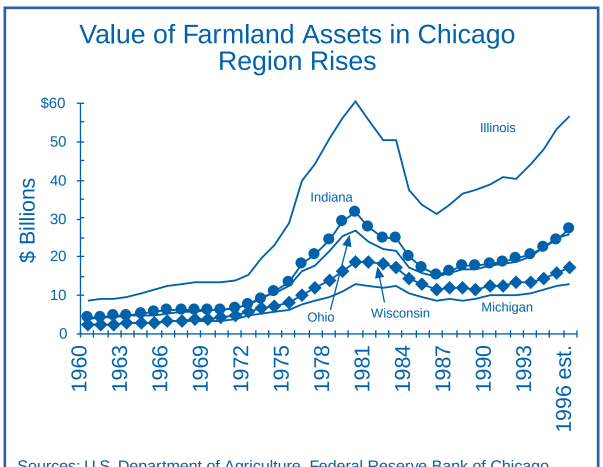
While farmland prices have trended upward, commodity prices have tended to fluctuate widely. For example, prices received by farmers for milk gyrated considerably in the past year. Prices broke out of the $12- to $14-per-hundredweight (Cwt) range experienced since 1992, first climbing to over $16 per Cwt and then plunging to around $12.50 per Cwt recently (see Chart 5, next page). Such volatility adds pressure in a market already undergoing structural change.

Many dairy farmers also are responding to challenges from lower cost producers, which have expanded noticeably in the West. California, where operations average 438 cows per herd, displaced Wisconsin, where the average is 52 cows per herd, as the leading milk-producing state in 1994. The challenge of lower cost competition from large operators is especially important in **Wisconsin**, where dairy goods account for 52 percent of the state's receipts from farming. Dairy farming also is important to the agricultural sectors in **Michigan** and **Ohio**, where it generates 20 percent and 13 percent, respectively, of each state's agricultural receipts.

Other agricultural markets important to the Chicago Region also are experiencing volatile prices. Despite favorable production estimates, price movements for corn and soybeans may be more pronounced than usual this season because of very low reserves. The unpredictability of weather and growing conditions may cause these markets to remain jittery and subject to large price swings until the harvests are in.

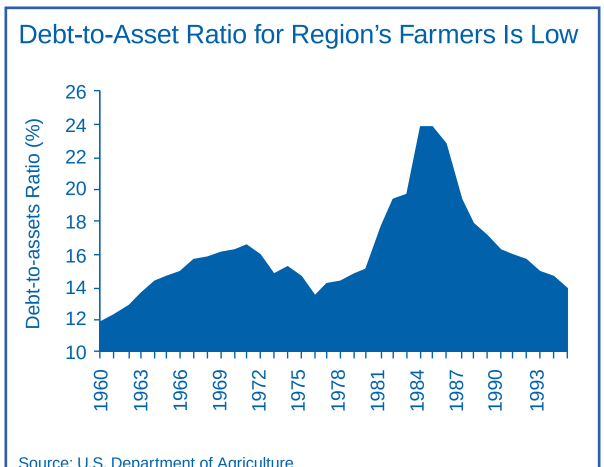
Implications: The value of farmland in the Region climbed by 61 percent from its 1986 low through 1995, thus contributing to the currently low debt-to-assets ratio. *As land values approach previous peaks and farmers face potentially increased price volatility resulting from the 1996 Farm Bill, lenders must*

CHART 3



Sources: U.S. Department of Agriculture, Federal Reserve Bank of Chicago

CHART 4



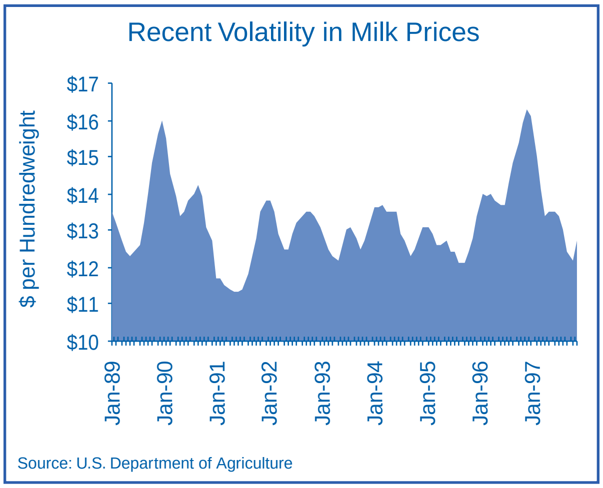
Source: U.S. Department of Agriculture

evaluate whether real estate values will hold or appreciate further.

In addition, the impacts of some industry-specific developments deserve watching. Modernization steps by some small dairy operators in the Midwest are an example. As they expand their herds and adopt more capital-intensive methods, these farmers' traditional financial arrangements may also change considerably. They may place greater reliance on debt financing, for instance, to pay for new buildings or equipment to mechanize tasks and realize production efficiencies. Larger operators, in turn, may rely more heavily on purchased inputs such as feed. All told, modernization by dairy farmers could cause both their capital and operating needs to shift from those to which they and their bankers have become accustomed.

Joan D. Schneider, Regional Economist

CHART 5



Financial Markets

- **Bank holding companies of all sizes have issued trust preferred stock following the Federal Reserve's decision in October 1996 to count these tax-advantaged capital securities toward Tier 1 capital.**

- **Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget this year, there still exists the possibility that the Internal Revenue Service may alter the tax treatment of trust preferred dividends.**

- **Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the potential risks associated with excessive reliance on debt-like capital instruments.**

Bank holding company capital requirements were effectively relaxed in October 1996 when the Federal Reserve ruled that trust preferred stock may be included in the portion of cumulative preferred stock that can compose up to 25 percent of a bank holding company's Tier 1 capital. In the wake of this decision, financial institutions moved quickly to issue trust preferred stock. Trust preferred stock can be a less expensive form of Tier 1 capital for bank holding companies because of the tax deductibility of the dividend payments paid on this type of preferred stock.

Approximately 90 banking organizations issued an estimated $21 billion of trust preferred shares from October 1996 through June 1997.[1] The dollar amount of trust preferred stock issued represented almost 95 percent of the incremental amount of Tier 1 capital added by those institutions during the period. A number of these institutions used the proceeds of trust preferred stock issues to fund stock buyback programs. As an example of the relative importance of these stock buyback programs, one large bank holding company's Tier 1 capital ratio would be 7.25 percent excluding the trust preferred shares, and 8.34 percent including the shares.

Rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital because of its limited life and debt-like characteristics. These characteristics include the tax treatment of trust preferred dividends,[2] the limited life of the shares, and the ability of investors to accelerate their claims against the bank holding company. Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the possibility that excessive reliance on debt-like capital instruments could increase their financial fragility during times of economic stress.

Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative

Trust preferred shares, also known as capital securities, are traded under different names depending on the underwriter, payment terms, and maturity. Some of the more common acronyms include TOPRS (Trust Originated Preferred Shares), QUIPS (Quarterly Income Preferred Shares), and MIPS (Monthly Income Preferred Shares).

Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary is owned by the bank holding company, and the trust preferred stock is sold to investors. The trust upstreams the proceeds from the sale of the preferred shares to the bank holding company in exchange for a long-term, deeply subordinated note with terms identical to the trust preferred shares. (The subordinated note must be the sole asset of the trust and subordinated to all other debt of the bank holding company.)

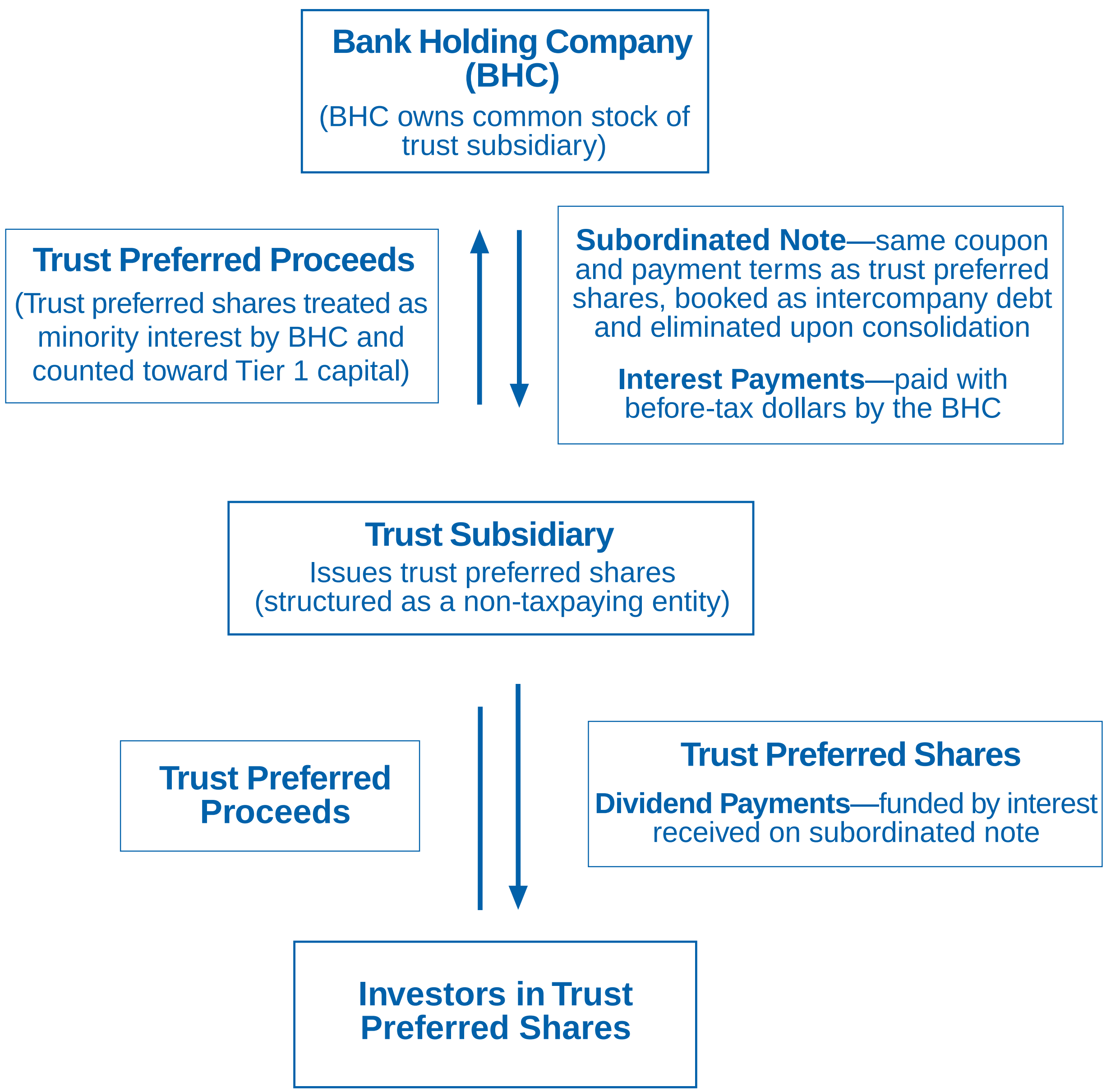
On a consolidated basis, the trust preferred stock is treated as a minority interest of the bank holding company, and the subordinated note is eliminated as inter-

[1] The amount of trust preferred stock outstanding is not delineated in Call Reports.

[2] Trust preferred dividends, unlike dividends on traditional preferred stock, are treated as a tax-deductible expense at the bank holding company level and as taxable income by investors of the trust preferred shares.

CHART 1

How Is Trust Preferred Stock Structured to Count as Tier 1 Capital?



company debt. The interest paid by the bank holding company on the subordinated note, which is tax-deductible at the bank holding company level, is used to fund the dividends on the trust preferred shares. In short, the issuing trust serves as a conduit for exchanging cash flows between the bank holding company and the investors in the trust preferred shares.

To be eligible for Tier 1 capital treatment, trust preferred dividends may be cumulative, but dividends must be deferrable for a minimum of five years. If the dividends are not paid for more than five years, the trust preferred shares could be exchanged for junior subordinated debt of the trust. After the exchange, the trust preferred holder could declare an event of default and accelerate the claim against the bank holding company. Trust preferred shareholders would then be treated similarly to deeply subordinated debt holders or preferred stockholders of the bank holding company.

Trust preferred shares typically have maturities of 30 years or more and contain call options and redemption provisions. The redemption provisions, which are subject to Federal Reserve approval, permit the issuer to redeem or buy back the preferred shares prior to maturity upon an adverse event such as the loss of Tier 1 capital treatment or the tax deductible status.

Banks are not permitted to count trust preferred stock toward Tier 1 capital because of the cumulative feature of trust preferred dividends. While bank holding companies are permitted to include up to 25 percent of Tier 1 capital as cumulative preferred stock, including trust preferred shares, banks must exclude cumulative preferred stock from Tier 1 capital ratios pursuant to the Risk-Based Capital Standards set by the Basle Accord.

Bank Holding Companies of All Sizes Have Issued Trust Preferred Stock

The flood of trust preferred stock issuance was prompted in part by the threat of extinction under the 1997 federal budget. Bank holding companies rushed to take advantage of a potentially short-lived tax loophole, while investors were attracted by the opportunity to earn higher rates than on similarly rated bank debt. Bank holding companies have used proceeds from trust preferred stock to retire or call more expensive outstanding preferred issues, to provide capital to bank subsidiaries, to finance acquisitions, and to buy back common stock.

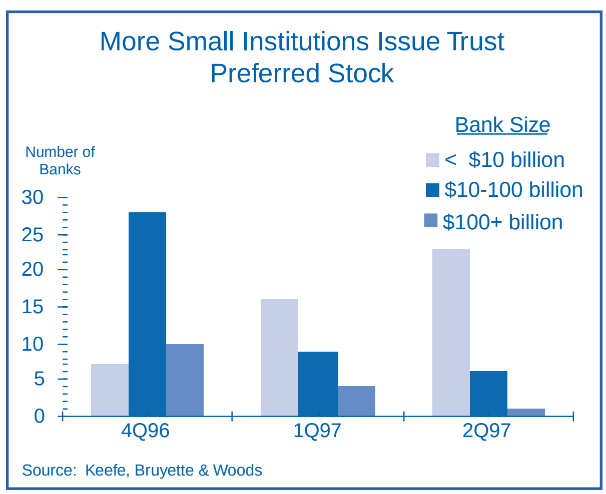
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated $4.3 billion in the first quarter of 1997 to just under $2.5 billion in the second quarter. Trust preferred issuance by larger banks declined as some approached their limit on Tier 1 trust preferred, while more smaller banks took advantage of the market for trust preferred stock. (See Chart 2 for a distribution of the number of banks in various size categories that have issued trust preferred stock in recent quarters.) Investment bankers are reportedly working on new structures that may make it easier and more cost effective for smaller institutions to issue these capital securities, perhaps through some pooling arrangement.

REIT Preferred Stock—Another Type of Tax-Advantaged Tier 1 Capital

Prior to the Federal Reserve's announcement last October, the REIT (real estate investment trust) preferred stock structure was the chosen way for financial institutions to issue tax-advantaged preferred shares. Bank-issued REIT preferreds lost favor once trust preferreds debuted, because the trust structure is less costly and easier to administer than REIT preferreds.

In an REIT preferred structure, the issuer establishes a corporation that elects REIT tax status. Proceeds from the preferred shares that are sold to investors are used to purchase qualifying real estate assets such as mortgage-backed securities or equity interests in real property. Cash flow from the real estate assets funds the REIT's

CHART 2



operating costs and preferred dividends. As long as the subsidiary continues to qualify for REIT tax status,[3] dividend payments on the common and preferred shares are tax deductible by the holding company.

Will the Tax-Advantaged Status of Trust Preferred Stock Continue?

Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget, the possibility still exists that the Internal Revenue Service (IRS) may alter the tax treatment of trust preferred dividends. (In the first half of 1997, the IRS issued a ruling that eliminated the tax-advantaged status of a specific type of preferred stock known as Step-Down preferred stock.) If the tax advantage is eliminated, REIT preferred shares might again become a more popular means of raising tax advantaged Tier 1 capital.

Issues and Concerns

A number of bank holding companies have embarked on stock buyback programs financed by trust preferred stock issuance, thereby boosting earnings per share by reducing the number of common shares outstanding, while maintaining Tier 1 regulatory capital ratios. Rating agencies and investment analysts, however, generally view trust preferreds as analogous to preferred stock or deeply subordinated debt of the issuer. *In fact, **Standard & Poor's** has announced that bank holding companies with trust preferred stock in excess of 10 percent of Tier 1 capital may be subject to a ratings review.* This announcement reflects the view of some analysts that trust preferred stock is a weaker form of Tier 1 capital than other forms of capital such as common and perpetual preferred stock, because of its limited life and treatment upon a liquidation of the trust.

A recent regulatory interpretation has underscored the debt-like nature of trust preferred stock. The Office of the Comptroller of the Currency (OCC) has determined that investments by banks in trust preferred stock should be treated as investments in debt securities.[4] The OCC cited a number of similarities between trust preferred stock and debt securities, including the fact that an investment in trust preferred securities is functionally equivalent to an investment in the underlying subordinated debt issued by the bank holding company, and that the trading characteristics of trust preferred securities are similar to traditional debt securities.

Banking organizations should be aware of the views of rating agencies and bank analysts toward trust preferred stock. In times of economic stress, excessive reliance on debt-like capital instruments could result in increased financial fragility of the overall organization, a higher cost of raising new capital, and potential ratings downgrades. In extreme scenarios, pressures on the bank to service the obligations (explicit or implicit) of the holding company could attract the attention of bank regulators.

Kathy R. Kalser, Chief
Financial Sector Analysis Section

[3] To qualify as an REIT, the subsidiary must comply with Section 856 of the U.S. Federal Income Tax Code, which requires that 75 percent of the REIT's income come from real property rents, interest income from mortgage debt on real property, and other related sources. In addition, the REIT must distribute at least 95 percent of its net income to shareholders.

[4] In a letter dated April 8, 1997, the OCC stated that subject to applicable rating and marketability requirements, bank investments in trust preferred stock would be treated as Type III investments under 12 CFR Section 2 1.2 (k).

Credit Quality Risk Management Becomes Even More Important as Economic Expansion Ages

- **A prolonged economic expansion has helped maintain good credit quality at insured institutions in the Region. However, given the age of the expansion, a growing number of interested parties argue that now is an ideal time to review and strengthen lending practices.**

- **Charge-off rates in the Region reflect changing economic activity and pinpoint consumer lending as an area of concern.**

- **Past-due rates confirm consumer loan problems and identify other areas of interest.**

- **While primarily favorable, loan surveys show some weaknesses in the types of lending where Regional growth has been strong, especially commercial and industrial and commercial real estate loans.**

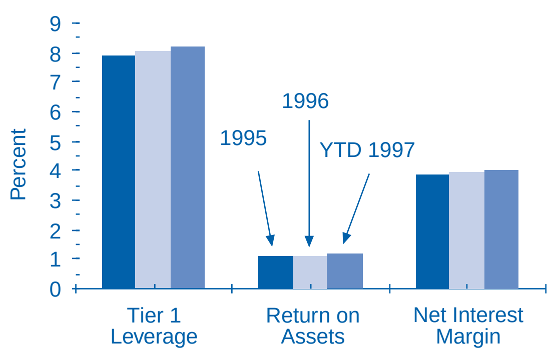
Overview

Insured institutions in the Chicago Region continue to adapt to a rapidly changing operating environment. For example, the trend toward fewer but larger institutions accelerated during the second quarter and was fueled by the recent changes in interstate branching laws. As a result, during the second quarter there were 49 fewer insured institutions operating in the five-state Region, but the Region's total assets have increased by almost $67 billion to $911 billion.

To date, banks and thrifts have generally been able to manage such changes and maintain relatively strong earnings and capital positions (see Chart 1). Thus far in 1997, the Chicago Region's institutions increased aggregate leverage capital to over 8 percent of average assets and recorded a solid aggregate return on assets of 1.24 percent.

CHART 1

Chicago Region Institutions Continue to Show Financial Strength



Source: Bank and Thrift Call Reports

Certainly, the prolonged economic expansion in the Region and a relatively stable interest rate environment have assisted bank performance, including credit quality. (See ***Regional Economy: The Chicago Region's Economy in the Seventh Year of Expansion***.) Recently, however, a number of industry observers have voiced varying degrees of concern over credit quality issues, particularly lending terms and underwriting standards. These comments have become more numerous as the current economic expansion ages.

A review of traditional credit quality indicators and various surveys on underwriting standards reveals that some of these concerns may be justified. In particular, consumer loan charge-off rates and delinquency levels have been trending upward. Additionally, recent Federal Reserve Board (FRB) and Federal Deposit Insurance Corporation (FDIC) underwriting surveys note some evidence of eased underwriting or credit administration standards in other portfolios.

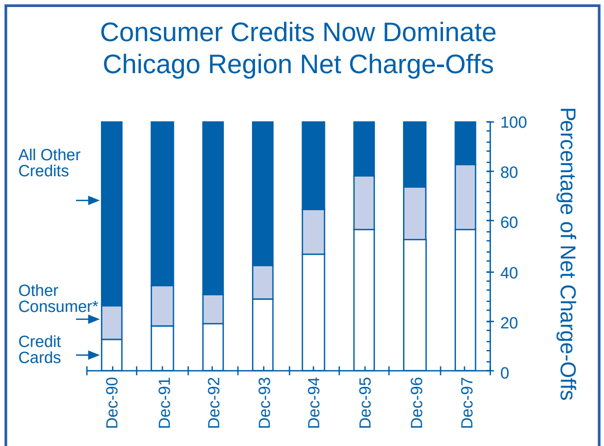
Charge-Off Rates Pinpoint Consumer Lending as an Area of Concern

Not surprisingly, net charge-off rates in the Region reflect changing economic activity and pinpoint consumer lending as an area of concern. From late 1992 through first quarter 1995, insured institutions in the Chicago Region were able to dramatically reduce net charge-offs (see Chart 2, next page). Most of the reduction was realized in the commercial and commercial real estate sectors—two areas of the Region's economy that substantially improved during this period.

Unfortunately, the overall net charge-off rate for the Region began to rise a couple of years ago despite the fact that commercial and commercial real estate charge-offs remain relatively low. The recent rise has been due to a dramatic increase in charge-offs of consumer loans. This deterioration appears to be attributable to aggressive underwriting and solicitations, generally high consumer debt levels, and high rates of consumer bankruptcy during this period.

Consumer loans comprised over 80 percent of all net charge-offs thus far in 1997, a significant increase from the 26 percent noted earlier in this decade (see Chart 3). The bulk of these charge-offs are occurring in credit card portfolios of larger institutions. Of additional concern is the continuing increase in the credit card charge-off rate, with recognized net losses for the Region approximating a 6 percent annualized rate during the second quarter.

CHART 3



Source: Bank & Thrift Call Reports *Not real estate secured

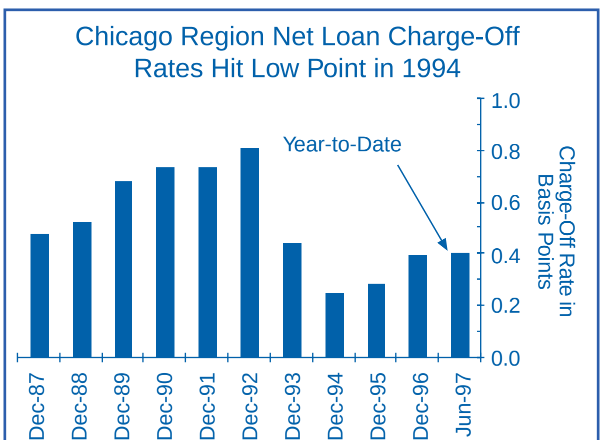
tain portfolios and a minority of individual institutions have weaknesses in this area.

Past-Due Rates Confirm Consumer Loan Problems and Identify Other Areas of Interest

Like charge-off activity, the aggregate past-due loan rate (30 days or more past due or on nonaccrual) for Chicago Region institutions declined through the first half of the 1990s, then rose slightly over the past few years (see Chart 4). Though it remains fairly low by historical standards, at about 2.2 percent of total loans, certain portfolios and a minority of individual institutions have weaknesses in this area.

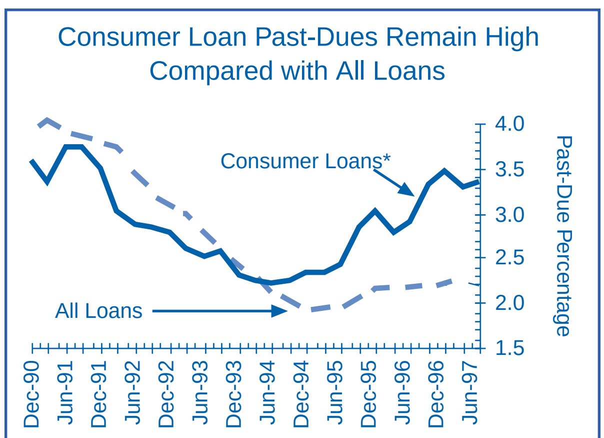
The slight increase in overall past-due loans is primarily the result of increases in problem consumer credit. On an aggregate basis, the consumer loans held by the Region's institutions had a past-due rate of 3.3 percent as of June 30, 1997, up from about 2.4 percent two years earlier. Credit card portfolios remain weak and now reflect over a 5 percent past-due rate. *Anecdotal comments from some analysts suggest that past-due levels on consumer lending would be even higher were it not for some of these credits migrating to home equity and residential real estate portfolios.* Home equity loans in the Region continue to be aggressively marketed, as evidenced by a proliferation of radio and print advertisements for these plans, some of which feature high loan-to-value limits.

CHART 2



Source: Bank & Thrift Call Reports

CHART 4



Source: Bank & Thrift Call Reports * Not secured by real estate

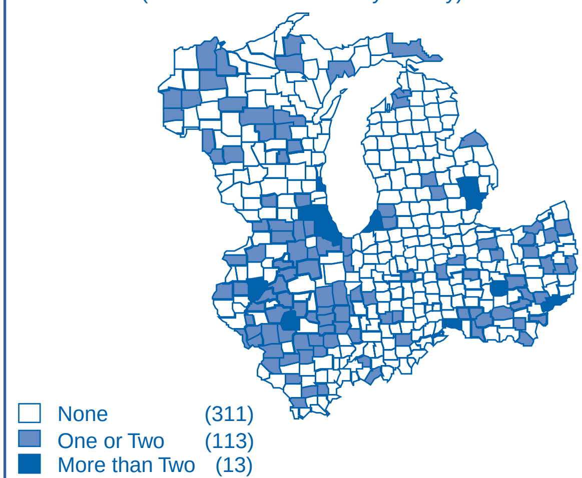
Another note of caution is that the overall volume of past-due loans (consumer, commercial, and real estate loans combined) is on the rise at a significant number of institutions. Almost one-third of Chicago Region institutions have registered a 30 percent or higher growth rate in past-due loans over the past four quarters. In addition, about 200 institutions have elevated (over 5 percent) past-due loan ratios. These institutions are geographically dispersed between metropolitan and non-metropolitan areas and are centered in **Illinois**, **Ohio**, and **Wisconsin** (see Chart 5).

To some degree, the concerns in this area are softened by the fact that delinquency levels still are considered low by historical standards at many of the institutions where past-due loan growth has been high. In addition, the majority of institutions reflecting elevated past-due rates appear to have considerable financial flexibility in the form of strong capital and earnings, which may compensate for this added risk.

CHART 5

Location of Institutions with 5 Percent or More Past-Due Loans

(Number of Institutions by County)



Source: Bank and Thrift Call Reports

Loan Survey Results Show Some Weaknesses in Areas Where Regional Loan Growth Has Been Strong

Traditional measures of credit quality, such as charge-off and past-due rates, are intended to identify weaknesses in current conditions and may not be good predictors of future areas of concern. To take a more proactive approach to risk assessment in loan portfolios, bankers and regulators have focused on reviewing underwriting standards—especially in areas where there is significant growth.

In that regard, the Federal Reserve recently released the results of its ***August 1997 Senior Loan Officer Opinion Survey on Bank Lending Practices***. As part of this survey, the FRB elicits responses from large banking organizations nationwide concerning loan standards, terms, and demand. Among other things, the survey noted the following areas of potential concern:

- Increased competition has apparently led a large percentage of banks in the survey to ease interest rates on commercial and commercial real estate loans during the previous three months. Other loan *terms* also were eased, although not to the same extent as interest rates. These terms include increasing the maximum size of credit lines, adjusting loan covenants, and relaxing collateralization requirements.
- A "small but significant" share of respondents eased *standards* on commercial real estate loans. Standards reflect the level of risk an institution is willing to accept.

In addition, as part of every safety and soundness examination, FDIC examiners complete a credit underwriting survey on the institution's policies and practices. For second quarter 1997, 120 surveys were completed in the Chicago Region. Although these surveys did not disclose widespread problems with underwriting practices, loan administration was viewed as having "greater than average" risk in about 17 percent of the surveys. In addition, examiners noted the following:

- About 10 percent of institutions examined were "frequently or commonly" funding speculative construction projects.
- About 21 percent of institutions examined have "frequently or commonly" made business loans that lack documentation of financial strength.

Eased underwriting terms and standards for commercial and commercial real estate lending take on added significance in the Chicago Region because these remain areas of substantial growth for many insured institutions (see Table 1, next page). The growth of these portfolios appears to be broad-based both geographically and by size of institution.

TABLE 1

Commercial Real Estate, Residential, and Commercial Loans Are Growing at a Rapid Pace at Many Institutions (4 qtrs growth ending 6/97)	Percentage of Chicago Region Institutions with Loan Category Growth Approximating		
	20% to 30%	30% or More	Total over 20%
Total Loans and Leases	10	11	21
Construction Loans	5	35	39
Commercial Real Estate Loans	9	27	36
Total CRE	10	26	36
1-4 Family Residential Loans	12	16	28
Home Equity Lines	7	33	40
Total Residential	12	16	29
Farm Loans Secured by Real Estate	5	16	21
Other Farm Loans	4	12	16
Total Farm Loans	4	13	17
Credit Card Loans and Related Plans	4	16	20
Other Consumer Loans	8	17	25
Total Consumer Loans	8	17	24
Commercial Loans	9	23	32

Source: Bank & Thrift Call Reports

Implications: To be prepared for the credit quality problems a general or localized economic downturn might cause, maintenance and, where needed, strengthening of credit risk management procedures is essential. Institutions in this Region may want to be especially cognizant of the following:

- Continuing weaknesses in consumer loan portfolios;
- Possible migration of consumer lending problems to home equity and residential real estate portfolios;
- Effects of eased underwriting on commercial and commercial real estate loans—especially in cases where growth has been significant, past-due levels are already high, or portfolios have large volumes of loans to customers that were not operating during the last economic downturn and, therefore, may have little experience with such conditions; and
- Adequacy and support of loan loss reserves.

James D. Eisfeller, Bank Examiner
Michael J. Feeney, Regional Analyst
John D. Weier, Regional Manager

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta	________	Boston	________	Chicago	________
Dallas	________	Kansas City	________	Memphis	________
New York	________	San Francisco	________	All	________

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE
MAIL
Postage &
Fees Paid
FDIC
Permit No. G-36