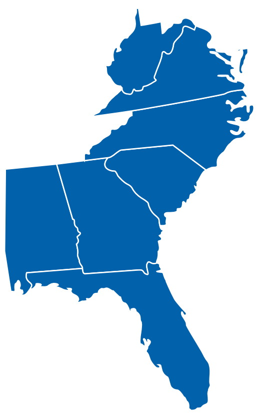
Regional Outlook

Federal Deposit Insurance Corporation — Fourth Quarter 1998

FDIC
Atlanta
Region



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In Focus This Quarter

◆ ***Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale*—The size and value of recent mergers and acquisitions (M&A) in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers. For banks, deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among important drivers of the trend. By identifying the rationale and incentives for bank M&A activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.** *See page 5.*

By Steven E. Cunningham, John F. Sherman

◆ ***Risks and Challenges for Consolidating Institutions*—M&A activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. As premiums paid in bank M&A deals have escalated, some industry observers have questioned whether the promised benefits of the transactions can be realized. Institutions in the process of integrating an acquired entity may be especially vulnerable to a downturn in the economy.** *See page 11.*

By John F. Sherman

◆ ***Industry Consolidation Presents Unique Risks and Challenges for Community Banks*—Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope. Aside from merging with or selling to competitors, some small banks are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets. While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate these institutions' operations and risk profiles.** *See page 14.*

By Steven E. Cunningham

Regional Perspectives

◆ ***Region's Economic and Banking Conditions*—Economic growth in the Atlanta Region continues to outperform the nation…a number of factors, however, including the impact of the Asian crisis, have combined to slow growth…insured institutions are benefiting from the Region's continued growth, reporting strong earnings, solid asset quality, and high capital levels…returns were strong across asset sizes, but many institutions are being affected by declining net interest margins.** *See page 19.*

◆ ***Structural Transformation in the New South*—The Greenville, South Carolina, metropolitan area reflects the emergence of the "New South" or "New Economy"…growth is being driven by an influx of high-tech and information-driven industries…gains in new industries have resulted in higher levels of economic diversification, tighter labor markets, and steady population growth…one drawback may be that the local economy could become more susceptible to national or international shocks. Greenville's insured institution landscape is reflective of the area's growth…a hallmark of this change has been an increase in number of newly chartered banks.** *See page 23.*

By Atlanta Region Staff

A Publication of the Division of Insurance

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Sincerely,

George French
Executive Editor

The *Regional Outlook* has three *In Focus* articles that address national issues and a *Regional Perspectives* article that analyzes the economic and banking conditions in each of the eight FDIC supervisory regions.

	0 No Opinion	**1 Strongly Disagree**	**2 Disagree**	**3 Agree**	**4 Strongly Agree**
1 The *In Focus* articles **improve my understanding** of risks affecting the financial institutions of interest to me.					
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Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale

- **The size and value of recent mergers and acquisitions in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers.**

- **Deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among the important drivers of bank merger and acquisition activity.**

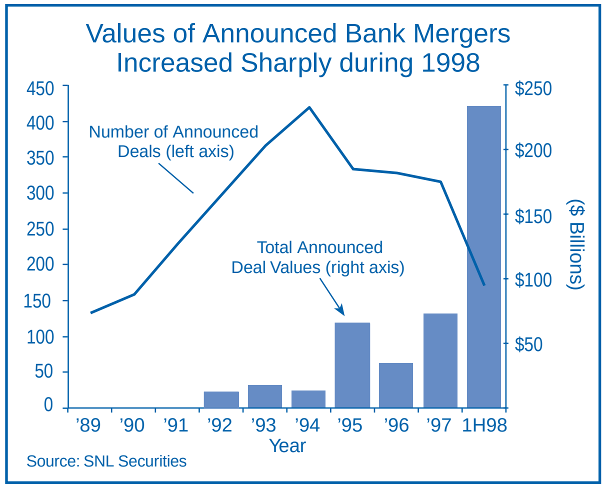
- **By identifying the rationale and incentives for bank merger and acquisition activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.**

Merger and acquisition (M&A) activity among banking companies is changing the industry's structure. The number of insured commercial banks in the United States, which held relatively steady during the FDIC's first 51 years of existence, has declined by one-third since year-end 1984, resulting in just under 9,000 commercial banks at the end of the second quarter of 1998. The number of banking organizations (bank holding companies, independent banks, and thrifts) also has declined precipitously since the mid-1980s.

The recent flurry in M&A activity by banking companies has attracted significant attention as the magnitude of transactions has escalated. As shown in Chart 1, the announced values of bank mergers have increased sharply in recent years. However, increased consolidation activity is not unique to the banking industry: The United States is now experiencing the fifth major wave of business M&A in this century, which is in turn part of an unprecedented level of worldwide M&A activity. According to data from ***Mergerstat***, the value of M&A deals announced for all U.S. industries during the first half of 1998, measured both absolutely and as a percentage of nominal gross domestic product, exceeded the value of announced transactions for any full calendar year on record.

The factors that have contributed to this activity, including the availability of capital, technological change, and

Chart 1



globalization, are particularly important to the banking industry. Indeed, according to data from ***SNL Securities***, the announced values of banking M&A have accounted for roughly one-third of all U.S. merger activity for the first half of 1998, exceeding any full calendar year percentage since the data have been collected (1989). This article will briefly describe the factors that are driving M&A activity in banking.

Why Are Banks Merging?

Deregulation

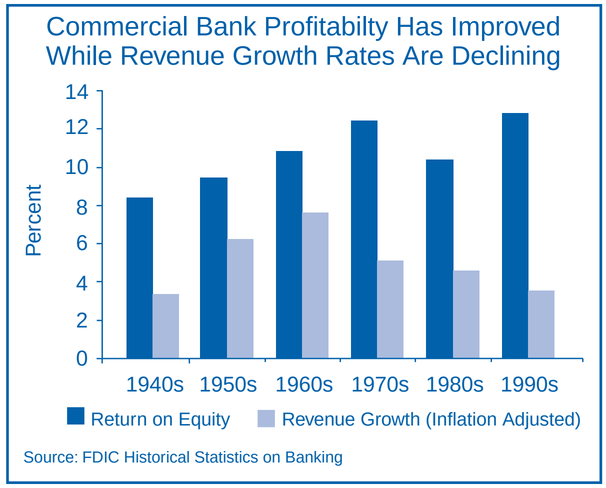
Historically, state regulations and boundaries dictated the structure of commercial banking in the United States. Not until the 1980s did most states remove or substantially relax intrastate branching restrictions. Subsequently, the Riegle-Neal Interstate Banking and Branching Act removed most remaining restrictions to interstate expansion—restrictions that had been significantly liberalized by a 1985 U.S. Supreme Court decision (*Northeast Bancorp* v. *The Board of Governors of the Federal Reserve System*) that upheld the ability of states to reduce restrictions on entry by out-of-state holding companies.[1] As recently as January 1994 only 10 commercial banks owning 30 branches operated across state lines. By early 1998, 165 institutions owned 12,694 interstate branches.[2]

[1] "Interstate Banking—The Past, Present and Future," *FDIC Banking Review,* Fall 1996.

[2] Figures provided by the FDIC's Division of Research and Statistics.

There is some evidence that the recent increase in expansion and branching opportunities arising from deregulation has led to improved efficiencies and profitability, both from M&A activity and from intracompany consolidation of bank subsidiaries by multibank holding companies. In addition, the recent easing of Federal Reserve Board restrictions governing Section 20 securities underwriting subsidiaries of bank holding companies and favorable bank operating subsidiary rule interpretations by the Office of the Comptroller of the Currency have made expansions into new lines of business and mergers across financial sectors more feasible. For example, according to data provided by ***SNL Securities***, since the beginning of 1997, 47 banking companies have purchased investment banking units, investment advisors, or broker-dealers.

CHART 2



Increasing Competition

Significant changes in the competitive environment also have contributed to the trend in bank M&A activity. One way to consider competition in an industry is through the "industry life cycle" framework. In this framework, an industry is generally categorized into one of four stages—start-up, rapid growth, mature, or decline. In each stage, firms are likely to take certain actions in response to the competitive environment. As discussed below, banking best fits the criteria for an industry in the mature stage. These criteria include declining revenue growth, improving profitability, increasing competition, and a shortage of investment opportunities relative to the amount of capital being generated.

As shown in Chart 2, over the long term, commercial banks have experienced the declining trend in revenue growth and the improving trend in profitability that characterize a mature industry. The average annual revenue growth rate by decade, adjusted for inflation, has declined since the 1960s. Profitability, as measured by the average annual return on equity by decade, has steadily improved since the 1940s, with the exception of the crisis period of the 1980s.

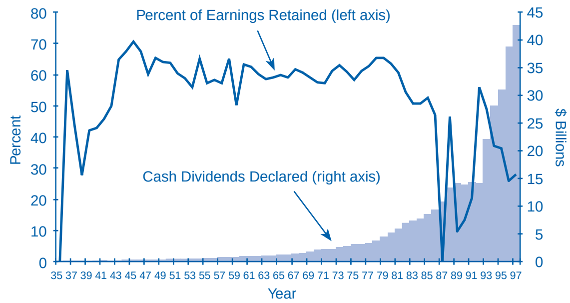
Competition in a mature industry often intensifies as competitors focus on sustaining market share as revenue growth rates slow. In banking, recent changes in the operating environment have stimulated a dramatic increase in competition. Specifically, barriers to entry into the industry have fallen: Capital is plentiful, experienced managerial talent is available (as a result of the many mergers), and regulatory restrictions have been relaxed. Technological and financial innovations also are influencing how banks compete by enabling them to manage disparate operations with broader product arrays more efficiently. Moreover, as a result of intensifying nonbank competition and continuing evolution in distribution systems, some banking services have come to resemble commodities. Consequently, brand loyalty appears to be declining and banks are experiencing reduced influence over pricing.

The final criterion for a mature industry, a shortage of investment opportunities relative to the level of capital being generated ("excess capital"), as discussed below, has become an obstacle for banks. Although generating and retaining capital increase the level of protection from insolvency risk for depositors and the FDIC, rising capital levels without a corresponding increase in profitability reduce returns on equity and, thus, returns to shareholders. Attempts to increase assets relative to equity capital in an industry with excess capital also can be undesirable because competition drives the yield on available investments to levels that either dilute current earnings or fail to compensate adequately for the amount of risk taken. (See ***"Bank Earnings: Competitive Pressures and Risks," Regional Outlook,*** Fourth Quarter 1997.) Alternatives for managing capital in such an environment include dividends, share repurchases, and M&A transactions; banks have pursued all three.

Commercial bank cash dividend payments have reached record levels in the 1990s. In fact, the level of earnings retained over the past two years (26 percent in 1996 and 28 percent in 1997) was the lowest during a noncrisis period since the FDIC's inception (see Chart 3). A large percentage of these dividend payments is made to bank

CHART 3

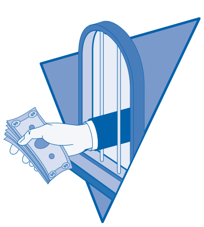
Commercial Banks Are Retaining a Smaller Share of Earnings than during Any Other Profitable Period



Note: Negative 285 percent rate in 1987 shown as zero.
Source: FDIC Historical Statistics on Banking

holding companies, which, in turn, use the funds to repurchase common stock—another means of reducing book capital, increasing financial leverage, and improving return on equity. According to data compiled by ***Keefe, Bruyette & Woods, Inc.***, share repurchases by the top 25 banking organizations increased in each quarter during 1995 and 1996 and reached an all-time high of $11.5 billion in the first quarter of 1997, but have declined steadily since then. There are at least two likely reasons for this trend. First, the continued escalation in share prices through the first half of 1998 made repurchases more expensive. Second, as share prices increase, the "pooling of interests" method of accounting for a merger becomes more attractive; however, it carries certain Securities and Exchange Commission restrictions on share repurchases both before and after the transaction. Therefore, as values rise, institutions considering future mergers are less likely to initiate repurchase programs.

The third capital management alternative, M&A, offers potential benefits to both parties to the transaction. M&A may permit acquirers to deploy excess capital while improving earnings through operating and financial economies, diversification of revenues and geographic exposures, and greater management expertise. M&A also can provide access to new products—a common objective of competitors in mature industries. For institutions acquired through a purchase transaction in which ownership rights are relinquished, mergers provide a means of returning capital to shareholders rather than attempting to remain independent in an increasingly competitive environment.



Market Valuations

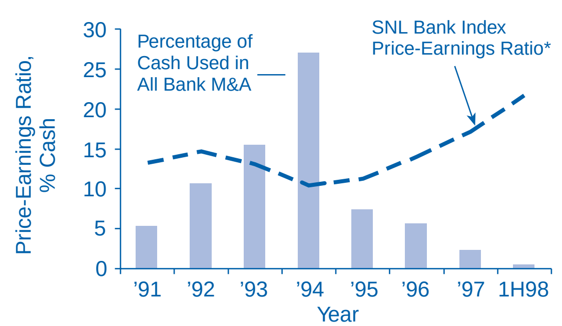
The increased market values commercial banking companies have experienced through the first half of 1998 played a major role in recent M&A activity, as common stock increasingly has been used as "currency" in transactions, especially the largest mergers. More valuable stock allows banks to issue fewer shares to execute mergers, which reduces the potential dilutive effects to shareholders. Through mid-April 1998, the amount of cash used to fund all U.S. business mergers (13.4 percent) had reached the lowest point in ten years.[3] Similarly, the aggregate cash amount of announced bank deal values through the first half of 1998 was less than 1 percent and reflects a steady decline since 1994. There appears to be a strong relationship between bank stock valuations and the level of cash committed in bank M&A activity since 1991 (see Chart 4), although this relationship is obviously influenced by large, stock-based mergers.

Record earnings, positive market assessments of earnings quality and stability, and continued consolidation expectations sparked the upward trend in bank stocks through June 1998. The value of the ***SNL Bank Index***, which is composed of publicly traded banking companies, quadrupled between January 1990 and June 1998 and far outstripped gains in the broader S&P 500 over the same period. The result was a rise in bank stock prices as a multiple of earnings per share (the price-

[3] As reported by the *Wall Street Journal,* April 16, 1998, p. C1.

CHART 4

As Market Valuations Have Increased, Cash Usage in Bank Mergers Has Declined



* Price-Earnings Ratio = stock price of index members to previous 12 months' earnings weighted by market capitalization.
Source: SNL Securities

earnings ratio) both absolutely and relative to the S&P 500. For example, according to the price-earnings ratio for the ***SNL Bank Index***, at year-end 1994, investors paid $9.76 per dollar of bank earnings; on June 30, 1998, investors paid $22.88 per dollar of earnings. Over the same period, the price-earnings ratio of the ***SNL Bank Index*** relative to the S&P 500 increased from 65 percent to 79 percent.

From a corporate finance perspective, firms create wealth for shareholders by generating returns on invested long-term debt and equity capital that exceed their combined cost. Since long-term debt is used less in banking than in other industries, ***Credit Suisse/First Boston*** uses return on equity less the cost of equity capital as a proxy for measuring wealth generation by banks.[4] As shown in Chart 5, over the long term, increases in the price-earnings ratio for banks relative to that for the S&P 500 tends to track with the banking industry's ability to generate returns on equity in excess of the cost of equity capital. Through 1997, high levels of industry profitability, low market interest rates, and market expectations of more stable long-term industry earnings had driven the spread between the return on and cost of equity capital to unprecedented levels.

Following the strong performance through the first half of 1998, the ***SNL Bank Index*** lost 21 percent of its value during the third quarter of 1998 (all during the month of August) because of concerns about corporate earnings, international exposures, the flat yield curve, and the ability of banking companies to expand market-sensitive revenues. Over the same period, the S&P 500 declined only 10 percent. Likely in response to relatively poor stock market conditions, only 75 bank mergers were announced during the third quarter of 1998— a 30 percent decline from the second quarter—with over half announced during July. According to ***SNL Securities***, only 32 bank mergers were announced in August and September 1998, the lowest number for any two-month period since March and April 1997, when 31 mergers were announced. The August 1998 decline in the ***SNL Bank Index*** was the largest monthly decline since a 7 percent drop in March 1997. In addition, the average price-earnings ratio for the index relative to the S&P 500 during third-quarter 1998 was the lowest in eight quarters. Consistent with the aforementioned relationship between bank stock valuations and the level of cash committed to bank M&A activity, the amount of cash committed to mergers in September increased significantly.

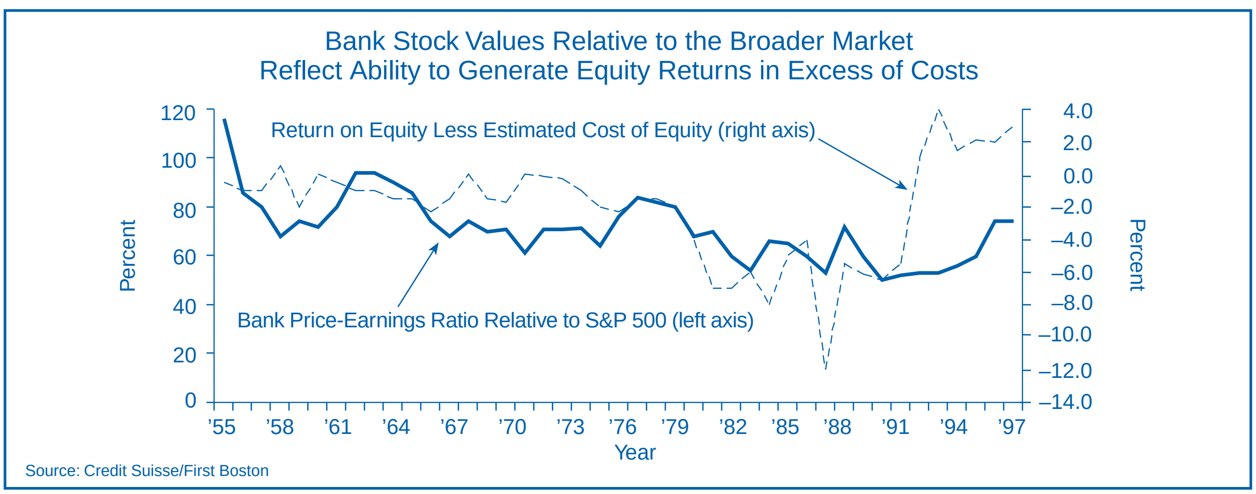
Synergistic Opportunities

A primary motive for M&A activity is to increase the value of the combined company by creating synergies. In other words, through some combination of cost cutting and revenue growth, M&A can produce additional wealth for shareholders of the combined company beyond what the companies operating independently could generate. Although each transaction has unique characteristics, most bank M&A generate additional value from some combination of operating economies, diversification of revenues and geographic exposures, financial economies, and transfer of management expertise.

Operating economies are achieved by eliminating overlapping administrative functions and infrastructure as

[4] "Value-Based Analysis of Banks," Credit Suisse/First Boston, *Equity Research—Americas,* June 4, 1998.

CHART 5

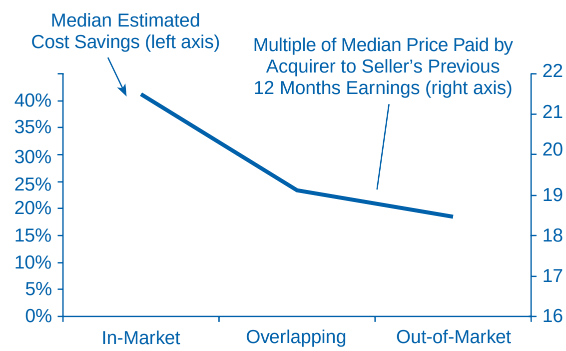


well as by using existing distribution networks to cross-sell products and services to generate revenue gains. However, the degree to which these benefits materialize will depend on the specific characteristics of the merger partners and their markets. For example, a review of 48 banking company mergers from 1995 through the first half of 1998, where the seller held more than $1 billion in assets, revealed estimated cost savings that increased with the degree of market overlap (see Chart 6). Expected cost savings should translate into an increase in a firm's value. This appears to be the case in this sample, as the median price paid by acquirers as a multiple of the target's previous 12 months' earnings increased with the level of expected cost savings. Although perceived cost savings have contributed to bank M&A activity, whether the gains actually materialize hinges on execution, as discussed in ***"Risks and Challenges for Consolidating Institutions"*** in this issue.

Whereas mergers in overlapping markets provide opportunities for cost cutting, value creation from revenue enhancements is more likely to materialize in M&A transactions across markets and industries. Such mergers can be expected to lead to increased diversification of revenues and geographic exposures. These expectations may be driving the recent trend in acquisitions of investment banking units and brokerage houses by banking companies. As traditional interest-spread income has stagnated, many institutions have focused on expanding noninterest sources of revenue. At June 30, 1998, noninterest income made up 40 percent of net operating revenue (net interest income plus noninterest income) for all commercial banks, compared with only 25 percent in 1984. Similarly, geographic expansion can

CHART 6

Estimated Cost Savings and Pricing for Bank Mergers Are Tied to the Degree of Market Overlap



Source: SNL Securities

reduce a firm's dependency on local, undiversified economies. Supporting this notion, a May 1998 working paper by the ***Federal Reserve Bank of Philadelphia*** found that economic benefits are strongest for banks engaged in interstate expansion, especially for mergers that diversify macroeconomic exposures.[5]

As an institution's size increases through M&A activity, financial economies may result from greater access to nondeposit funding alternatives as well as traded and over-the-counter off-balance-sheet financial instruments. As of June 30, 1998, commercial banks with assets less than $1 billion funded approximately 80 percent of assets with domestic deposits, compared with roughly 50 percent for commercial banks with assets greater than $1 billion—reflecting how funding flexibility and accessibility increase with scale. Access to money and capital markets is enhanced for larger institutions through potentially lower transaction costs and increased coverage by securities analysts and rating agencies. For the same reasons, large banks are also the primary users of off-balance-sheet financial derivatives.

Differences in the ability of managers to operate institutions efficiently may also provide impetus for acquisitions. As Federal Reserve Board Chairman Alan Greenspan noted in recent testimony, "there are considerable differences in the cost efficiencies of banks within all bank classes, implying that there is substantial potential for many banks to improve efficiency of their operations, perhaps through mergers."[6] Thus, managers of more efficient banks may acquire less efficient competitors in an attempt to increase the latters' value through improved management. As shown in Chart 7 (next page), the efficiency ratios[7] of bank holding companies improved significantly from 1987 to 1997. However, continued disparities in efficiency among companies, as reflected by the upward slope of the lines in Chart 7, may offer additional opportunities for M&A activity.

Technology and Globalization

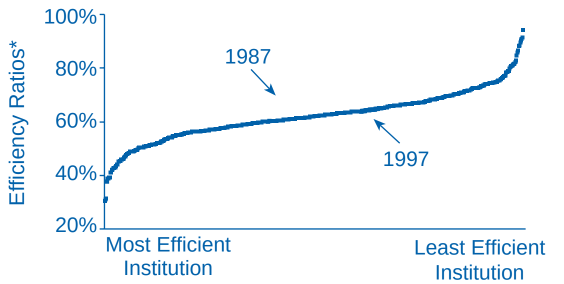
The application of technology to nearly every aspect of banking offers the potential for more streamlined oversight, management, and evaluation of far-flung

[5] *The Dollars and Sense of Bank Consolidation,* Working Paper No. 98-10,The Federal Reserve Bank of Philadelphia.
[6] Testimony before the Committee on the Judiciary, U.S. Senate, June 16, 1998.
[7] The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.

CHART 7

Bank Efficiency Has Improved, but Differences among Institutions May Provide Merger Incentives

Bank Holding Companies Continuously Operating from 1987 to 1997



* The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

Source: Federal Reserve Board Y-9 Reports, adapted from an analysis by McKinsey & Company.

operations both domestically and internationally. Consequently, technology can facilitate merger activity. Moreover, some insured institutions may turn to mergers with compliant partners as a solution to Year 2000 computer problems.

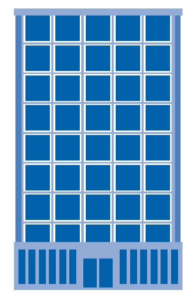
In a June 1997 speech to the Institute for International Economics, Deputy Treasury Secretary Lawrence Summers credited information and communication technologies as a contributing factor to the trillion-dollar-a-day volume of cross-border capital flows.[8] Although the number of insured branches of foreign banks and the number of foreign offices of insured domestic banks have both declined in recent years, increasingly interconnected financial markets, firms, and customers have heightened the potential for competition across borders and continents.

The scale, scope, and structure of many foreign competitors may promote combinations by U.S. institutions looking to enhance competitiveness in the global arena. Approval of proposed large mergers announced in early 1998 will elevate several U.S. banking companies to banking's global elite in terms of assets and market capitalization. Mergers among large European financial institutions in anticipation of the European economic and monetary union may spur U.S. multinational banks to consider strategic mergers across financial sectors.

Management Incentives

Other factors that may drive M&A activity are related to managers' compensation, special reward structures, and job security. Industry observers have noted that executive salaries are highly correlated with company size and revenues. Some analysts have noted that compensation of bank executives rises as assets expand, regardless of the source of the expansion. ***Bear, Stearns & Company*** opined in June 1998 that bank mergers would continue partly because "executive compensation in banking is correlating more with asset size than with any other financial performance measure."

Special reward structures also may influence acquisition programs. Large salary increases and special merger bonuses have been observed recently for executives of large acquiring banking companies. Amassed stock holdings and options may offer significant wealth for managers who decide to sell. Additionally, managers may take actions to lessen the likelihood of takeover and the corresponding probability of job loss. Such defensive managers may undertake acquisitions to avoid having their own banks targeted for purchase.



Summary and Conclusions

By identifying the rationale and incentives for bank M&A activity, regulators and industry participants can better understand and evaluate the risks and challenges facing merged institutions. The recent wave of banking industry M&A activity has been stimulated by a number of factors, including deregulation, increasing competition, market valuations, synergistic opportunities, technology and globalization, and management incentives. Although the pace of M&A activity may slow in the short term due to such factors as a stock market downturn or concern about Year 2000 implementation issues, the presence of multiple drivers will likely extend the consolidation trend well into the future.

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[8] "Promoting Global Financial Stability: The G-7 Agenda," delivered to the Institute for International Economics, June 12, 1997.

Risks and Challenges for Consolidating Institutions

- **Bank merger and acquisition (M&A) activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies.**

- **As premiums paid in M&A transactions have escalated, some industry observers have raised concerns over whether the assumptions concerning potential earnings and strategic benefits can be realized.**

- **Institutions in the process of integrating an acquired entity are likely to be especially vulnerable to a downturn in the economy.**

Merging institutions are under great pressure to execute the combination smoothly and realize its anticipated benefits. On the basis of anticipated earnings improvement and other strategic benefits, M&A deals are often executed at premiums substantially above recent market prices. As a result, financial market participants closely scrutinize post-merger results. Senior management of the merged entities, who typically are instrumental in convincing shareholders to agree to the transaction, are responsible for ensuring that expectations are realized. Entities that have demonstrated a proficiency at executing mergers have been regarded favorably by the capital markets. For some organizations, merging has effectively become a line of business. Alternatively, those that struggle after a merger may experience poor financial performance and could potentially become targets for acquisition themselves.

Execution Risk

The term "execution risk" often is applied to potential obstacles to integrating merging institutions. According to some analysts, execution risks are the primary risk in these combinations. These risks stem from a variety of uncertainties that arise following a merger: Can the new institution combine its management teams, integrate technological systems, realize the benefits of diversification, and maximize operating economies, all without interrupting services? Each of these uncertainties, summarized below, presents significant challenges to bank managers.

Management

Combining the management teams of consolidating companies is a critical first step in the transition process. Lines of reporting and authority must be delineated, and compensation arrangements coordinated and aligned with corporate goals. All of this must be accomplished without alienating critical personnel. The most difficult aspect may involve intangible cultural differences. A recent poll by ***Hewitt Associates***[1] of human resource managers of 218 large U.S. companies identified integrating organizational cultures as the "top challenge" in mergers. While some level of turnover must be expected, losses of key personnel and interruptions in service can result in dissatisfied customers, which in turn can lead to poor financial performance.

Technology

Technological advances often are identified as the single greatest enabler of the wave of bank consolidation; however, smoothly integrating existing systems and maximizing potential benefits of technology can be difficult. A ***Federal Reserve Board***[2] study of nine recent mergers concluded that the most frequent and serious problem merging institutions encountered was unexpected difficulty in integrating data processing systems and operations. The faster systems can be consolidated, the sooner cost savings can be realized; however, disruptions in service or breakdowns in control mechanisms may be less likely with a more measured integration timetable. Rather than attempting to integrate existing, sometimes incompatible systems, many merger partners have chosen to maintain parallel operations while integrating data processing systems over time. Year 2000 compliance efforts add yet another layer of complexity to these endeavors.

Diversification

M&A transactions provide an opportunity to diversify risk exposures, thereby potentially decreasing earnings volatility and moderating the effect of economic down-

[1] "Career Tracks: Personnel Execs: Toughest Job in Mergers Is Blending." *American Banker,* August 10, 1998, p. 6.

[2] "The Efficiency Effects of Bank Mergers: An Overview of Case Studies of Nine Mergers." *Journal of Banking & Finance,* March 1998, vol. 22, no. 3, pp. 273–291.

turns on an institution's performance. However, diversification creates added complexity for bank managers. They may have little practical experience with new product lines or new geographic markets and as a result they may not fully understand the risks involved in these new areas.

Operating Economies

The degree to which anticipated operating economies are realized hinges on management's ability to carry out multiple objectives. To achieve anticipated revenue enhancements, managers of consolidating institutions have attempted to promote a culture of cross-selling new and existing products to a broader customer base in new markets, often through new distribution networks. At the same time, they have sought to reduce expenses by eliminating redundant administrative functions. Underlying these efforts is the need to establish strong internal controls and develop appropriate risk management systems.

Are Expectations Unreasonable?

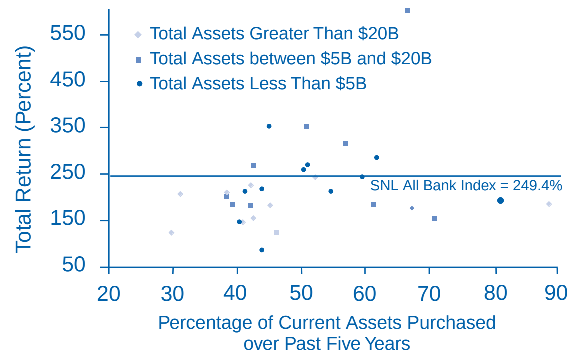
As premiums paid to carry out M&A transactions have escalated, some industry analysts have viewed the assumptions regarding the expected earnings and strategic benefits as aggressive, raising uncertainty as to whether these benefits can be realized. Shares of banking organizations that have been active acquirers have not necessarily outperformed the universe of bank stocks, even before the recent market volatility. According to ***BankINVESTOR***, for the five-year period ending March 31, 1998, most of the returns of the most acquisitive banking organizations across three separate size categories lagged the ***SNL Bank Index*** (Chart 1). This lag may be due to investor concerns about whether and to what extent the anticipated benefits of merger activity will be realized. For example, the assumed benefits related to economies of scale and diversification may be overoptimistic.

Benefits of Scale

Economies of scale associated with greater size and capacity are commonly identified as a potential benefit of consolidation. Large banks make substantial capital investment in areas such as technology and delivery-system infrastructures; spreading these costs across a larger customer base may lead to greater efficiency. However, some observers question whether there is a limit to benefits of scale. Federal Reserve Board Chairman Alan Greenspan testified before the Senate Judiciary Committee in June 1998 that "there are no clear-cut findings that suggest bank mergers uniformly lead to efficiency gains. Returns could be muted by large company inefficiencies, and their customers may face bureaucratic inflexibility." Perhaps the increased complexity of larger institutions combined with their involvement in more nontraditional activities offset the advantages of larger scale.

CHART 1

Many of the Most Acquisitive Banking Companies Have Underperformed the Universe of Bank Stocks
(March 31, 1993–March 31, 1998)



Source: *BankINVESTOR*

Benefits of Diversification

Another common goal of M&A activity is to promote diversification of revenue streams. The relaxation of regulatory restrictions on geographic expansion and permissible activities has made possible new combinations of revenue sources. However, the extent to which combining traditional banking with a broader range of activities will yield a diversified income stream is not yet clear. Industry analysts often point to the declining share of total revenues from net interest income as an example of improved diversification and potentially less volatile earnings. However, others argue that, like margin-related income, fee income from activities such as mutual fund sales, investment management, and brokerage operations is sensitive to both increasing interest rates and deteriorating economic conditions.

Cost of Capital

Failure to meet performance expectations following a merger can lead to negative market assessments of earnings quality and stability. As creditors and investors view an institution's performance less favorably, they require a higher rate of return on capital markets instruments. While cost of capital always has been important for institutions that rely significantly on capital markets as a funding source, changes in the competitive environment have made it a critical issue for all banking organizations. Technological advances and deregulation now permit low-cost competitors to enter previously insulated markets. (See ***"Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale"*** for a discussion of changes in the competitive environment.) Competitors with a lower cost of capital often can provide services at a lower price, or they can accept similar risks in exchange for a lower expected return. Such competition may lead higher-cost competitors to pursue higher-yielding but riskier investment alternatives.

Economic Conditions

The M&A activity of the past few years has occurred in an environment of nearly ideal economic conditions. As a result, many of the new business combinations have yet to be tested by a downturn in the economy. Until these new entities experience a full business (and credit) cycle, the results of the M&A activity cannot be fully assessed.

Regardless of whether the long-term objectives of M&A activity are achievable, institutions that are transitioning to a new structure following a merger are likely to be especially vulnerable to deteriorating economic conditions. The experience of newly chartered institutions during the 1980s banking crisis is an example of deteriorating economic conditions interrupting this transition period. According to the FDIC's recent study, ***History of the Eighties—Lessons for the Future***, more than 16 percent of institutions chartered during the 1980s failed by 1994, compared with just 7.6 percent of preexisting institutions. The study attributed the high failure rate to a combination of "powerful competitive pressures to assume greater risk with relative inexperience in a demanding new environment." The competitive pressures included incentives to "leverage high initial capital positions, increase earnings per share, and meet stockholder expectations." Although recently merged institutions and newly chartered institutions are not identical, today's merger participants face many of the same pressures.

The percentage of institutions that have recently experienced a structural change is higher today than at any other time since the consolidation trend began. Institutions that were chartered or involved in a merger over the past three years represent nearly 13 percent of all commercial banks and 65 percent of commercial bank assets. (See ***"Industry Consolidation Presents Unique Risks and Challenges for Community Banks"*** for a discussion of the trend in newly chartered institutions.) As shown in Chart 2, these percentages have increased substantially in recent years. Much of the consolidation activity is occurring between institutions that have been part of the same holding company for extended periods; however, even these transactions present integration challenges that would be complicated by an economic downturn.

Summary and Conclusions

While substantial benefits may be derived from bank M&A activity, mergers impose heavy demands on bank managers and present potential risks to banking organizations, bank investors, and the insurance funds. Bank managers face significant challenges associated with executing the merger, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. Additionally, uncertainty remains as to whether merger-related expectations can be fully realized. Finally, the process of integrating two institutions is complex and time-consuming. Should this process be interrupted by an economic downturn, these institutions may be especially vulnerable.

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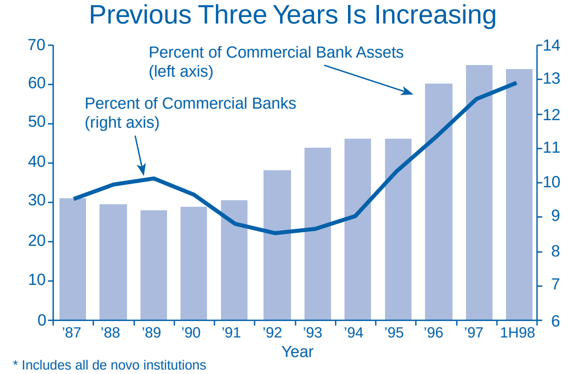
CHART 2

The Share of Institutions That Were Newly Chartered* or Involved in a Merger within the Previous Three Years Is Increasing



* Includes all de novo institutions
Source: Bank Call Reports

Industry Consolidation Presents Unique Risks and Challenges for Community Banks

- **Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope.**

- **Some small banks that are not merging with or selling to competitors are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets.**

- **While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.**

Historically, commercial banking has been characterized by a large number of small institutions operating at the community level. Although the number of small, or community, banks (defined as those with total assets of $500 million or less) has declined significantly since consolidation began in the 1980s, they continue to dominate the industry's demographics. At June 30, 1998, 92 percent (8,306) of FDIC-insured commercial banks held assets of $500 million or less. Approximately 73 percent of these banks had no holding company or were subsidiaries of one-bank holding companies, and more than one-third operated only one office. The June 30, 1997, ***Summary of Deposits*** data present more evidence of the extent of community banking. On that date, two-thirds of all commercial banks operated offices exclusively within a one-county area.

In terms of demographics, the structure of commercial banking continues to reflect the time when state and interstate banking and branching restrictions tended to limit rivalry in many local markets. However, recent changes in the structure, regulation, and operating environment of the financial services sector have affected commercial banks, especially smaller community banks. Specifically, industry consolidation has created new challenges for small banks arising from heightened competition and accentuates traditional small bank obstacles related to size and scope of operations.

Competitive Pressures

In addition to intensifying competitive pressures from nonbanks, industry consolidation has heightened competition among commercial banks. According to the ***Federal Reserve Board's Flow of Funds*** data, for the seven-year period ending on March 31, 1998, commercial banks' share of total financial assets in the U.S. economy declined nearly 6 percentage points to just over 20 percent. At the same time that banks are capturing a smaller slice of the financial services pie, mergers, acquisitions, and consolidation have set the stage for increased competition within the industry. Larger banks operating across state lines and in multiple markets via branches, mailings, or technology now vie for community bank customers. Moreover, the rebound in new bank charters over the past four years, an outgrowth of the consolidation trend, has increased the number of small bank competitors in many markets. The inaugural ***ABA Community Bank Competitiveness Survey***[1] in 1997 reported that small bankers considered other community banks their chief competitors for deposit gathering and all types of lending, and considered large banks formidable competitors in commercial and consumer lending and deposit gathering. While competition among small banks in common markets has existed for some time, the emergence of larger institutions as challengers results largely from many of the merger motivators and drivers discussed in ***"Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale"*** in this issue.

New Chartering Activity

A secondary effect of industry consolidation, and a potential source of increased competition for preexisting community banks, is the recent trend in new bank charters. From June 1994 to June 1998, more than 500 commercial banks were established in 48 states. Although rebounding, the annual level of new chartering activity remains well below the peaks of the previous three decades. Industry observers attribute the recent increase in new charters to many factors, including the availability of displaced banking talent, strong economic growth, potential niche opportunities in mar-

[1] As presented in the *ABA Banking Journal,* April 1997, p. 55.

ket segments underserved by larger banks, and the loss of local decision making and perceived service gaps as local banks are acquired by larger banks or are consolidated into far-flung multibank companies.

New bank activity is not concentrated in one region of the country. However, at the state level there appears to be a relationship between new chartering activity and the number of institutions sold or consolidated in merger and acquisition transactions (see Chart 1). Forty percent of all banks sold or consolidated and 27 percent of new charters from June 1994 to June 1998 were in Texas, California, Florida, Illinois, and Georgia.

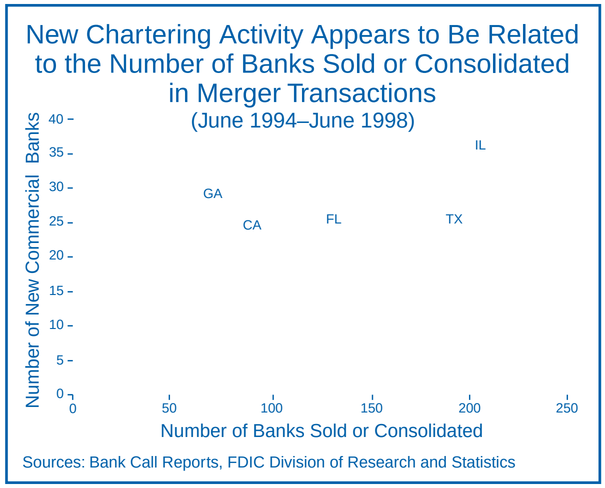
As shown in Map 1, ten states currently host a high percentage of recently established community banks. Many of these states have experienced strong economic growth during this expansion and have a large number of banking offices owned by out-of-state institutions. These concentrations are especially noteworthy since newly chartered institutions often pursue aggressive growth to improve profitability, which may influence pricing and terms for competitors within their markets. Reflecting the recent surge in new banks, 57 percent of the 402 unprofitable commercial banks through the first half of 1998 had been in business less than four years, up from 17 percent at year-end 1994 (see Chart 2). As would be expected, the ten states highlighted in Map 1 rank among the top in terms of the percentage of small banks that were unprofitable during the first half of 1998.

Challenges of Scale and Scope

A by-product of industry consolidation is the emergence of larger institutions. By definition, community banks operate with relatively less scale than their regional, super-regional, and money-center counterparts. As a result, small banks have limited ability to spread the costs of new investments or operating expenses across a broad asset base. This characteristic has traditionally forced community banks to spend more to generate each dollar of revenue than the rest of the industry, as measured by efficiency ratios.[2] The inability of many community banks to fund large expenditures, such as investments in technology, alternative delivery systems, or new business lines, may cause

[2] The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.

CHART 1



MAP 1

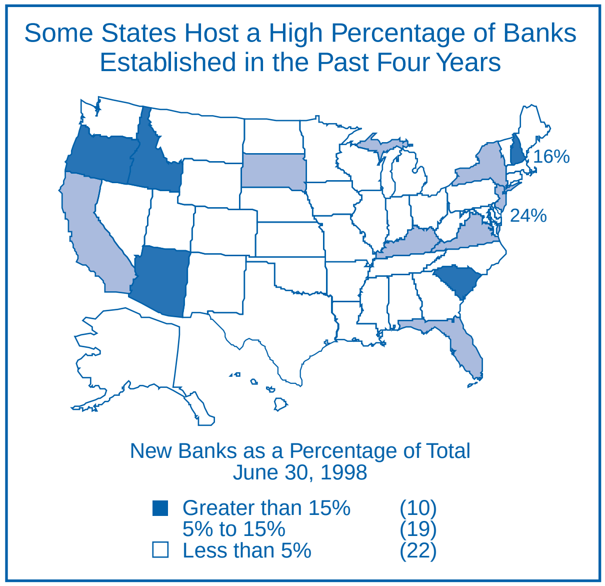


CHART 2

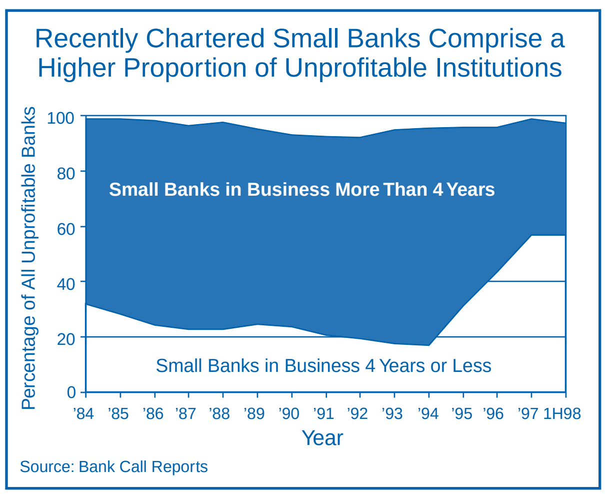
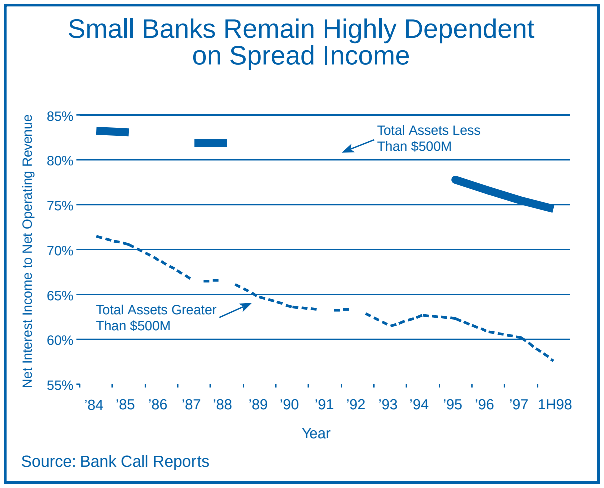


CHART 3



long-term competitive disadvantages. For example, ***The Tower Group*** estimates that 70 percent of 1997 information technology (IT) spending by banks was by the top 15 institutions.[3] Smaller institutions competing with larger banks that are investing in technology to improve operational efficiency, increase customer convenience, or to better identify customer profitability, pricing strategies, or cross-selling opportunities may find a diminished presence in the marketplace. Consequently, small banks may face increasing competition for customers who are attracted to sophisticated pricing, wider product arrays, and multiple delivery channels offered by competitors.

Closely related to scale is the issue of scope of operations, both business line and geographic. Community banks' scale may limit their ability to expand into new business lines or activities, thereby reducing the degree of revenue diversification and resulting in dependence on spread income. Since many noninterest sources of revenue require scale to economically justify investment, small banks tend to derive a greater percentage of net operating revenue from spread income, as shown in Chart 3. Also, the limited geographic scope of many community banks may result in less loan portfolio diversification and greater exposures to local economic downturns. From a portfolio management perspective, lenders with more diverse loan portfolios that can spread risks over a broader customer and economic base may gain pricing advantages over less diversified competitors.

[3] "How Much Do US Banks Spend On Information Technology?," The Tower Group Research Notes, www.towergroup.com.

How Are Community Banks Addressing Consolidation Challenges?

In response to competitive pressures arising from industry consolidation, community banks, new and old, appear to be adapting to meet strategic challenges to their long-term viability. Indeed, this summer, Federal Reserve Board Chairman Alan Greenspan told the Charlotte, North Carolina, Chamber of Commerce that "well-managed smaller banks have little to fear from technology, deregulation, or consolidation." Recent surveys and anecdotes reveal that small banks that are not selling to or merging with competitors are adjusting business practices to cope with the aforementioned pressures and challenges. Their strategies include outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, emphasizing personalized service, and developing niches or specialties. However, as described below, while these approaches may help small banks meet the challenges of consolidation, they potentially complicate the operations and risk profiles of these institutions.

Outsourcing

A recent survey by ***Electronic Data Systems Corporation*** and ***Bank Earnings International LLP***[4] found that community bankers are more concerned with controlling operating expenses than any other issue. This finding is not surprising given the cost savings expected from many recent mergers. The study also revealed that banks view IT as the most valuable tool for improving day-to-day performance—from controlling expenses to increasing fee income. Yet, according to ***The Tower Group***, IT budgets as a percentage of total noninterest expenses for small banks are typically half of those for larger banks.[5] As a result, some small banks are turning to outside parties to maximize the utility of expenditures, IT and others.

American Banker recently reported on a trend among small banks to outsource the origination of consumer loans. ***The Tower Group*** noted that third parties handled 2.7 million noncard, nonmortgage loan applications (mostly from small institutions) in 1997, and annual outsourced volume growth is projected to average 40 percent through 2002.[6] Vendor networks designed to

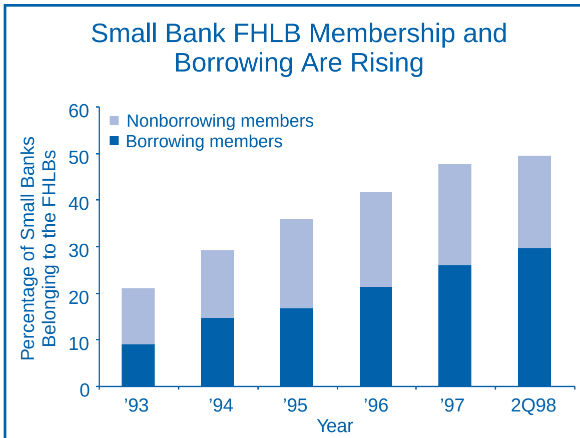
[4] *American Banker,* July 22, 1998, p. 16.
[5] *Computerworld,* May 25, 1998, p. 20.
[6] "More Banks Handing Off Nitty-Gritty of Consumer Lending," *American Banker,* June 12, 1998, p. 1.

enable small banks to reduce hardware and personnel needs also have emerged and allow for more cost-efficient processing and cheaper access to customer information. Many small banks planning Internet-based or home banking also are turning to outside experts. Outsourcing certain business functions may allow for greater focus on profitable business lines, less risky access to state-of-the-art technology, cost savings, and more options for customers. However, these arrangements are not without risk. Indeed, FDIC-insured institutions have experienced difficulties in the past with indirect consumer lending, such as auto lending. Moreover, banks that outsource business functions may have less control over those functions and may become over-reliant on third-party providers.

Nondeposit Funding Sources

As noted above, increasing competition for deposits has left some small banks searching for alternative funding sources to meet loan demand. On average each year from 1993 to 1997, 64 percent of small commercial banks experienced loan growth in excess of deposit growth. Similarly, six in ten banks responding to the ***1998 ABA Community Bank Competitiveness Survey***[7] reported that deposit levels were not keeping pace with loan demand. In response, small banks are increasingly turning to nondeposit funding sources. From 1993 through the second quarter of 1998, the percentage of small banks using borrowings of any type increased from 48 to 56 percent. Over the same period, the percentage of small banks funding with borrowings other than overnight funds (Federal funds and repurchase agreements) increased from 20 percent to 35 percent, and the percentage reporting brokered deposits rose from 7 percent to 12 percent.

CHART 4



Sources: Bank Call Reports, Federal Housing Finance Board

The rising number of commercial banks joining the Federal Home Loan Bank (FHLB) System in recent years, as reflected in Chart 4, is likely a symptom of the aforementioned funding trend. At June 30, 1998, nearly half of all small banks were FHLB members, compared with 21 percent at year-end 1993. On the same date, 90 percent of FHLB commercial bank members and 87 percent of FHLB commercial bank borrowers were small banks. In addition to providing a backup source of liquidity, the FHLB is essentially acting as an intermediary to the capital markets for banks with limited access. The relatively limited nondeposit funding options available to many small banks may explain their increasing reliance on FHLB advances. At June 30, 1998, approximately 80 percent of small banks' nonovernight borrowings were FHLB advances.

The increasing liquidity of loan portfolios is becoming another funding alternative. Many small banks have used participation arrangements to sell off portions of loans to correspondent banks or have turned to Fannie Mae or Freddie Mac to sell mortgages. The securitization of other loan types also may become increasingly appealing as funding shortages persist and market opportunities for small banks increase. For example, in July 1998, ***American Banker*** highlighted the creation of a new commercial mortgage conduit established specifically to buy loans originated by community banks.[8] The secondary market for the guaranteed portion of Small Business Administration loans also has been cited as a potential source of liquidity.

Although identifying and expanding the use of nondeposit funds may increase the flexibility of small banks, their use complicates asset-liability management. While net interest margins for small banks have yet to reveal significant compression, recent evidence suggests future declines. For example, a recent survey conducted by the ***Federal Reserve Bank of Minneapolis*** found that 57 percent of small bankers in the upper Midwest expect a shift away from deposit funding to decrease profitability.[9]

[7] *ABA Banking Journal,* February 1998, p. 47.

[8] "Commercial Real Estate: New Conduit Plans to Help Small Banks Enter," *American Banker,* July 21, 1998, p. 29.

[9] "Location Influences Community Bank Challenges," Fedgazzette, Federal Reserve Bank of Minneapolis, July 1998, p. 2.

Partnering

In an effort to expand revenue sources and attract and retain customers, smaller banks are expanding their spectrum of products and services through partnerships with other entities. The ***1998 ABA Community Bank Competitiveness Survey*** found that 10 percent of community banks partnered with other banks in 1997, while nearly twice as many have teamed up with nonbanks. Over two-thirds of the survey's respondents considered their partnering approach profitable. The leading types of arrangements with other banks include loan participations, title insurance, data processing, credit card programs, and mortgage lending. Nonbank partnering has been used to expand offerings to customers such as brokerage, insurance, and travel agency services. However, like outsourcing, partnering could result in less control and overreliance on third parties.

Service Orientation

Small banks have long touted personalized service and local decision making as a competitive advantage. Influenced by the recent wave of merger and acquisition activity in the industry, community bankers cited service as an area with great opportunity in the ***1998 ABA Community Bank Competitiveness Survey***. Indeed, many community bankers have publicly welcomed consolidation as a chance to establish new relationships and attract customers affected by integration problems and personnel shifting at larger acquiring or merging banks.

Establishing prudent relationships with smaller, underserved customers may present opportunities and profits for small banks. This may be especially true for small business customers, which may not fit more standardized lending models of larger banks yet remain acceptable credit risks. According to the Federal Reserve Board's second-quarter 1998 ***Survey of Terms of Business Lending***, rates on small commercial and industrial loans earn the greatest spread of any size business loans. Further, a recent survey by ***PSI Global*** of small business owners in south Florida, which has seen a great deal of merger and acquisition activity in recent years, found that nearly one-quarter of respondents would move their business if their bank was purchased, exemplifying the extent to which small banks may be able to use service to capitalize on consolidation activity.[10]

Developing Niches or Specialties

Anecdotal evidence suggests that some small banks are specializing in narrow markets and niches. Some analysts and consultants have emphasized that community banks should not try to be what they are not, but should instead focus on a particular market segment or niche. By default, many small banks depend on their customers' local businesses and, through local expertise, may be better at serving specific industries than their larger competitors. However, a narrow focus may reduce portfolio diversification and could lead to greater exposures during an economic downturn.

Summary and Conclusions

Small banks are facing heightened competitive pressures from larger, merged institutions and from new banks. Their ability to respond to these pressures is restricted by traditional scale and scope limitations. Community banks are addressing these challenges by outsourcing business functions, utilizing nondeposit funding sources, partnering with other banks and nonbanks to diversify revenues and widen customer options, capitalizing on personalized service, and developing niches or specialties. While these strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.

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[10] *South Florida Business Journal,* May 22, 1998, p. 6.

Regional Perspectives

- **Economic growth in the Atlanta Region continues to outperform that of the nation, but a number of factors, including the impact of the Asian crisis, have combined to slow growth.**

- **Insured institutions are benefiting from the Atlanta Region's continued economic success, reporting strong earnings, solid asset quality, and high capital levels. The Region's commercial banks reported an aggregate return on assets of 1.22 percent in the second quarter.**

- **The Greenville, South Carolina, metropolitan area reflects the emergence of the "New South" or "New Economy," where growth is shifting from older industries, such as textiles and apparel, to high-tech and information-driven industries. The "New Economy" may offset the secular decline in older industries but may introduce new risks related to the altered relationship between the metropolitan area and the domestic and global economies.**

- **Greenville's insured institution landscape has changed over the past several years, reflecting the area's growth. A hallmark of this change has been an increase in de novo activity.**

Region's Economic and Banking Conditions

The Atlanta Region's economy continues to outperform that of the nation. Employment growth for the Region stood at 3.1 percent in the second quarter. Although still nearly one-half a percentage point above the national average, growth was slightly lower than in the fourth quarter of 1997 and the first quarter of 1998. Insured institutions are benefiting from the Region's economic success, reporting strong earnings, solid asset quality, and high capital levels. Atlanta Region commercial banks reported an aggregate return on assets (ROA) of 1.22 percent in the second quarter, down slightly from the same period in 1997 but in line with the national average. Returns were strong across asset sizes, although large banks generally outperformed smaller banks (see Chart 1, next page). Thrifts also reported a lower ROA than a year ago, at 0.76 percent. However, if restructuring losses at the Region's largest thrift and sizable losses at an upstart Internet-based thrift are excluded, the adjusted return of 1.01 percent was only slightly below the national thrift average for the quarter. A flattening of the yield curve and increasing competition continue to erode bank and thrift net interest margins, but large banks have, for the most part, been able to offset margin compression by expanding non-interest (fee-generating) business lines.

Despite its strong overall economy, weakening international markets are beginning to affect many of the Region's prominent industries. Falling demand from global markets, industry consolidation, and vulnerability to cyclical fluctuations have accelerated the secular decline in the textile and apparel industries. Likewise, pulp and paper manufacturers in the Region have felt the strain of increased global competition, while the steel industry has suffered as the Asian economic crisis has increased imports and decreased exports. The Region's agricultural producers are being affected by a number of circumstances, including increasing global production, trade pressures, falling commodity prices, and devastating weather-related crop losses, all at a time when federal subsidy programs are being phased out. Reduced income and employment in any of these industries could affect the Region's insured institutions, particularly in the less economically diverse rural areas.

South Carolina's job growth continued to rise in the second quarter of 1998, eclipsing **Florida's** gains by a full percentage point. South Carolina's strong performance is partially attributable to its success in attracting tourism. Tourism-related industries, particularly in coastal areas such as **Charleston, Myrtle Beach,** and **Hilton Head,** grew by 9.4 percent in 1997, and even stronger gains are expected in 1998, according to Mark Vitner, an economist at ***First Union***. Likewise, construction employment has been strong in the state, rising 7 percent in the past year. Single-family construction is at record levels, and the pace of commercial construction has picked up as well. Nearly $5.5 billion in new industrial capital investments announced in 1997 are just beginning to be built out. The performance of South

CHART 1

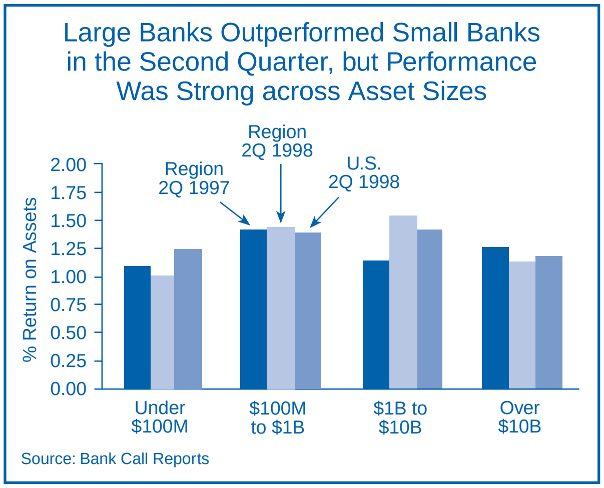
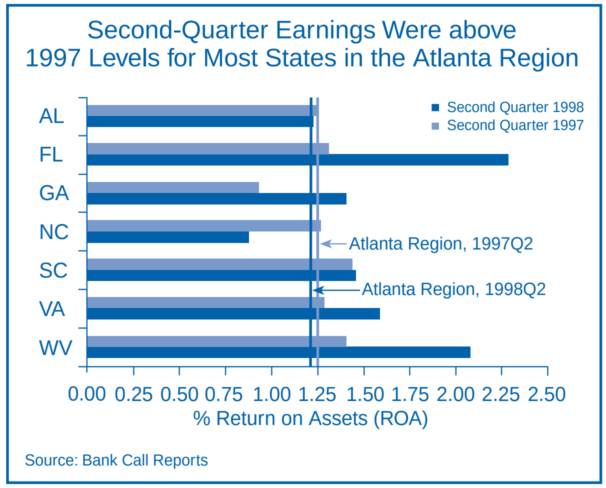


CHART 2



Carolina's insured institutions reflects the state's thriving economy, as banks and thrifts reported second-quarter ROAs of 1.46 percent and 1.15 percent, respectively, both exceeding the Regional and national averages (see Chart 2). South Carolina institutions, as a group, are very well capitalized, and asset quality remains solid. However, growth in metropolitan areas such as **Greenville** (discussed below) and **Columbia** has been accompanied by a rise in commercial and industrial (C&I) lending exposure, and although current risks are low, such credits could be affected negatively by an economic slowdown. Institutions in agricultural areas could see some near-term economic slowing and possible credit quality deterioration as farm incomes decline as a result of the summer drought.

Florida's economy continues to outpace that of the nation, with job growth of 3.7 percent in the second quarter of 1998. The state's economy continues to grow despite the year's floods, tornadoes, drought, and wildfires. A drop in summer tourism as a result of wildfires dealt a temporary economic blow to the state, but that industry is expected to rebound quickly. Pulp and paper are less likely to recover in the short term, because premature harvesting in response to drought and wildfires has increased the market supply of timber and pushed prices lower. Asian economic turmoil has taken an additional toll on the pulp and paper industry in the form of an increased supply of cheap imports and reduced export demand.

Despite recent setbacks in tourism and pulp and paper, Florida's banks performed reasonably well in the second quarter. The aggregate ROA of 2.29 percent was inflated by merger accounting at the state's largest bank, however. Small banks posted the lowest returns (0.78 percent), as overhead costs continued to weigh on that group. Falling net interest margins hurt both large and small institutions during the quarter. Thrifts, despite reducing overhead considerably since the second quarter of 1997, posted their lowest ROA in five quarters at 0.86 percent. A steady quarterly decline in the net interest margin has contributed greatly to the lower thrift returns. Competitive pressures are likely to intensify for Florida institutions in the future as more large out-of-state banks aggressively enter this attractive and growing market. Also, insured institutions in areas where economic growth and development activity have been the strongest, such as **Miami** and **Orlando,** have seen higher rates of growth in commercial lending. Although credit quality is not currently a concern, these products would react negatively to a slowdown in the state's tourism industry (Orlando) or to further weakening in the Latin American markets (Miami).

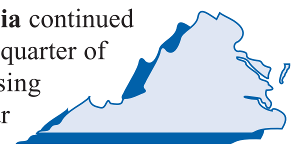
Georgia's economy remains strong: Year-over-year job growth of 3.5 percent in the second quarter of 1998 continued to outpace that of the nation. However, a number of factors may be coalescing to weaken the state's performance. Tight labor markets may slow the **Atlanta** metropolitan area's economic expansion as employers find it increasingly difficult to locate qualified workers. In addition, the Asian crisis continues to affect Georgia's apparel and paper industries. The state's apparel employment has declined by 15 percent in the past year and by 50 percent over the past three years. Pulp and paper producers are finding it difficult to compete as Asian countries dump excess capacity on the market at discounted prices. Stone Container Corporation, the state's latest casualty of the Asian crisis, announced in

September that it would lay off 400 employees because of weakness in international markets.

Georgia's banks have not yet shown any significant negative effects from the current situation; rather, they reported second-quarter earnings sharply higher than those of a year ago, with an ROA of 1.41 percent. Thrifts, constrained by high overhead expenses, underperformed their peers in the Region and nation in the quarter, despite posting their highest return in four quarters. However, when the losses of one Internet-based institution are excluded, Georgia's aggregate thrift ROA rises from a dismal 0.45 percent to a solid 1.06 percent. Current measures reflect strong asset quality among Georgia's banks and thrifts, but risks may be increasing at institutions in metropolitan areas—specifically Atlanta—that report construction and development (C&D) loan exposures well above levels in the Region and nation. Although capital and reserves also have increased in metro Atlanta, it is important to note that institutions with similar credit concentrations have struggled in past economic downturns. Meanwhile, concentrations of agricultural credit could pose a risk to institutions in south Georgia, particularly around the **Albany** area, whose sizable agricultural sector was devastated by heavy spring rains and the summer drought. Albany's job growth already has stalled, pushing the metro area's unemployment rate to a four-year high of 9 percent in August 1998.

Alabama's economic expansion continued in the second quarter of 1998, albeit at its slowest pace since the end of 1991, with employment levels up 1 percent from a year earlier. Weaknesses in the state's economy are mostly concentrated in the manufacturing and mining sectors. Within manufacturing, older industries such as pulp and paper, textiles and apparel, and metals have continued to see losses, particularly as overseas competition has intensified and the U.S. dollar has remained strong. Losses in these sectors have been partially offset, however, by growth in newer industries such as automobile manufacturing. Growth in other sectors also has helped keep the economy going.

Despite transitions in Alabama's economy, the state's banking sector has maintained very stable performance in recent years. In fact, banks' aggregate ROA has remained within a 14-basis-point range over the past 12 quarters. The second-quarter 1998 ROA of 1.23 percent was in line with averages in the Region and nation, and performance was comparable across asset sizes, with the largest and smallest peer group returns varying by only 5 basis points. Thrifts, aided by securities gains and lower reserve provisions, reported higher earnings than a year ago (0.86 percent ROA), although they were below the national average. Alabama was the only state in the Atlanta Region to show an increase in past-due loans at both banks and thrifts during the past year, which may reflect the continuing declines in some of the state's larger industries, including textiles and apparel and pulp and paper. Moreover, some rural Alabama institutions report high and increasing levels of C&I loan exposure, despite the ongoing deterioration in these dominant industries. This trend may indicate that exposure to the troubled industries is growing or that out-of-market lending activity is rising, either of which could have credit risk implications. Additional challenges may face rural institutions in the state's southeast corner, where spring flooding and a summer drought substantially affected crop production.



Economic growth in **Virginia** continued at high levels in the second quarter of 1998, with employment rising nearly 3 percent from a year earlier. Gains have been concentrated mostly along the "Golden Crescent," which arcs from northern Virginia through **Richmond** and over to **Norfolk.** In this area, strong population growth, high-tech manufacturing, business services, software engineering, and construction activity have fueled economic expansion. The area is not immune to global forces, however: Richmond recently suffered a setback with Motorola's indefinite postponement of construction of a large semiconductor manufacturing facility. Outside the arc, gains have been less robust, as losses in textiles and apparel continue to constrain growth in many rural areas.

A strong economy has benefited Virginia's banking sector, which posted a second-quarter ROA of 1.59 percent, above the averages for the Region and nation and well above the banking sector's average for the same period in 1997. Performance was solid across asset sizes, in part thanks to the state's overall favorable economic environment. Virginia's thrift performance also improved from a year ago and compares favorably with those of the Region and nation when the losses of one large institution are excluded. Asset quality remains strong, but repayment capacities may become strained for institutions in agricultural areas as a result of the summer drought and, more recently, Hurricane Bonnie. Some counties have estimated storm damage of up to 60 percent of tobacco, 55 percent of corn, and 25 percent of cotton and soybean crops. Meanwhile, strong growth and development in metropolitan areas such as Norfolk and northern Virginia are not yet being reflected in higher C&D loan exposures. Declining office vacancy rates are fueling higher levels of construction in northern Virginia.

North Carolina's economic expansion continued in the second quarter of 1998, but the pace of growth may be slowing. During the quarter, the state's workforce grew 2.5 percent from a year earlier, marking the first time that the state's job growth had fallen below the national average growth rate since 1991. As in other areas of the Atlanta Region, some of the weakness in the economy can be traced to job losses in manufacturing, particularly textiles and apparel. Growth in the retail sector has been tepid as well. Steel is another of the state's industries that faces emerging risks from abroad. Nucor Corporation, for example, pressured by an increasing supply of cheap foreign imports, recently cut steel prices by $20, to $270/ton. (Steel was selling for $350/ton a year ago.) Finally, as in most states in the Region, a summer drought and a general decline in commodity prices have adversely affected North Carolina's agricultural producers.

One sector of North Carolina's economy that continues to show strong growth is financial services. The state is clearly the banking center of the Atlanta Region, claiming 55 percent of the Region's bank and thrift assets in the second quarter of 1998. A drop in ROA from the year-ago second quarter, from 1.27 percent to 0.88 percent, can be explained largely by two factors. First, acquisition-related charges reduced the earnings of one bank that accounts for 38 percent of the state's total banking assets. Second, small banks (under $100 million) reported a negative aggregate return primarily because most banks in that group were chartered within the past three years and have not yet reached sustainable profitability. Although erratic or even negative earnings are not unusual for new institutions, history has shown that an economic slowdown can disrupt the growth and earnings patterns of young institutions, particularly if larger, more established banks compete aggressively on product pricing to garner or protect market share. North Carolina's relatively large thrift sector performed reasonably well in the quarter, although margin compression and a slight rise in overhead spending held returns below the year-ago level at 0.95 percent. While current reported asset quality is strong at North Carolina's banks and thrifts, the growing pressures on industries mentioned above could affect credit quality at institutions actively serving these industries or related borrowers.

West Virginia's economic performance remains erratic, with year-over-year job growth fluctuating between 1 and 2 percent over the past three years. Nonetheless, continued job growth and a rise in out-migration helped push the state's jobless rate down to 4.4 percent in the second quarter in 1998 — the lowest level since early 1970. Despite its recent gains, West Virginia's economy is not immune to global developments. For example, some areas of the state are highly dependent on steel production, and steel scrap prices have fallen more than 10 percent in the past year. Also, coal-producing counties could face increasing pressure, as slumping Asian demand and strong oil production from exporting countries have steadily depressed energy prices.

West Virginia's banks have enjoyed the state's gradual economic expansion, reporting strong and stable profitability over the past several quarters; however, the second-quarter ROA of 2.08 percent was inflated by nontraditional operations at one institution and nonrecurring items at another. Small banks reported lower second-quarter returns than a year ago, largely because of net interest margin compression, while large banks were able to offset margin declines with higher noninterest income. Asset quality has improved from a year ago, but delinquency and charge-off rates still exceed those for the Region as a whole. Thrifts, like banks, have been hurt by falling net interest margins, which contributed to a 21-basis-point drop in ROA (to 0.72 percent) from the second quarter of 1997. Thrifts' reported capital remains high, however, and despite a slight rise in charge-offs in the second quarter, reported asset quality is generally solid.

Structural Transformation in the New South

Greenville-Spartanburg-Anderson Metropolitan Area May Face New and Old Risks in the Future

In many ways, the **Greenville-Spartanburg-Anderson, South Carolina,** metropolitan statistical area (Greenville MSA) embodies what some describe as the "New South" or the "New Economy," where an influx of high-tech and information-driven industries is replacing a shrinking manufacturing base. Gains in new industries have resulted in higher levels of economic diversification, tighter labor markets, and steady population growth. One drawback, however, is that the local economy could become more susceptible to national or international shocks. Furthermore, although economic changes are occurring, the continued strong presence of textiles and apparel still poses a significant risk to the Greenville metropolitan economy. The New Economy may offset the secular decline in these industries but may introduce new risks related to the altered relationship between the metropolitan area and the domestic and global economies.

The Greenville economy has undergone a significant structural transformation over the past several years. This process accelerated during the 1990s, as investment in new industries, particularly automobile manufacturing, occurred and losses in the critical textiles and apparel industries increased. Not only is the industrial mix changing, the economy is moving away from dependence on manufacturing toward services and retailing. These shifts will change how the metropolitan area is affected by future economic downturns.

Greenville's insured institution landscape also has changed over the past several years, reflecting the area's growth. For example, from 1985 through the first half of 1998, the Greenville MSA lost seven insured institutions to consolidation but gained ten new charters, resulting in a net addition of three institutions. Although some new charters (mostly in the 1980s) resulted from corporate reorganizations rather than new market entrants, six de novo institutions were chartered in the 1990s. In fact, nearly one in four institutions headquartered within the Greenville MSA has opened since 1990. An increase in de novo activity is consistent with steady economic expansion.

Greenville's Historical Development Based Primarily on Textiles and Apparel

Historically, the manufacturing sector, particularly textiles and apparels, has dictated Greenville's economic performance. In 1970, nearly one in four jobs in the metropolitan area was in these industries. Their presence had shrunk somewhat by 1980 but still accounted for almost 20 percent of total employment. Manufacturing as a whole accounted for 37 percent of all jobs in 1980—rubber, plastics, and industrial and commercial machinery production had a significant presence as well. Nationally that year, approximately 22 percent of jobs were in manufacturing. An economy that relies heavily on manufacturing, especially a single industry, is often highly cyclical. In the past four recessions (1973–1975, 1980, 1981–1982, and 1990–1991), employment losses were felt more acutely in the Greenville metropolitan area than at the national level on a monthly year-over-year percentage basis.

Aggregated bank data were unavailable before 1984, but, as Table 1 (next page) suggests, Greenville's insured institutions performed reasonably well during the mid- to late 1980s despite the ongoing decline in textiles and apparel that was occurring during that time. Institutions in the MSA, as a group, maintained reasonably strong profitability, increased capital ratios, and reported very low levels of past-due and charged-off loans. Asset quality did weaken somewhat during the recessionary period of 1991; however, profitability and capitalization measures continued to strengthen. The ability of Greenville's insured institutions to perform well during the recession left them in a favorable position to benefit from the economic expansion that followed.

Gains in the 1990s Driven by New Industries

In the 1990s, growing overseas competition and rising levels of automation contributed to faster erosion in the textiles and apparel industries in the Greenville MSA, as well as the entire Region (see ***Atlanta Regional Outlook,*** second quarter 1998, for a discussion of the textiles and apparel industries). International trade agreements have contributed to some of the losses as well. While the 1980s saw steady or slightly rising job levels in textiles and apparel in the Greenville metro area, these industries have lost more than 13,000 workers in the past eight years.

Despite those losses, economic growth in the Greenville MSA has remained comparable to the national average throughout the 1990s. Much of the growth resulted from aggressive state and local government efforts to lure relocating industries by offering tax incentives and promoting the area's low wage rates, low levels of unionization, and low land costs, as well as its location along Interstate 85 between Atlanta and **Charlotte**. These efforts attracted billions of dollars of investment to South Carolina's economy, much of it in the Greenville MSA. Perhaps the zenith of the recruitment effort was BMW's decision to build its Z3 Roadster assembly plant in the metropolitan area. The plant, opened in 1992, employs 2,000 workers. Whereas the average annual salary in the textiles and apparel industries was $26,252 in 1996, the average worker in Greenville's transportation equipment industry earned $46,824. In addition to direct hires, the BMW plant has had a cascade effect, attracting the company's first- and second-tier suppliers to the area. Existing manufacturers such as Hitachi also have expanded their area operations. Employment gains in these new industries have helped offset losses in textiles and apparel.

Greenville may be emerging as a regional retailing center as well. The retail sector has seen annual job growth in excess of 3.5 percent since 1994, and retail space construction activity has increased gradually since 1993. Absorption has remained steady, however, and the divergence between supply and demand has resulted in a rise in retail vacancy rates to a seasonally adjusted 14.3 percent in the first quarter of 1998 (see Chart 3). Nonetheless, there is continued optimism about the market's retail potential. According to ***F.W. Dodge***, the metropolitan area had over 10 million square feet of retail space in the planning stages as of June 1998. In comparison, the Charlotte metropolitan area had about 5.5 million square feet in the planning stages. Greenville's residential markets have been active as well. Job, income, and population growth, combined with low mortgage rates, have fueled demand for new housing over the past few years. Permit issuance in the metropolitan area reflects the sustained level of demand: The number of units authorized has remained above 6,000 since 1994. Through June 1998, however, total year-to-date permit issuance was down 5 percent from year-ago levels, owing entirely to declines in multifamily permitting. The trend toward homeownership may be the result of low mortgage rates, which encourage homebuying. In any case, the decline in multifamily issuance may help prevent any major overbuilding in Greenville's residential markets.

As Greenville emerged from the 1991 recession, area institutions saw past-due and charge-off measures moderate. Credit quality improvements were accompanied by steady asset growth and solid gains in earnings and capital (see Table 1). Greenville's economic expansion, as well as its industrial diversification, generally has helped improve the risk profile of insured institutions. Specifically, the aggregate equity-to-assets ratio for

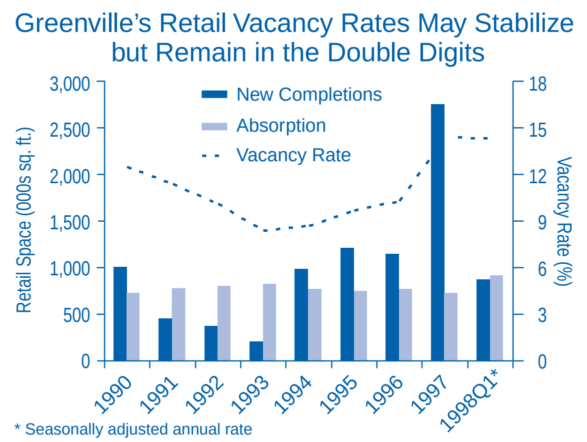
Table 1

Greenville's Insured Community Institutions* Are Benefiting from the Area's New Economy

Year	Institutions in MSA	Median Asset Size ($ in 000s)	C&I Loans to Assets (%)	CRE Loans to Assets (%)	ALLL to Loans (%)	Past Due Loans	Past Due C&I Loans	Past Due CRE Loans	Net Loan Charge-Offs (%)	C&I Loan Charge-Offs (%)	CRE Loan Charge-Offs (%)	ROA	Equity to Assets
1998Q2	23	88,246	8.63	7.28	0.89	1.60	1.37	0.85	0.06	0.02	0.00	1.13	13.03
1997	26	89,558	9.62	8,76	0.87	1.77	2.59	1.07	0.12	0.50	0.01	1.08	12.16
1995	23	92,982	6.23	7.20	0.87	1.51	1.17	1.87	0.06	0.17	(0.05)	1.11	10.94
1993	24	77,772	8.87	10.87	0.99	1.67	0.96	0.99	0.17	0.28	0.14	1.19	9.76
1991	24	65,859	9.59	8.03	0.92	2.29	2.05	2.10	0.31	0.92	0.33	0.81	8.37
1989	23	55,521	9.81	5.93	0.66	0.95	2.06	—	0.23	0.79	—	0.73	8.07
1987	20	53,544	9.61	4.71	0.62	0.94	1.52	—	0.11	0.28	—	0.92	7.22
1985	21	55,197	6.64	5.85	0.34	0.43	1.10	—	0.10	0.60	—	0.88	4.04

* Includes all insured institutions headquartered in the Greenville, South Carolina, metropolitan statistical area (MSA) with assets under $1 billion.
Past dues include all loans delinquent 30 days or more or on nonaccrual.
C&I = commercial and industrial loans.
CRE = commercial real estate loans.
ALLL = Allowance for loan and lease losses.
ROA = Return on assets, annualized for 1998Q2.
Source: Bank and Thrift Call Reports

CHART 3



* Seasonally adjusted annual rate
Source: F.W. Dodge Real Estate Analysis and Planning Service

community institutions (those with assets less than $1 billion) in the MSA has increased steadily since the mid-1980s and is well above the state average. Asset returns in the 1990s have been much higher than in the 1980s, loss reserves have increased relative to loans, and delinquencies and charge-offs have remained at low levels. The vibrancy of the Greenville market is evidenced further by the fact that all six of the new institutions chartered in the MSA during the 1990s, including four that have opened since the beginning of 1996, were profitable in the first half of 1998.

Although current measures reflect a very healthy financial sector, the risk exposure of some Greenville institutions may be increasing. For instance, while there has been no significant or sustained rise in aggregate C&I or commercial real estate (CRE) exposure in the MSA for community institutions, the number with concentrated exposure in these products has increased. Nine institutions had C&I exposures of 15 percent or more of assets in 1997, up from six in 1991 and five in 1987. Seven institutions had at least 15 percent of assets in CRE loans in 1997, compared with just three in 1991 and one in 1987. The aggregate exposure changes considerably when two institutions headquartered in the MSA with assets over $1 billion are included: Aggregate C&I exposure rises from 8.6 percent to 9.4 percent of assets, and CRE exposure jumps from 7.3 percent to 15.9 percent. This fact may indicate that Greenville's growth is being financed more by large, statewide institutions than by smaller, in-market participants. But, because these institutions have sizable operations outside the Greenville MSA, it is difficult to determine how much of their exposure actually is concentrated within the MSA. In addition to the two large Greenville banks, some regional and super-regional banks also maintain a strong presence in the Greenville market. According to the latest ***Summary of Deposits*** data, institutions with assets over $1 billion, including regionals and super-regionals headquartered outside the MSA, held more than 70 percent of the deposits in Greenville County and had nearly a 50 percent market share in Spartanburg and Anderson counties.

Regarding C&D lending, both aggregate and individual institution exposures have remained relatively low despite an increase in residential and other development activity. For community banks headquartered in the Greenville MSA, aggregate C&D lending over the past few years has remained steady at around 5 percent of assets, which is only slightly above the national average for metropolitan institutions. This ratio does not change significantly when institutions with assets over $1 billion are included.

The fact that community banks, as a group, have not taken on excessive levels of concentrated lending exposure may bode well in the event of an economic downturn. Moreover, the larger banks that appear to be more actively funding the area's growth and development are likely to have greater geographic and loan product diversification, which should improve their ability to withstand any future volatility in the Greenville market.

Even the 'New' Greenville MSA Economy Faces Risk

The greatest source of growth to the Greenville metropolitan area during the 1990s has been corporate investment and relocation. Conversely, the greatest risk the area faces may be a reduction in the pace of investment. A selling point Greenville has used to attract corporate relocation is the availability of inexpensive labor. With a 2.2 percent unemployment rate in the second quarter of 1998, labor has become scarce. Rapid growth in the metropolitan area's labor force has been critical to satisfying the demand for new workers. Demographics may contribute to Greenville's labor shortages, as economic growth elsewhere in the nation may be discouraging in-migration. In 1997, net in-migration to the metropolitan area fell to 6,487, down 2,000 from a year earlier. Consequently, the MSA's population growth slipped to 1.0 percent. While on par with that of the nation, the MSA's population growth is at its lowest level since 1986. The lack of adequate infrastructure development became a barrier to further growth, particularly in Anderson County. Tight labor markets and high demand for new space may raise the cost of doing business, thus eroding Greenville's competitive edge in attracting and retaining corporate relocation.

Corporate investment in the Greenville MSA in the 1990s has diversified the local economy and attracted migrating job seekers. As a result, the character of the MSA has changed significantly since the last economic downturn. How the "new" economy will fare during any future recession remains uncertain. The shift toward service employment may help insulate the economy from the effects of a downturn as this sector typically displays less volatility over the business cycle. However, the economy still remains highly dependent on the textiles and apparel industries, which account for approximately 40,000 of the MSA's 460,000 jobs. Recent strength in the U.S. dollar could further aggravate losses in these industries as domestic manufacturers face pricing competition from abroad.

In contrast to weakness in textiles and apparel, growth has been strong in the metropolitan area's nascent transportation equipment industry. However, employment in the sector currently accounts for just 5 percent of total manufacturing employment or approximately 6,700 jobs. Gains are expected to continue, especially with BMW's recently announced plans to begin assembly of sport utility vehicles in the MSA. Nonetheless, since the rising importance of automotive production in the area postdates the 1990–1991 recession, the local economy has not yet experienced the effects of an economic downturn in the automotive industry, which is prone to large cyclical swings.

Just as the Greenville economy faces new and different risks, insured institutions also face new challenges. Managers of insured institutions must recognize and be knowledgeable of the differing characteristics of Greenville's new industries. For example, when evaluating credit quality, events that affect the automotive industry now must be considered on a scale similar to those affecting textiles and apparel. Also, as the level and volatility of income and employment in Greenville's new industries is likely to differ from textiles and apparel, loans advanced to these industries and related borrowers may react differently during an economic downturn. These risks may be higher for de novo institutions, which may lack the financial flexibility (risk-bearing capacity), local market expertise, and pricing power of their larger, more established competitors.

The economic transformations of the 1990s are not unique to the Greenville MSA, but rather may be indicative of a trend in the Atlanta Region. In **Tuscaloosa, Alabama,** for example, the rise of transportation equipment production is having a significant impact on local economies. **Florence, South Carolina,** may share similar experiences in the future with the location of a new Honda facility. Finally, as more metropolitan areas see corporate relocation and investment as a possible economic panacea, Greenville may face more intense competition for corporate relocation in the future.

Atlanta Region Staff

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