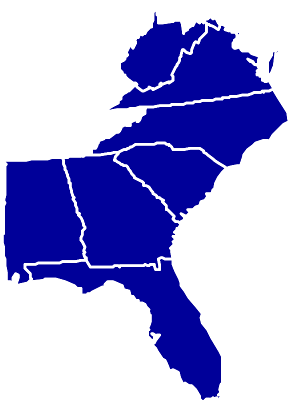
◈ Regional Outlook ◈

FEDERAL DEPOSIT INSURANCE CORPORATION SECOND QUARTER 1997

In Focus This Quarter

FDIC ATLANTA REGION



■ ***Will Credit Scoring Transform the Market for Small-Business Lending?*** **- In an effort to reduce the cost of small-business lending, some institutions are using credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios, in some cases venturing into markets well beyond their local economies. The ramifications could be significant. An overreliance on credit scoring models could expose lenders to increased credit risks. Over time, the traditional niche enjoyed by small banks in small-business lending could come under considerable pressure.** *See page 3.*

■ ***Banking on the Internet: New Technologies, New Opportunities, New Risks*** **- Internet banking promises a wide range of new benefits. It also offers a host of new problems and some new twists on old ones. The tradeoff is one that depository institutions and regulators alike must grapple with as they stake out their positions in cyberspace.** *See page 7.*

DIVISION OF INSURANCE

JACK M.W. PHELPS, SENIOR REGIONAL ANALYST

SCOTT C. HUGHES, REGIONAL ECONOMIST

PAMELA R. STALLINGS, FINANCIAL ANALYST

Regular Features

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Will Credit Scoring Transform the Market for Small-Business Lending?

- **Small-business lending, traditionally a segment in which small banks have enjoyed comparative advantages, is receiving greater focus from larger banks and nonbank financial companies.**

- **Some insured institutions are beginning to re-think traditional approaches to small-business loan underwriting to include the use of credit scoring models.**

- **The use of small-business lending credit scoring models, while providing banks opportunities for underwriting and servicing efficiencies, carries with it a number of potential risks.**

Background

As of 1994, there were more than 22 million small businesses in the U.S., making this a very attractive potential market for lenders. Small-business lending has been a line of business in which small banks have been very successful given their traditional strong niche in relationship banking. Small-business lending traditionally has been a relatively cost-intensive lending segment, since origination costs are spread over smaller loan balances. Some institutions are now beginning to use credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios. A number of larger banks, especially, appear to be looking to the efficiencies of credit scoring to help provide quick loan approvals and more competitive loan rates. With the aid of this technology, some institutions are rapidly expanding their loan portfolios, in some cases venturing into markets well beyond their local economies.

Commercial bank small business lending exposures in the Atlanta Region are considerable. (For purposes of this article, small business lending refers to loans categorized as commercial and industrial loans with original amounts of $1 million or less reported on the June Call Reports.) At midyear 1996, commercial banks in this Region reported $29 billion of small business loans, amounting to 32 percent of all commercial and industrial loans. This is an increase of $1.3 billion or 5 percent from a year ago. There are 388 banks in the Region with small business loan exposures exceeding equity, and 82 banks with exposure exceeding 200 percent of equity.

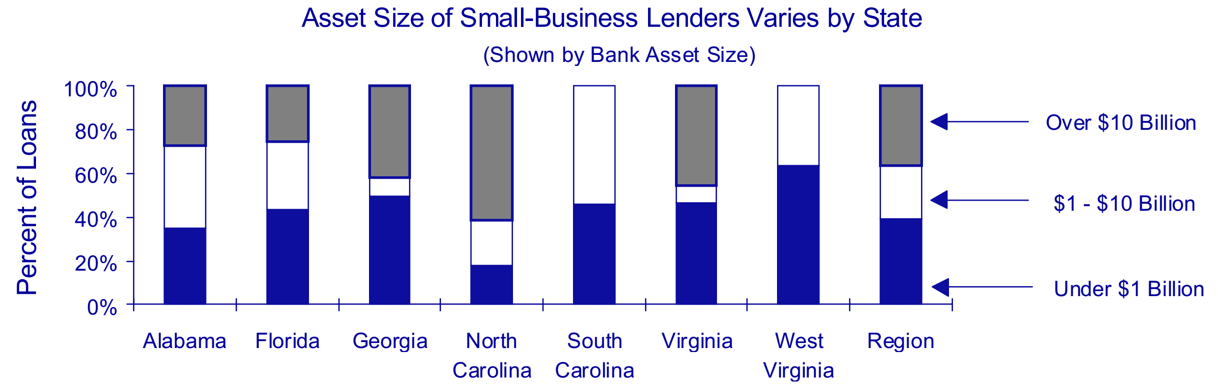
Small banks with assets under $1 billion have a substantial 39 percent share of the Regions' small business loans (see Chart 1 next page). However, the market share held by the Region's small banks may come under pressure as several large banking companies have announced nationwide programs to increase their share of small business lending. These nationwide programs may have been prompted by new credit scoring technologies that have reportedly allowed some companies to offer pre-approved and pre-qualified lines of credit.

The Growing Importance of Credit Scoring

While credit scoring technology is not new, until recently it typically has been associated with consumer lending, particularly with credit card lending. Primarily using credit bureau information, credit scoring provides lenders with a tool to rank risks or probabilities of default, assigning statistically derived numerical ratings or scores based upon a borrower's past experience with paying debt. Based upon the enormous volume of historical information on consumers contained in credit bureaus, model developers link incidences of good and bad credit performance with borrower characteristics. Applicants then are compared to these credit performance indicators in order to make credit extension decisions. While credit scoring has helped consumer lenders reduce origination costs and to grow receivables at rapid rates, the recent rise in credit card charge-offs has raised concerns about the effectiveness of such models, or at least about how the models are being used.

Small-business credit scoring is a relatively new concept in scoring technology, but is gaining more attention from lenders. *Small-business credit scoring models are similar to consumer credit scoring models in one significant aspect -- the most important indicator of credit performance is the credit profile of the principals of the business derived from consumer credit bureau information.* Other business information from

CHART 1



Source: June 30, 1996 Bank Call Reports

companies such as Dun and Bradstreet Corporation and Experian (formerly TRW) also is used in the scoring process.

A primary vendor of these scoring models has cited analysis purporting to show that business financial statement information did not prove a useful indicator of credit performance for small-business loans. The reasons for this result may be due to inconsistency in financial statement quality and the difficulty in separating business entity cashflow information from the business owners' activities. Also, the relative importance of principals' credit history and financial statement information in predicting credit performance was found to change somewhat with the size of the business -- the larger the business the more important financial statements become in assessing performance.

Many institutions cite the potential cost savings involved in the underwriting process as one of the most significant characteristics of credit scoring. In many cases, with scoring technology, loan application processes have been streamlined to one page forms for loans up to $50,000, not dissimilar to that of consumer loan applications. In some cases, financial statements are not required at all. Reducing paperwork helps to reduce both processing time and costs. Table 1 illustrates how scoring has changed underwriting practices, as reported by one large bank at a recent conference on credit scoring. While it is impossible to know whether the information presented in Table 1 is representative of the way most institutions are using credit scoring models, it is clear that credit scoring may represent a significant departure from traditional underwriting methods.

Part of the reduction in underwriting costs may come from improvements in the allocation of underwriting resources. It has been argued that credit scoring allows banks to more easily identify those applicants which are clearly either approvals or denials. This process would enable banks to reallocate their underwriting resources more efficiently to those loans which pose intermediate risks and require closer attention. Other advantages of credit scoring systems that often are cited are greater consistency in underwriting, better measures for pricing strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

Small-business lending has historically been a prof-

TABLE 1

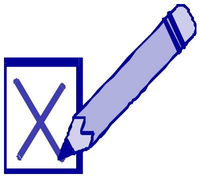
SMALL-BUSINESS LENDING: CREDIT SCORING VERSUS TRADITIONAL LOAN UNDERWRITING

	1993	1996	1997
PERCENT OF LOANS REQUIRING ANNUAL FINANCIAL STATEMENTS	100%	20%	--
PERCENT OF LINES REVIEWED ANNUALLY	100%	0 - 5%	--
PROCESSING TIME FOR LOANS OF $50,000 - $250,000	3 DAYS	1 DAY	1 HOUR

SOURCE: REPORTED BY A LARGE BANK AT A RECENT CONFERENCE ON CREDIT SCORING.

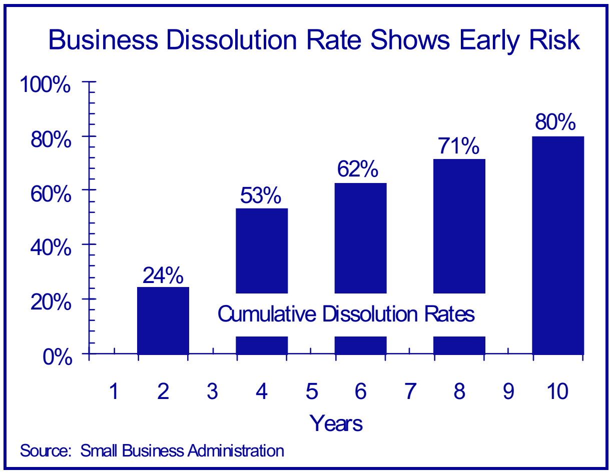
itable area of bank lending. This situation is most likely attributable to lenders thoroughly analyzing potential customers, persistently monitoring their performance, and building solid lending relationships. Credit scoring for small-business lending raises the possibility that some banks will forgo the traditional underwriting concepts of relationship lending in favor of a more mass-marketing approach, in a manner similar to credit card lending. To the extent that credit scoring is used to rapidly gain new customers by either targeting out-of-territory customers, or customers with less business experience, the risk profile of an institution's small-business lending portfolio may change. Any such change in profile may be significant due to the risks associated with newer borrowers. For example, new firms tend to fail at an extremely high rate, with 53 percent of new businesses failing within the first four years of inception (see Chart 2). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

There are potential dangers associated with placing undue reliance on credit scoring models. *The predictive value of any credit scoring system may be substantially diminished if the model is used for unintended purposes or customer types*. Therefore, misuse of a scoring system could expose an institution to considerable losses. Since only the largest banks have small-business loan portfolios large enough to create statistically valid scoring models customized for their own customer base, smaller companies should be especially aware of potential misuse. This risk takes on added meaning when one considers that a $1 million small-business loan represents substantially more capital to a $100 million bank than to a $10 billion bank. Adding further uncertainty, small-business credit scoring has been implemented during a period of relatively strong performance by businesses, with commercial and industrial loan delinquency ratios near historical lows. How well these models perform during an economic downturn remains to be seen.



Depending on the manner in which it is implemented, credit scoring for small-business lending may represent a fundamental shift in underwriting philosophy -- *viewing a small-business loan as more of a high-end consumer loan and, thus, granting credit more on the strength of the principals' personal credit history and less on the financial strength of the business itself.* While this may be appropriate in some cases, it is important to remember that the income from small businesses remains the primary source of repayment of most

CHART 2



loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

Competitive pressures in small-business lending are increasing not only because of large banks' efforts to expand their lending but also because of greater participation in the market by nonbank financial companies. Several large firms, such as American Express, AT&T, the Money Store, and GE Capital Services, are expanding their business lines to service the needs of small businesses. These companies are offering small-business credit cards, innovative new types of credit, and other services such as consulting, accounting and investment services. Some observers have suggested that the cost advantages of credit scoring may cause small-business lending in the future to be dominated by 12 to 15 large banks or financial firms. Faced with stiff competition, there may be strong motivation for some banks to increase the dollar threshold on low documentation loans, streamline the process for larger loans, or lower credit scoring thresholds for loan approvals.

The most recent ***FDIC Survey of Underwriting Practices*** and the ***Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices*** both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth goals were seen as the main reasons for easing in these cases. With regard to small-business credit scoring techniques, the Federal Reserve survey pointed out that banks were most commonly using credit scores for automatic acceptance or rejection of loans up to $50,000.

Summary

Credit scoring has the potential to transform the market for small-business lending. The traditional niche enjoyed by small banks in this area may come under tremendous pressure from larger banks and nonbank companies employing this new technology. Credit scoring at a number of institutions is driving dramatic changes in underwriting methods for small-business lending. These changes may facilitate short-term revenue generation as business can be expanded rapidly and underwriting costs can be slashed. It is extremely important, however, that banks understand and control the potential risks inherent in such a strategy. The application of credit scoring to small-business lending merits the close attention of both bankers and their supervisors.

Andrea W. Bazemore, Banking Analyst

Banking on the Internet

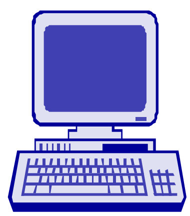
New Technologies, New Opportunities, New Risks

- **Despite the potential for lower transaction costs, increased efficiency, and greater asset diversification, few banks do business through the Internet.**

- **Although *competitive risks* are pushing banks to create an Internet presence, *operational risks* remain an obstacle to actually using those sites for moving information or money.**

- **The FDIC's Division of Supervision recently released examiner guidance on Internet banking and is developing training programs for its examiners.**

The Allure of Cyberbanking

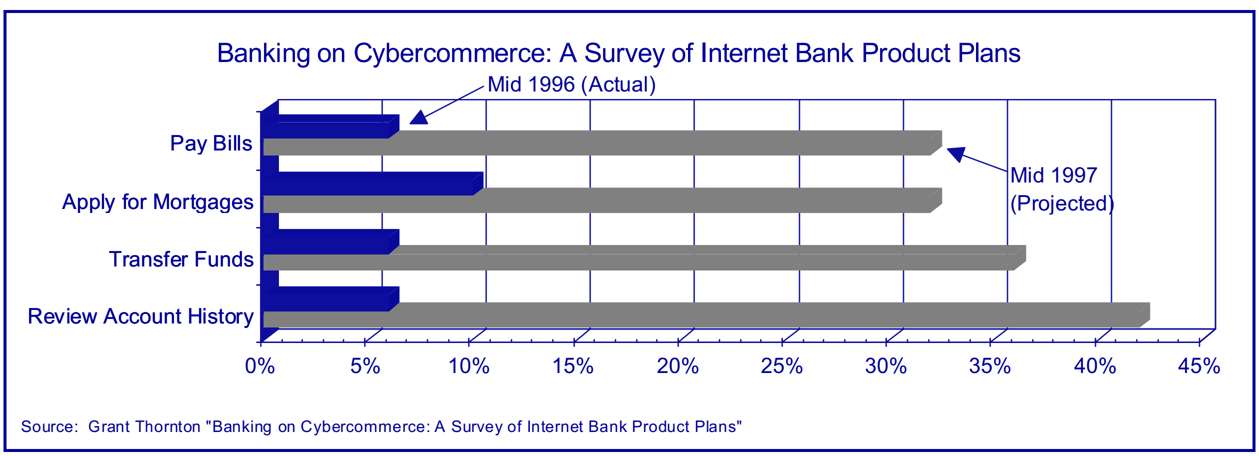


On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking,* is of particular interest to banks because it exploits an existing and geographically extensive public network infrastructure and promises a range of new operating and marketing benefits. One such benefit is the ability for an institution to expand its trade area to include other cities, states, regions -- or even countries -- without a commensurate expansion of its branch structure. This greater geographic reach can do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. A March 1996, study by ***Booz, Allen & Hamilton Inc.*** estimated an average Internet transaction cost of $0.01 compared to $0.27 for an ATM, $0.54 for a telephone, and $1.07 for a full-service branch.

Slow Migration to the Future

Another 1996 study, this one by ***Grant Thornton*** in July (see Chart 1), found that despite these potential benefits, most banks established an Internet presence for appearance's sake -- being perceived as a leader, advertising bank services or staying abreast of competitors -- rather than with an intent to grow deposits or capture the transaction economies that cyberbanking could provide. Of the 44 Internet institutions surveyed, only one in three expressed intentions to begin offering bill payment or funds transfer over the Internet by the end of the second quarter of this year. Even this subdued enthusiasm now appears optimistic. Despite the perceived benefits and the scarcity of competition, few banks have to date ventured into this area in a meaningful way. According to the ***Bankweb*** world- wide web site, only 800 or so banks -- less than 1 percent of the industry -- have an Internet site and only 18 of those permit transactions. In the Atlanta Region, 120 institutions have an Internet presence but only five allow customers to pay bills or

CHART 1



transfer funds. A major question, then, is why so few institutions have chosen to exploit this medium?

Risk

The reason is risk. Banks are familiar with the control of exposures found in proprietary or private payment channels, but they are less comfortable with the new risks attendant to a public network. On one hand, there are *operational* exposures that convincingly argue against rushing headlong into cyberspace. On the other hand, there are *competitive* risks. Nonbank competitors with strong foundations in cybertechnology pose a budding threat to the banks' historical payment-services monopoly and argue with equal authority for an immediate Internet presence to gain or preserve market share. These opposing forces help explain the large numbers of banks establishing web sites that stop short of actually moving information or money.

Of these two types, operational risks are the most immediate and command the most attention. They derive from the formative state of both the technology supporting on-line commerce, and the legal and regulatory structure governing its use. These risks include theft or misappropriation of internal data or external transmissions, transaction fraud, errors in underwriting virtual transactions, liquidity shortfalls, changing technical standards, inadequate or geographically inconsistent regulatory and legal infrastructure, noncompliance with existing laws or regulations that were not designed for an on-line world, and damage to an institution's reputation from the realization of any or all of these risks (see ***Some Concerns or the CyberBanker,*** right).

Systemic Threats and a New Payments Model

In addition to bank-specific risks there are the systemic threats that a public domain payments model could bring. One of the key features of the Internet is redundancy. Any one of a large number of possible paths can be used for a given transaction and therefore the failure of any one path or node will not affect the functionality of the network as a whole. This feature presents a multitude of new and -- from a banker's perspective -- previously unconsidered points of vulnerability to technologically-sophisticated miscreants. In a cyberworld of small value transactions, the effects of an attack may not be much more severe than those which accompany credit card crime. However, there is good reason to expect that Internet transaction sizes will continue to grow. According to one software vendor,

Some Concerns or the CyberBanker

Internal Data Security. The Internet cannot distinguish between customers and criminals. Invasive attacks can range from simple vandalism to theft or destruction of proprietary operating or customer data. Firewall software, data encryption, specialized hardware configurations and commercial insurance can limit such exposures.

External Transmission Security. Because the Internet is an open network, transaction messages are completely exposed, rendering them vulnerable to theft or tampering. Message encryption is a common response, but hardware or implementation flaws can circumvent it. This threat will increase greatly if large value or interbank transactions migrate to the Internet.

Transaction Fraud. Fraud takes two forms: misrepresentation during a transaction or repudiation following it. This problem takes new dimensions in cyberspace because no physical relationship with a customer exists. Encryption protocols which include digital signatures are one response. Biometric authentication schemes, the most commonly proposed being fingerprint or retinal verification, are another.

Difficulties with Virtual Underwriting. Even if your cyberborrowers are who they claim to be, there remain difficulties in establishing their creditworthiness. The lack of a personal relationship is one factor. The limited knowledge of local employers and credit grantors that appear on applications is another. Such difficulties could hasten and heighten dependency upon credit scoring models.

Liquidity Risks. Internet transaction volume and velocity are expected to increase rapidly, potentially creating transactions which occur so rapidly as to exceed immediate bank liquidity. Denial of service attacks, where a site is intentionally deluged with transactions in order to shut it down, also can affect liquidity if affected customers decide to close their accounts.

Lack of Technical Standards. An institution building an early presence on the Internet is making a financial bet as to which standards will endure.

Lack of Regulatory and Legal Infrastructure. Regulators are waiting and observing. Future promulgated "best practices" may not be those which an institution has already adopted. Similarly, a lack of legal precedent hinders criminal and civil prosecution of cybercriminals. Even where precedent exists, it is frequently inconsistent across jurisdictions.

Reputation Risk. An image of solidity is a cornerstone of banking. Internet banking confronts banks with more exposure and potentially greater publicity about losses.

Competitive Risks. Unlike the operational risks discussed above, competitive risks accrue to institutions not securing an Internet foothold. They involve the threat of lost market share or payment system position to more aggressive peers and nonbank competitors.

inter*branch* payments on the Internet are likely to begin in 1997 with inter*bank* activity to follow a year or so later. This development would be a significant evolution because wholesale transactions are generally large relative to bank liquidity. An attack or disruption of the Internet payments mechanism for a single large transaction could conceivably pass liquidity shocks to other banks in the same way that bad weather at a major airport can disrupt air traffic throughout the country.

New Technologies, Old Reporting

The advent of fully transactional web sites also could heat up bank competition for low cost deposits and frustrate regulatory oversight in the process. One possibility is a "deposit arbitrageur," a hybrid of brokered deposits and program trading in which a computer program could search the Internet for the highest deposit rates and immediately reallocate deposits accordingly. In the long run, such activities could harmonize local interest rates. In the short run, however, this rapid turnover could mean substantial liquidity drains on institutions accustomed to local deposit monopolies. From the regulatory perspective, this transaction velocity -- and its potential to rapidly alter bank balance sheets -- could present new challenges in a world of quarterly Call Reports and examination intervals that can exceed one year.

FDIC -- the CyberRegulator

New risks demand new supervision techniques and the FDIC's Division of Supervision (DOS) has responded with their recently-released electronic banking safety and soundness examination guidance. Under that guidance, institutions having Internet sites are placed into one of three tiers based upon the "maturity" of their site. Safety and soundness examination procedures focus on bank policies, procedures and planning. The examination procedures are cumulative -- meaning that each successive tier adds an additional level of scrutiny to the tiers below -- and do not require a technical knowledge of Internet systems. "Information Specialist" involvement also varies by tier (see Table 1). A DOS training program for all safety and soundness examiners already has begun, and technical training for information systems specialists is being developed. A new specialty, the electronic banking Subject Matter Expert, also is being established.

Measured Steps in a New Environment

Banks increasingly are becoming distributors of commodity-like products. As such, profitability may become dependent upon both cost efficiencies and high volume -- a combination sometimes argued as inconsistent with high-cost branch structures. Internet banking offers institutions a means to compete in this new environment. It also offers new risks. Recognizing this tradeoff, many banks have entered this realm with measured steps. Those who have not face risk of a different sort. They face instead the risk that their competitive position will pass to more innovative competitors -- competitors with new technologies and the drive to accomplish old business in thoroughly new ways.

Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

Table 1

The Division of Supervision Classifications for Internet Banks

	Level 1	Level 2	Level 3
Description	An information-only site	A site permitting electronic submission of loan or deposit applications	Transactional site offering electronic bill payment or funds transfer services
Specialist Examination Requirement (in addition to Safety and Soundness Exam)	Information Specialist review required only if site is tied into internal bank systems.	Consultation with Information Specialist required to determine if further review is warranted.	Concurrent Information Specialist Examination required.

For More In ormation:

Division o Supervision

DOS currently is implementing examination guidance for safety and soundness examiners and developing training for technical specialists.

Cynthia Bonnette, Examiner
Chairman, New Banking Technologies Task Force
(202) 898-6583

Stephen White, Information Systems Review Examiner
Chairman, Information Systems Subcommittee
Federal Financial Institutions Examination Council Task Force on Supervision
(202) 898-6923

Division o Compliance and Consumer A airs

DCA is reviewing new banking technologies from a consumer protection, fair lending and CRA perspective to provide guidance on compliance matters. DCA also is coordinating outreach efforts with consumer community groups.

John Jackwood, Special Assistant to the Director
(202) 942-3854

Regional O ice Contacts

Frederick Barnes, Review Examiner (EDP)
Division of Supervision
Atlanta Regional Office
(404) 817-2570

Christina Quinlan, Review Examiner
Division of Compliance and Consumer Affairs
Atlanta Regional Office
(404) 817-2551

O ice of Policy Development

OPD provides leadership in developing FDIC policies, including those addressing new banking technologies. The office coordinates several interdivisional electronic banking efforts and represents the FDIC on the interagency U. S. Treasury Consumer Electronic Payments Task Force.

Sharon Powers Sivertsen, Director
(202) 898-8710

Related Web Sites

FDIC	http://www.fdic.gov
FFIEC	http://www.ffiec.gov
NETBanker	http://www.netbanker.com
Bankweb	http://www.bankweb.com
National Computer Security Assoc.	http://www.ncsa.com
RSA Data Security Inc.	http://www.rsa.com
Smart Card Resource Center	http://www.smart-card.com
American Bankers Association	http://www.aba.com

Slower Growth in the Atlanta Region

- **Growth in the Atlanta Region may slow in 1997 as the economy moves further away from its 1994 cyclical peak. The Region, however, should continue to grow at a pace that exceeds the national average.**

- **The metropolitan Atlanta retail real estate market appears to be at overcapacity. The multifamily and office segments may not be far behind.**

- **Years of fast-paced economic growth have created the possibility that as Atlanta's growth cools, new net**

A Downshift in the Economy?

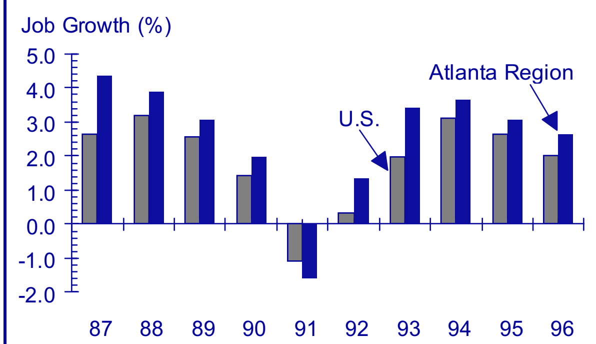
The economic performance of the Atlanta Region continues to cool, though numerous pockets of growth remain. The Region's cyclical peak occurred in 1994, when job growth reached a robust 3.6 percent, compared to a more modest 2.6 percent increase in 1996 (see Chart 1). Still, the smaller increase in employment in 1996 continued to surpass the national average of 2 percent. *Indeed, the Atlanta Region boasts three of the five states east of the Mississippi ranked in the top quartile of U.S. job growth (Georgia, Florida, and North Carolina).*

In many respects, the Region's performance parallels that of the nation, which also has seen a deceleration in growth. This similar performance is the result of increased diversification and financial interdependence with the rest of the nation and global markets. Nonetheless, the Region is host to some industries that do not necessarily move in tandem with the nation, such as its large and structurally declining textiles and apparel industries, which are heavily concentrated in the Carolinas, Georgia, and Alabama. Tobacco, though not as large an employer as textiles and apparel, still generates substantial levels of income for the Region. Federal fiscal austerity also has been a drag on the Region's growth, especially in Virginia.

...analysts expect that growth in the Region will continue to slow in 1997 as the economy moves further away from its 1994 cyclical peak.

Some analysts expect that growth in the Region will continue to slow in 1997 as the economy moves further away from its 1994 cyclical peak. Growth, however, should continue to exceed national averages. Above-average population growth in the Region should lend considerable support to continued demand for local goods and services. *Geographically, the most robust gains should continue to occur in Georgia and Florida, which have the Region's most dynamic economies. Georgia's economy, nonetheless, will face a challenge in the post-Olympic era.* Even with the Games, job growth in Georgia averaged less than 4 percent in 1996 and employment gains this year should be substantially lower.

CHART 1



The Atlanta Region Economy: Beyond the Peak

Source: Bureau of Labor Statistics

North Carolina, though still hampered by the persistent erosion of its older industrial base (tobacco and textiles and apparel), should benefit from high-tech growth and corporate relocation. Business in-migration slackened in 1996 due to legal challenges, which have since been put to rest, and the state foresees a year of aggressive corporate courting in 1997. Virginia and West Virginia also are encouraging corporate relocation. Virginia is pursuing high-tech industries, and West Virginia is attempting to attract automobile parts manufacturers. Job growth in Alabama is expected to remain sluggish even with the start up of the much anticipated Mercedes-Benz plant in Tuscaloosa. *Weak population growth and shortages of* *skilled labor have continued to constrain Alabama's economic performance.*

Corporate relocation fuels economic activity and bank lending. As businesses move into an area, population and other commercial growth soon follow. Subsequently, infrastructure development also is required.

Nonetheless, the 'relocation game' is a double-edged sword, as it may be risky and competitive. Government incentives to migrating business can prove costly, and areas of concentrated relocation have the potential to attract commercial development away from neighboring areas, thus adversely affecting adjacent local economies. *Nonetheless, the* ***Wall Street Journal*** *notes that four of the Atlanta Region's seven states (Florida, Georgia, North Carolina, and South Carolina) anticipate increasing incentive programs over the next five years.* Alabama, Virginia, and West Virginia plan to stabilize their business-incentive programs.

Implications: Slowing growth ultimately translates into weaker loan demand. *There is an additional risk that consumers and businesses may not recognize the changing economic conditions and become over-extended. Longer term, growing economic linkages may make the Atlanta Region more sensitive to national conditions.*

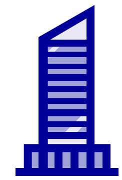
...consumers and businesses may not recognize the changing economic conditions and become over-extended.

Trends in Commercial Real Estate in Atlanta

The Atlanta metropolitan area faces a number of risks to its economic well-being that could potentially affect its banking sector. Years of fast-paced economic growth have created the possibility that as the city's growth cools, new net supply may fail to slow commensurately, which could potentially lead to the emergence of real estate "bubbles" (see ***Current Regional Banking Conditions***).

Office Markets Tightening

Over the last four years, the Atlanta metro office vacancy rate has shown dramatic improvement from 19.9 percent in 1992 to a current estimated 6.5 percent. However, office vacancy rates vary widely through the city. Buckhead, the Central Perimeter, and North Fulton are well below the metro-wide average. Near Hartsfield International Airport, the office vacancy rate is near 20 percent. Midtown and downtown vacancy rates are in the double-digits. Moreover, the construction of the new Federal Center is expected to raise the downtown class A and B vacancy levels up to 22 percent.

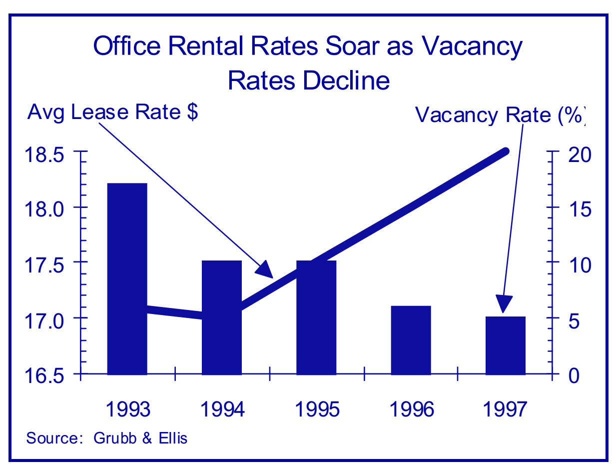


A lack of new construction from 1991 to 1995 has contributed to the occupancy of Atlanta's vacant office space and has led to a rapid rise in rental rates (see Chart 2). The sharp rise in rental rates has spurred a resurgence in speculative office construction in Atlanta which has more than doubled over the past year from about 1.1 million square feet in 1996 to about 2.4 million square feet scheduled for construction this year. *Atlanta currently is the most active speculative office construction market in the country.* In total, four million square feet of new office space is expected to come on line in both 1997 and 1998. Following the Olympics, most construction has shifted to the suburbs and away from the downtown area. For example, the Atlanta North Fulton submarket, has over 1.8 million square feet of office space currently under construction -- more than all the rest of the Atlanta market combined.

Atlanta currently is the most active speculative office construction market in the country.

The rise in rental rates also is being driven by record lease expirations of over 30.8 million square feet from 1995 through 1998. Office job growth is expected to

CHART 2

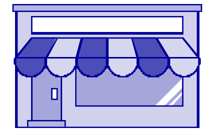


drive demand for new office space to record highs for at least the next two years. Over the last three years, office employment growth has escalated by over 11 percent, but growth is expected to slow to 4 percent in 1997 and to 3 percent in 1998, according to Donald Ratajczak, Director of the Economic Forecasting Center at Georgia State University. Atlanta's office vacancy rate is expected to reach an estimated 6.8 percent rate for 1997, well below the projected 11 percent national average. *While fundamentals appear strong over the next two years, the office market may experience a correction if the pace of new construction continues and the forecasted slowdown in office employment growth materializes over the longer term.*

Retail Markets Oversupplied?

The Atlanta metropolitan area's retail market has enjoyed several years of expansion. Prompted by strong levels of absorption following the recession early in the decade, net new supply of retail space has consistently trended upward. Strong growth, exemplified by rapid gains in retail trade employment, has steadily reduced a vacancy rate that stood above 13 percent in 1990. By 1994, the peak of the recovery, the Atlanta retail vacancy rate was close to 6 percent. Since then, absorption has slowed, except for a brief surge in 1996 associated with the Olympic Games. In contrast, net new supply has continued its upward trend (see Chart 3), and consequently, the vacancy rate has started to inch upward.

Net new supply of retail space in the third quarter of 1996 was estimated by ***F. W. Dodge*** to be 9 million square feet (annual rate). *This amount is a remarkable 10 percent of the total new retail space for 58 major markets reporting nationally. Considerable space also remains in the construction pipeline at a time when absorption is weakening.* These conditions are exacerbated by the approval for construction of the Mall of Georgia in northern Gwinnett County scheduled to open in August 1999. The new mall will add 1.8 million square feet of mall space and another 1.8 million square feet in other retail space to an already competitive market. Property owners in Gwinnett county are beginning to convert retail properties into office space because of a shortage of tenants, which is further evidence that the retail market is becoming overbuilt. *As Atlanta's overall economy continues to cool, so will growth in retail trade and consumer spending. As such, the potential exists for a shakeout in the retail real estate market.*



Multifamily Construction -- Where Will the Renters Come From?

Recently, there have been concerns about overbuilding of multifamily dwellings in the Atlanta metropolitan area. As noted in the ***Wall Street Journal***, the pursuit of renters by landlords has included the use of "bobbing balloons" outside apartment complexes. In one case, an employee dressed up in a rabbit suit to lure potential renters.

Over the past three years, the Atlanta apartment market has been quite strong. During 1994 and 1995, the occupancy rate held steady at 96 percent, then declined to 94 percent in 1996 as 12,000 new units were added to the market, according to the Atlanta Business Chroni-

CHART 3

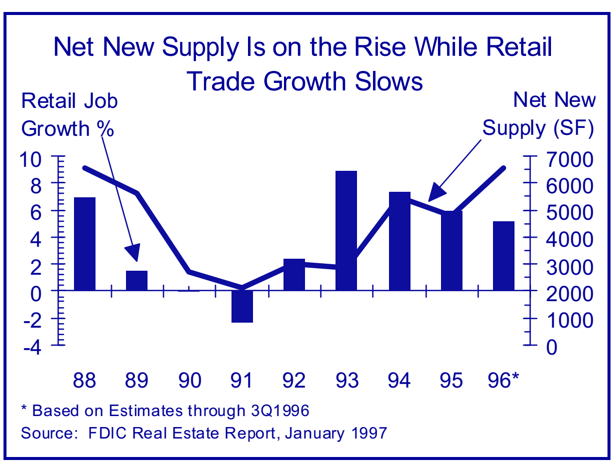
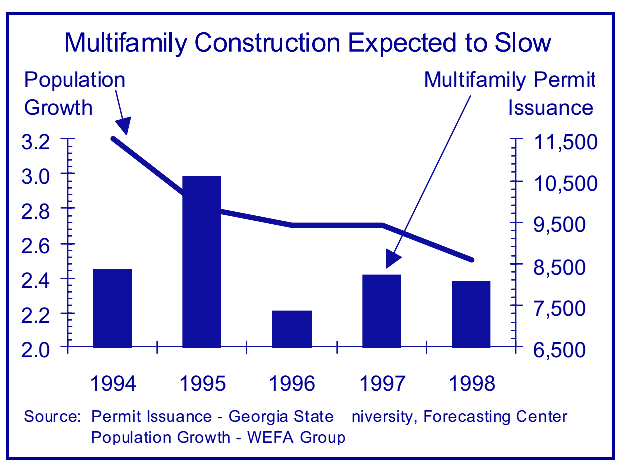


CHART 4



cle. The metro area's occupancy rate is expected to decline again in 1997 to 92 percent occupancy as an additional 10,000 units will be constructed. At the same time, analysts expect a slowdown in corporate relocation and in-migration to Atlanta from other parts of the nation. Hence, it appears that the Atlanta metro area population will not continue to grow at the rapid pace experienced over the past three years (see Chart 4 previous page). *Given that apartment construction is expected to remain strong and population growth appears to be leveling off, the Atlanta multifamily housing market may be in the early stages of overbuilding.*

Implications: Atlanta's economy appears to be in a state of transition, posing a number of challenges to the metro area's commercial real estate developers that have a presence in possibly overbuilt markets. As a result, caution may be warranted for lenders anticipating continued strong demand for commercial and multifamily real estate.

Jack M.W. Phelps, Senior Regional Analyst
Scott C. Hughes, Regional Economist
Pamela R. Stallings, Financial Analyst

Financial Markets

- **While demand for asset-backed securities continues to be strong, further deterioration in consumer credit quality could have adverse effects on both investors and issuers.**

- **Although there has been little net change in the Treasury yield curve between September 30, 1996, and early March 1997, rates in the 5-year to 30-year segment of the yield curve did fluctuate modestly during this time period.**

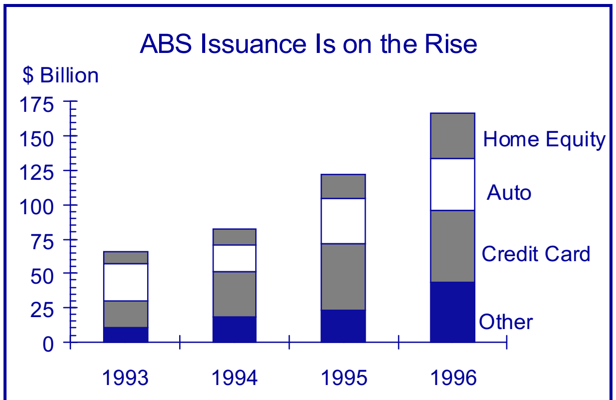
- **During the fourth quarter 1996, the Atlanta Region's Bank Index outperformed both the S&P Composite Bank Index and S&P 500, gaining almost 15 percent, compared to a 12 percent gain for the S&P Composite Bank Index and an almost 8 percent gain for the S&P 500.**

- **Banks' price/earnings ratios relative to the broader market have been trending upward since 1994, perhaps signaling an improved perception of the quality of bank earnings.**

The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

Asset-backed securities (ABS) are debt securities that are backed by loans such as credit cards, car loans, and home equity loans. Over the past ten years, the ABS market has grown dramatically. In 1996, the issuance of ABS was $167 billion, up from $65 billion issued in 1993 as illustrated in Chart 1. Commercial banks and credit card companies accounted for approximately 35 percent of total ABS issuance last year. Major buyers of ABS were mutual funds, insurance companies, corporations, and foreign and domestic banks. Although it is difficult to quantify the amount of bank investment in the ABS market, market participants have observed that small and midsized banks have recently increased their holdings of ABS.

CHART 1



Source: Bloomberg, *Inside MBS and ABS*

Monoline credit card banks and large banks with significant credit card operations have been particularly active ABS issuers. Issuing banks generally structure ABS transactions as nonrecourse sales (loans that cannot be "put back" to issuers upon default), which results in the removal of the assets from the bank's balance sheet and lowers capital requirements. In order to receive investment grade ratings on their ABS, issuers must provide credit support either in the form of overcollateralization, reserve accounts, or third party credit enhancement from bond insurers.

Bank issuers benefit from the sales treatment of assets into the security without completely severing their economic interest in the income generated by the assets. The economic interest results when the revenue generated by the sold assets after charge-offs, servicing fees, and interest coupon payment is recognized as income by the issuer. This surplus is referred to as excess spread. Banks that issue ABS usually continue to service the underlying assets, which not only generates servicing income but also permits customer relationships to continue.

Delinquency and charge-off rates rose in 1996 on consumer loans, particularly in credit cards and auto loans. Despite this rise, the difference between ABS and Treasury yields of similar maturity did not increase. As Chart 2 (next page) shows, the average spread to the two-year Treasury note on selected ABS products continued to tighten during 1996. The lack of widening spreads despite the overall weakening in consumer credit quality reflects strong demand from an expanding investor base, which increasingly includes overseas buyers. Spreads on selected credit card and auto ABS products began to increase during the first quarter of 1997, however, as investors reacted to higher than expected charge-offs reported by some of the larger issuers.

The increasing frequency of rating agencies' reviews for possible downgrades of credit card transactions, as well as problems in the auto finance sector, have raised some concerns in the ABS market. How would a further deterioration in consumer credit affect the ABS market? For the issuer, higher charge-offs, absent a corresponding increase in fees or rates, reduces the excess spread from the ABS. If deterioration worsens, the ABS face potential rating downgrades. This situation may compel the issuer to improve the overall loan quality in the ABS or face what is termed an "early amortization" event. An early amortization event may result in the termination of the ABS issue prior to the maturity date. Once an early amortization occurs, new receivables associated with the accounts in the asset-backed security no longer move into the security but must be funded by the bank on their balance sheet and accounted for in determining capital requirements. In addition, an issuer's access to the ABS market may become more costly after an early amortization if investors demand higher yields on subsequent issues.

For the investor, the threat of a ratings downgrade usually impairs the market value of the security. Investors also may forfeit some interest income in an early amortization because principal may be paid prior to the scheduled maturity date. ABS investors would lose principal, however, only if the deterioration in the quality of the underlying loans is severe enough to deplete the entire credit support. The high level of credit support demanded by rating agencies on existing ABS deals minimizes the risk of principal loss by investors.

During 1996, some bankcard issuers took steps to prevent a ratings downgrade or a possible early amortization. Methods used by bank issuers to support deteriorating ABS have included the sale of new receivables at a discount, the repurchase of low quality receivables from the issue, and the infusion of additional cash into a reserve account of the ABS. However these strategies were specifically cited by the Office of the Comptroller of the Currency (OCC) as actions that could be considered recourse and require full risk-based capital treatment for the assets in the particular ABS issue. The FDIC is working with other regulatory agencies through the Federal Financial Institutions Examination Council (FFIEC) on new Risk-Based Capital Guidelines that are expected to address limitations on post-sale actions and capital requirements for direct credit substitutes or credit enhancements for ABS.

Given the continuing trend of higher charge-offs and delinquencies for credit card loans, investors consider the ABS market less homogeneous in terms of issuer quality and therefore are scrutinizing the securitizations of issuers more closely. Although the risks vary by ABS issuer, banks that issue or invest in the ABS market should be cognizant of the changing market conditions and potential risks associated with ABS.

Changes in Interest Rates and Bond Values

Chart 3 (next page) shows little change in the Treasury yield curve between September 30, 1996, and early March 1997. What this chart does not show, however, is how rates in the 5-year to 30-year segment of the yield

CHART 2

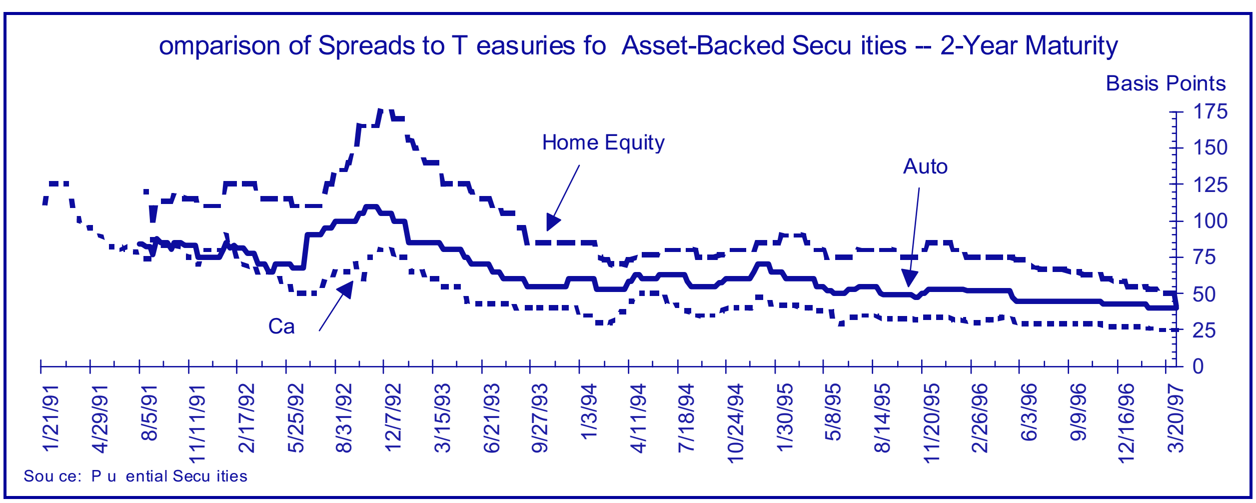


Chart 3

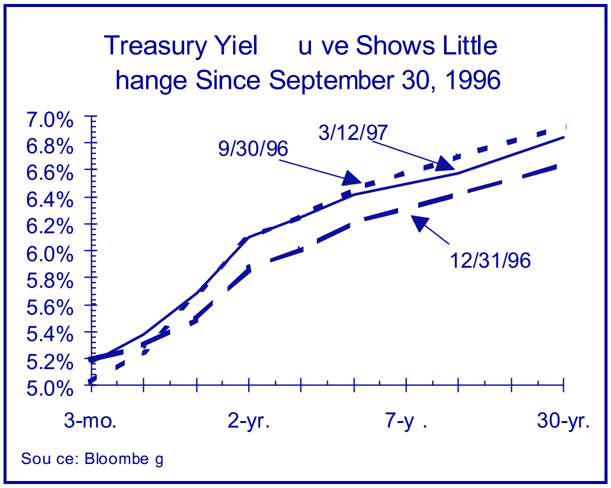
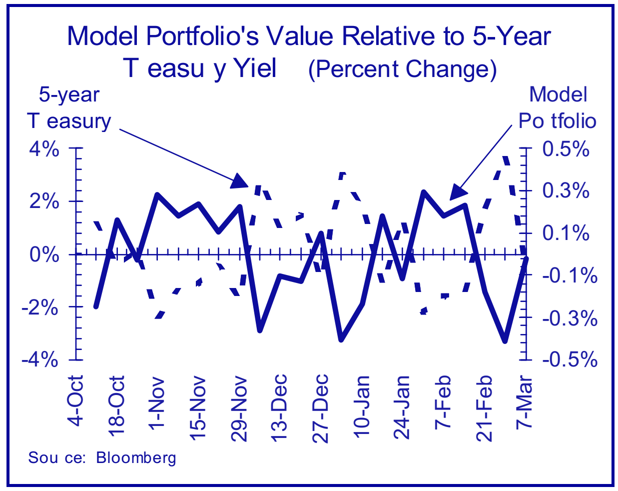


Chart 4



curve fluctuated during this time period. The path of yields on Treasury bonds with 5-year through 30-year maturities changed directions four times, rising or falling by more than 30 basis points. Movements in the shorter segment of the yield curve have been less pronounced.

In order to consider the effect that these rate swings may have had on banks' fixed income portfolios, Chart 4 shows the percent change in the yield on the 5-year Treasury and the percent change in the market value of a model bank portfolio created by the Division of Insurance. The presentation of this model portfolio extends an analysis that was introduced in the first quarter 1997 edition of the ***Regional Outlook***, which looked at the market values of several common fixed income instruments relative to interest rate movements.

In order to enhance the model portfolio's applicability to bank portfolios, the type and amount of the securities chosen for the portfolio are based on an aggregation of securities-related Call Report data. The limitations of Call Report data concerning the maturity distribution of securities required that assumptions be made when choosing the maturity of the securities for the model portfolio. An effort was made, however, to construct a model portfolio that approximates, in the aggregate, the maturity distribution of the aggregate commercial bank portfolio. The model portfolio is shown in Table 1.

As shown in Table 1, the total market value of the portfolio changed less than one-half of 1 percent since September 30, 1996. The portfolio's period-high value, representing a 1.51 percent increase from September 30, 1996, occurred on November 29, 1996, when the 5-year

Table 1

Type of Security	Par Value	Percent of Portfolio	Maturity or WAL	Percent Change from 9/30/96 to 12/31/96	Percent Change from 12/31/96 to 3/12/97	Percent Change from 9/30/96 to 3/12/97
U.S. Treasury 5.6%	2,000	20%	1yr	0.35%	-0.05%	0.30%
FNMA Agency 5.8% Callable	1,200	12%	2yr	0.59%	-0.25%	0.34%
State County Municipal GO 4.8%	800	8%	11yr	1.95%	-0.64%	1.95%
FNMA Mortgage Passthrough 7.5%	3,000	30%	8yr	1.08%	-0.30%	0.78%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5yr	0.58%	-0.68%	-0.10%
Credit Card Asset-Backed Security	1,000	10%	5yr	0.10%	0.00%	0.10%
Total	10,000	100%	4.85yr	0.77%	-0.29%	0.48%

Treasury rate fell to its period-low of 5.83 percent. Observe that, while longer term rates fluctuated modestly over the reporting period, the reasonably short weighted average life (WAL) of the portfolio further moderated the value changes sustained by the portfolio. Changes in the value of the model portfolio demonstrate a higher correlation to changes in the 5-year Treasury yield than to other maturities along the yield curve because the 5-year bond's maturity better matches the WAL of the model portfolio. Even though the 30-year Treasury rate is often cited as a benchmark for daily rate changes, it may not be the most significant rate in assessing exposures of bank securities portfolios to changes in interest rates.

On March 25, 1997, the Federal Reserve Open Market Committee met and raised the target federal funds rate 25 basis points to 5.50 percent. By the following day, the 5-year Treasury yield had risen to 6.66 percent, 23 basis points higher than the 5-year Treasury yield dated March 12, 1997, displayed in Chart 3 (previous page). The rise in rates from March 12 to March 26 caused the model portfolio's market value to fall 0.56 percent to $9,965.

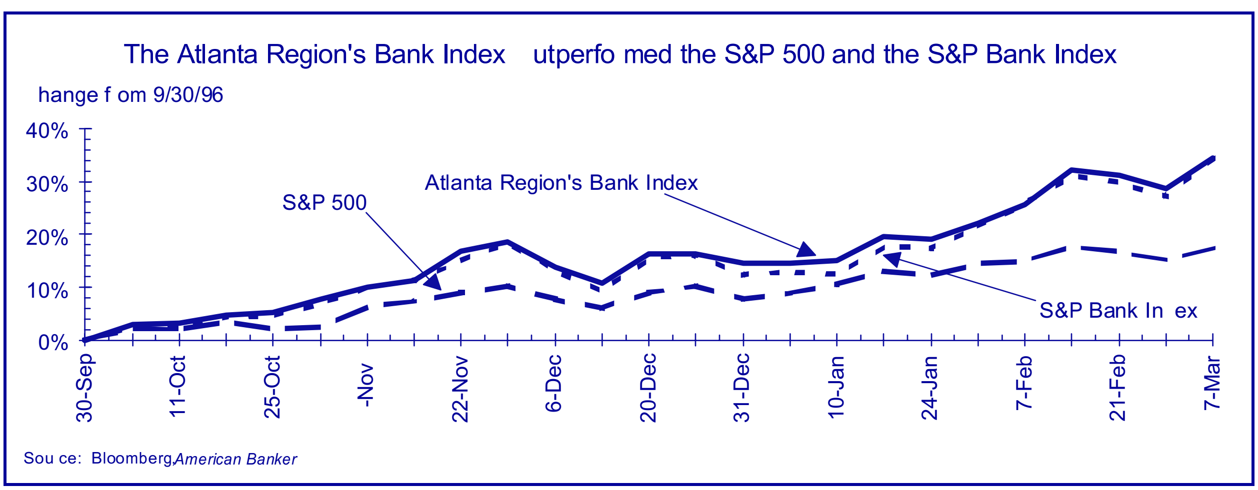
This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect a portfolio's relative volatility.

Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market Improving its Perception of the Quality of Bank Earnings?

During the fourth quarter of 1996, the S&P Composite Bank Index outperformed the S&P 500, gaining over 12 percent compared to an almost 8 percent gain for the S&P 500. The fourth quarter results topped off a year during which the S&P Composite Bank Index gained 37 percent compared to a 20 percent gain for the S&P 500. As shown in Chart 5, the Atlanta Region's Bank Index (ARBI) gained 14.6 percent in the fourth quarter 1996. The ARBI gained almost 34 percent for the full year 1996: enough to outperform the S&P 500, but not the S&P Composite Bank Index. The year's moderate economic growth, contained inflation, and favorable interest rates are credited for providing a friendly environment for bank stocks. As 1997 began with much the same economic conditions, bank equities have continued to do well. The ARBI was up a little more than 17 percent compared to an almost 20 percent gain for the S&P Bank Index and a 9 percent gain for the S&P 500, through March 7, 1997.

While appreciating stock prices provide an obvious positive signal about the health of the industry, the market provides other information about the prospects for the industry through the price/earnings (P/E) ratio. The P/E ratio presents the price of a company's stock as a multiple of its earnings per share and is derived by dividing the stock's market value by the company's earnings per share. Typically investors are willing to pay a higher price for a company with earnings that are expected to be consistent and growing. However, firms with more volatile earnings are generally penalized by investors in terms of stock price and lower P/E ratios. Generally, a higher P/E ratio can be interpreted to mean

CHART 5

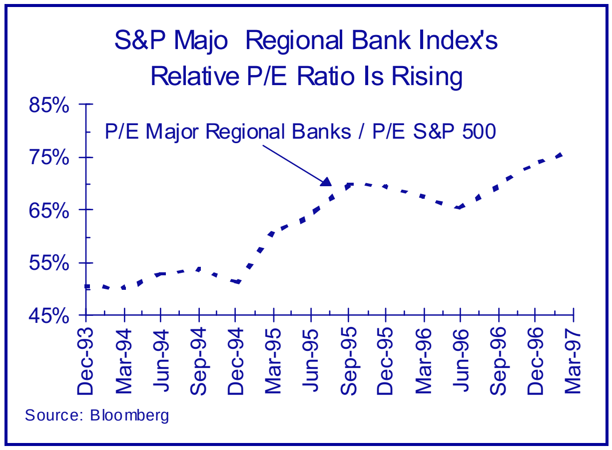


that investors have more confidence in the outlook for future earnings performance.

The relationship between bank P/E ratios and the P/E ratios for the broader market provides further insight into the market's perception of the quality of bank earnings compared to other firms. Historically, bank P/E ratios have been lower in the aggregate as compared to the rest of the market. The rationale posed for this discounted bank P/E ratio relative to the broader market has been that the primary sources of bank revenue, deposit taking and lending activities, traditionally have been viewed as being more volatile because they are prone to rising and falling with changes in the business cycle. For example, despite recording some of the highest quarterly return on equity averages ever at the end of 1993, the P/E ratio of the major regional bank index was at a level that was still only about 50 percent of the broader market P/E.

Over the past two years the magnitude of the banking sector's P/E discount has declined. As seen in Chart 6, the P/E discount has gone from 50 percent to only 24 percent (a relative P/E ratio of 76 percent). The higher P/E ratio may represent a view by market participants that bank earnings are becoming less sensitive to the business cycle, perhaps as a result of geographic or product-related diversification and more efficient management of overhead expenses. Another factor contributing to higher bank P/E ratios could include speculation on bank stocks as investors anticipate potential acquisitions.

Chart 6

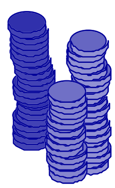


Allen Puwalski, Banking Analyst
Kathy R. Kalser, Chief,
Financial Sector Analysis Section

Current Regional Banking Conditions

- **In the Atlanta Region, bank profits slipped slightly during the quarter and thrift profitability bounced back. However, the percentage of unprofitable thrifts is well above the national average.**
- **Commercial banks in metropolitan Atlanta are increasing their commercial real estate lending activity.**
- **Consolidation has reduced the number of banks, but institutions opened more offices during the year.**

Fourth Quarter Profits Dip Slightly at Banks, but Rebound at Thrifts



For the second consecutive quarter, the quarterly return on assets (ROA) for banks in the Atlanta Region declined. Banks generated an annualized ROA of 1.17 percent, which matched results from a year ago. Current quarter results slightly trailed the national ROA of 1.19 percent. The number of banks reporting negative quarterly earnings rose for the third consecutive quarter to 111, or 9 percent of all banks in the Region compared to 8.8 percent nationally.

A narrowing of banks' net interest margin and increased loan loss provisions caused the drop in bank profitability. *The higher provisions were mainly driven by higher consumer loan losses, particularly credit cards.* The quarterly loan charge-off rate rose to 0.55 percent, up from 0.49 percent in the fourth quarter of 1995. *In dollar terms, net credit card charge-offs rose 62 percent in 1996 to $1.16 billion, for a charge-off rate of 4.21 percent, up from 3.15 percent last year and surpassing the last cyclical peak of 3.58 percent in 1991.*

After the one-time SAIF assessment last quarter caused a negative annualized ROA of 0.42 percent, the ROA for the Region's thrifts rebounded smartly to 0.70 percent. While the quarterly return matched last year's, it was 15 basis points below the national average for all thrifts. Several factors, including healthy net interest margins, lower provision and noninterest expenses, and higher securities gains led to the rebound in profitability. Nevertheless, there are some areas of weakness. *Overhead costs at 3.25 percent of assets for the Region's thrifts were 95 basis points above the national average.* Almost 14 percent of the Region's thrifts had negative earnings in the quarter, up from 9.8 percent last year. *Moreover, the percentage of unprofitable thrifts in the Region is almost twice as high as the national average of 7.3 percent.*

...the percentage of unprofitable thrifts in the Region is almost twice as high as the national average of 7.3 percent

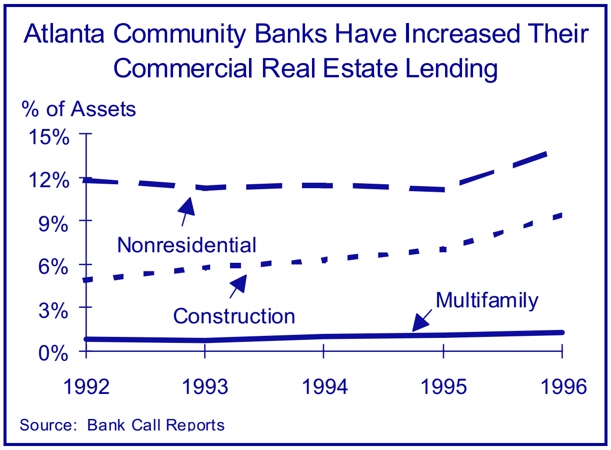
Commercial Real Estate Lending Exposure in Metropolitan Atlanta is Growing

Most segments of the commercial real estate market in metropolitan Atlanta have rebounded strongly from the last economic downturn. A cyclical high already may have been reached in the retail market, and highs may be nearing in the office and multifamily segment (see ***Slower Growth in the Atlanta Region***). At this stage of the cycle, an analysis of commercial real estate lending by Atlanta community banks is appropriate.

For this analysis, an Atlanta community bank peer group was developed. The group includes all commercial banks in the Atlanta Metropolitan Statistical Area (MSA), except four large banks that are controlled by super-regional bank holding companies. These four banks were excluded because a significant portion of their lending is outside the Atlanta MSA. Also, the Call Report does not provide lending data by geographic area. Commercial real estate loans include construction and development loans, loans secured by multifamily properties, and loans secured by nonresidential real estate.

As seen in Chart 1 (next page), Atlanta community banks have expanded their commercial real estate lending in recent years. Overall, commercial real estate loans

CHART 1



have increased from 17.5 percent to 24.8 percent of assets since year-end 1992. On average, commercial real estate loans represent 271 percent of equity, up from 202 percent at year-end 1992. Currently, 19 banks or 26 percent of the peer group have a concentration of commercial real estate loans to equity above 400 percent, compared with just ten banks and 11 percent of the peer group in 1992. The increased concentration of commercial real estate loans to equity is impressive considering that equity has grown at a 10.1 percent compound rate for the last five years.

The commercial real estate past-due ratio appears to be bottoming out. After hitting a cyclical high of 3.52 percent in 1991, the ratio dropped 260 basis points by 1992 and has declined gradually by 22 basis points to 0.70 percent over the last three years. onperforming construction and development loans increased 75 percent during 1996, but the past-due ratio is only 0.82 percent. The multifamily and nonresidential segment have shown a decline in the dollar volume of nonperformings and have a past-due ratio of close to 65 basis points.

> *...most Atlanta community banks are not actively involved in commercial office construction projects...*

FDIC examination personnel, however, report that most Atlanta community banks are not actively involved in commercial office construction projects and that the majority of their construction and development lending is for residential real estate projects located in bedroom communities outside the perimeter highway circling the city. This would suggest that the Atlanta community bank peer group would be minimally affected if a downturn occurred in Atlanta's commercial real estate markets. evertheless, the large and growing concentration of commercial real estate does make the peer group susceptible to any spillover effects from a downturn. Finally, since the bulk of construction and development lending is residential, the group is exposed to changes in economic and demographic factors that drive the Atlanta residential real estate market.

Bank Structure Changes in 1996: Fewer Banks, but More Offices

Table 1 provides a summary of structure changes of commercial banks in the Atlanta Region. *Last year, the number of banks declined by 81 or 6.2 percent while the number of domestic banking offices rose by 346 or*

TABLE 1

OWNERSHIP STRUCTURE, ASSETS, AND DOMESTIC OFFICES OF ATLANTA REGION BANKS

	Multibank Holding Company			One-Bank Holding Company			Independent Banks		
Year	#	Assets ($ Billions)	Offices	#	Assets ($ Billions)	Offices	#	Assets ($ Billions)	Offices
1995	427	$489.9	8,408	486	$120.2	3,400	396	$34.9	1,128
1996	390	542.2	8,887	479	124.1	3,407	359	34.7	988
Change	(37)	53.3	479	(7)	3.2	7	(37)	(0.2)	(140)

Source: Bank Call Reports, Bank Structure Data

2.7 percent. The majority of changes occurred within multibank holding companies (MBHCs) and independent banks. Mostly through internal reorganizations, MBHCs reduced the number of banks they control by 8.7 percent. Conversely, MBHCs expanded the number of their banking offices by 5.7 percent. *Independent banks saw reductions both in number (9.3 percent) and offices (12.4 percent); the opening of 19 de novo banks during the year prevented larger declines*.

Geographically, office expansion was concentrated in Virginia (8.2 percent) and Alabama (4.7 percent); all other states experienced growth rates below the 2.6 percent average. Although 18 percent of the increase in offices occurred in Georgia, state officials were expecting much stronger growth due to a liberalization of branching laws allowing limited *de novo* branching.
The growth in the number of banking offices seems paradoxical given the cost-cutting fixation of many banking organizations and the frequent brick-and-mortar obituaries penned by industry observers. Moreover, the expansion in offices is occurring despite the increased use of alternative delivery methods -- like ATMs, phone centers, closed personal computer systems, and the Internet. The other major structure trend is a greater concentration of assets and offices held by MBHCs and a decline in the number of banks with assets under $100 million. Since 1991, these small banks have declined in number by 37 percent to 705 from 1,112.

Jack M. W. Phelps, Senior Regional Analyst
Pamela R. Stallings, Financial Analyst
Scott C. Hughes, Regional Economist

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