# Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 1997


FDIC
MEMPHIS
REGION

## In Focus This Quarter

■ ***Subprime Lending: A Time for Caution—*****The extent of subprime lending is increasing as strong competition for high-quality borrowers has some lenders moving down the credit quality spectrum. Subprime lending requires a commitment of resources and expertise beyond that required in more conservative lending, and the consequences of deficiencies in underwriting, servicing, and collection can be severe.** *See page 3.*

*By Kathy R. Kalser, Debra L. Novak*

■ ***Retail Shakeout: Causes and Implications for Lenders—*****Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions.** *See page 6.*

*By Richard A. Brown, Diane Ellis*

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*By Gary L. Beasley, Tracy F. Hall, Wallace D. Peddicord*


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# Subprime Lending: A Time for Caution

- **Subprime lenders specialize in lending to borrowers with blemished or limited credit histories.**
- **The consequences of deficiencies in underwriting, servicing, and collection can be severe with subprime lending. Lenders that fail to dedicate the necessary resources in these areas likely will have trouble succeeding in the increasingly competitive market for subprime loans.**
- **Some institutions insured by the FDIC have failed to properly assess and control the risks associated with their subprime lending programs.**

### *What Are Subprime Loans?*

Faced with strong competition and shrinking margins on loans to high-quality borrowers, some lenders are moving down the credit quality spectrum. The strategy to extend loans to borrowers perceived as less creditworthy is referred to as "subprime" lending. *Subprime lending is most commonly associated with auto, home equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories.* Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

Subprime loans also are referred to as marginal, nonprime, or below "A" quality loans. There are no established guidelines for determining the degree to which a borrower is considered subprime, so one lender's "B" customer could be another lender's "C" customer. Definitional variations aside, some general market parameters on ranking loans are presented in Table 1.

**Table 1**

| Criteria for Loan Rankings | | |
|---|---|---|
| Grade | Payments Late 30 Days | Bankruptcy Filing |
| Prime | None | None |
| A- | Less than 2 | None in 5 years |
| B | Less than 4 | None in 3 years |
| C | Less than 6 | None in 2 years |
| D | Constantly Late | None in 1 year |

Sources: Duff & Phelps, Standard & Poor's, Mortgage Market Information Services

### *How Big Is the Market?*

The lack of a standard definition for a subprime loan makes it difficult to accurately determine the extent of the market. However, some industry experts estimated that during 1996, subprime loans secured by residences, including both home equity and mortgage loans, amounted to between $100 billion and $150 billion compared to the estimated $800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between $75 billion and $100 billion, or about 20 percent of total auto loans outstanding.

### *Who Makes Subprime Loans?*

In the past, subprime lending was primarily the domain of a limited number of finance companies. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of subprime lenders, however, has surged in recent years as more companies have been attracted by the significantly higher rates and fees earned on subprime loans. In some cases, yields on these higher risk assets have been as high as 15 percent to 30 percent. The new subprime participants include finance companies that traditionally served prime borrowers, new specialized subprime lenders, and banks.

The increase in the number of subprime lenders has been fueled by strong demand from investors for asset-backed securities (ABS). This method of funding enables the lender to effectively raise cash at a lower rate to fund loan growth. In addition, the subprime ABS market has attracted lenders that previously refrained from making subprime loans because they did not want to maintain these high-risk loans or the associated reserves on their balance sheet. By issuing securities backed by subprime loans, lenders now have the ability to originate subprime loans and sell them to ABS investors.

Favorable stock market conditions also helped to fund the growth of subprime lenders. Approximately 30 subprime lenders raised nearly $3 billion from stock offerings from January 1995 through April 1997, according to market watchers. This financing avenue may become less accessible, as investors' concerns over financial problems of several major market participants have caused stock prices of subprime lenders to decline significantly during the first part of 1997.

### *Financial Difficulties of Some Subprime Lenders*

Market participants have observed that, as in credit card lending, *increasing competition may be compelling some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share*. Financial difficulties reported by major subprime auto lenders Jayhawk Acceptance Corporation and Mercury Finance Company highlight these concerns.

Problems in subprime lending are not limited to auto loans. Lenders that specialize in subprime home equity loans and mortgages also are showing signs of stress. In April 1997, Moody's Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home equity loans. The reason was concern over the increasing level of delinquencies in the issuer's loan portfolio and the highly competitive environment for subprime home equity loans (see ***Financial Markets***).

### *Differences between Prime and Subprime Lending*

*There are key differences between the underwriting, servicing, and collection methods used for prime and subprime lending programs.* The goal of the subprime underwriting process is to differentiate those subprime borrowers whose past credit problems were due to such temporary events as illness or job loss from the habitually bad credits. Subprime lenders often supplement a prospective borrower's credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. This process allows the lender to better determine the credit risk or "grade" of the borrower. If this determination is successful, the lender can better establish the price at which the loan will be profitable.

Servicing and collection of subprime loans tends to be more labor intensive and costly than in prime lending. Subprime lenders tend to monitor payments more closely than prime lenders. Some purportedly call their borrowers regularly to remind them when a payment is due. In addition, while prime lenders may be willing to work with late borrowers by adjusting minimum amounts or payment schedules, subprime lenders generally pursue collections more aggressively and repossess collateral more quickly.

### *Insured Institutions and the Subprime Market*

Bank involvement in subprime lending is difficult to quantify because subprime loans are not delineated in bank and thrift Call Reports. *However, both large and small banks reportedly are participating in credit card, auto, home equity, and mortgage subprime lending.* Insured institutions have used various strategies to establish a presence in the subprime market. Some have:

- acquired or formed joint ventures with companies specializing in subprime lending;
- built subprime lending programs internally, using existing resources; and
- tapped a network of loan brokers with access to subprime borrowers. Smaller banks entering the market for subprime mortgages may use this method more commonly.

Through these strategies, insured institutions have:

- extended loans directly to subprime borrowers or purchased subprime loans from loan brokers;
- lent to subprime specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines; and
- serviced subprime loans or invested in asset-backed securities secured by subprime loans.

### *Risks Associated with Subprime Lending Need to Be Considered Carefully*

According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because of the relatively high default rates on such loans, the FIL indicates that this type of lending warrants particular caution and management attention.

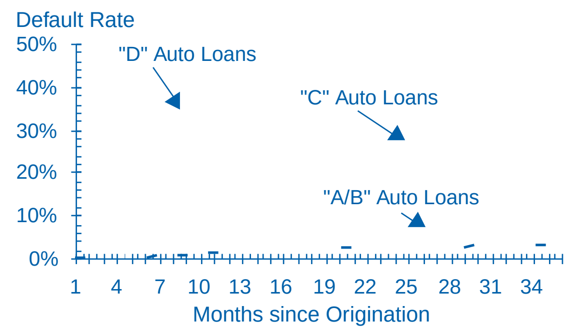
Institutions need to be thoroughly aware of the increased risks and costs associated with lending to higher risk borrowers. Some of these risks include:

- *Delinquencies and defaults tend to be more frequent and occur sooner on lower quality loans* (see Chart 1).
- Loan loss reserves that would have been adequate for prime lending may not properly cover higher loss rates associated with subprime loans.
- Strains on underwriting and collection resources may emerge.
- Because selling collateral is more frequently the source of repayment on subprime loans, failure to accurately estimate recovery values could severely affect the profitability of subprime lenders. For example, several subprime auto lenders recently reported lower profits when the supply of better quality cars coming off leases depressed the prices they received on repossessed cars.

Insured institutions that rapidly increase subprime exposures also may need to reevaluate delinquency measurement methodologies. Rapid loan growth can make it more difficult to accurately track delinquency and default trends. Generally loans do not default immediately, but "season" or reach peak loss rates over a period of time. *Delinquency and default rates can be deceptively low if the proportion of new loans exceeds the proportion of seasoned loans in a lender's portfolio.* Calculating default rates over time for loans originated in a particular period or lending program, instead of as a percentage of total outstanding loan balances, helps reduce the distortion caused by rapid loan growth. This method of computing delinquency and default rates, known as "static pool" or "vintage analysis," is a common measurement tool among investment analysts.

CHART 1

Defaults Are More Frequent and Occur Sooner on Lower Quality Auto Loans




Source: Fitch Investors Service, L.P.

Banks involved in subprime lending also should realize that the recent increase in subprime lending has occurred during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be more susceptible to downturns in the economy, which could further exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

In addition, banks that lend to subprime specialty lenders, who rely heavily on securitization, should evaluate the accounting treatment of securitization and the effect securitization may have on earnings (see ***Financial Markets***).

### *Conclusion*

The extent of involvement by insured institutions in subprime lending is difficult to quantify. To be successful in subprime lending requires a commitment of resources and expertise. Conversely, deficiencies in assessing and controlling the risks of subprime lending can have serious consequences. Such deficiencies have surfaced at a number of FDIC-insured institutions. Striking an appropriate balance between the risks and rewards of subprime lending is a challenge for bankers and merits the continued attention of bank supervisors.

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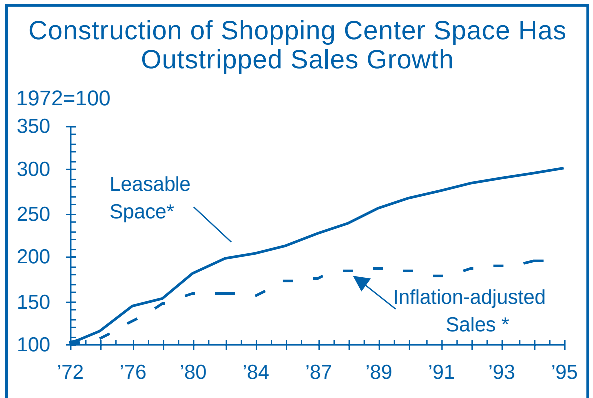
# Retail Shakeout: Causes and Implications for Lenders

- **Changes in the marketplace, technology, and finance are transforming retailing.**
- **These trends have given rise to rapid growth in the new "big box" store format.**
- **Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.**
- **The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.**

For the past two decades, construction of retail space has outstripped many indicators of demand such as growth in retail sales, population, and income. The broadest measure of the industry's health is sales per square foot, and, for shopping centers, it has fallen by around 35 percent in real terms since 1972. Chart 1 shows how growth in leasable shopping center space has exceeded growth in shopping centers' sales since 1972.

CHART 1




* Does not include non-shopping center space.
Source: International Council of Shopping Centers

Based on signs of "overstoring," a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate, they are exposed to heightened credit risk as the shakeout unfolds.

## *New Forces Are Reshaping the Retail Landscape*

A combination of demographic and economic forces has reduced growth in demand for retail goods from the boom days of the 1970s and mid-1980s. Meanwhile, technology is reconfiguring the way retail goods are marketed and delivered, and a low cost of capital has stimulated investment in new retail space and new retailing concepts.

A retail industry boom began roughly in 1970 when baby boomers and women began entering the work force in record numbers. At the same time, proliferation in general-purpose credit cards facilitated an extension in consumer borrowing power. As a result, there was a 98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

To meet this demand and serve expanding suburban communities, developers built shopping centers at a rapid pace. The number of shopping centers, from small neighborhood strip centers to huge regional malls, grew from about 13,000 in 1972 to over 41,000 in 1995.

***Despite economic conditions that seem favorable for the retail sector, revenue growth has been painfully slow in the 1990s.*** Payrolls have seen net growth of 13.4 million jobs since mid-1991, while real disposable personal incomes and consumer confidence have risen commensurately. An optimistic household sector has shown a willingness to take on debt under these favorable conditions and has done so with the benefit of lower interest rates compared to the 1980s.

Even with generally positive economic conditions, retail demand has grown slowly in the 1990s (see Chart 2, next page). Annual rates of increase in real expenditures on many durable and, especially, nondurable goods have lagged behind rates of the previous two decades.

Slow growth in retail revenues can be explained in part by the fact that retail goods overall have risen in price at only around two-thirds of the general rate of inflation during the 1990s, while the appliance, electronics, and personal computer sector has seen actual price deflation.

An aging consumer base is another factor holding down retail sales growth. The total number of households headed by persons age 20 to 35—the age at which families are getting established and acquiring household durable goods—is the same now as it was in 1980. The lack of growth in this key demographic group has limited growth in retail demand and should continue to do so for the foreseeable future. The total population in the 20 to 35 age bracket is projected to decline slightly by 2007.

Other broad trends have contributed to slower retail sales growth. Retail sales as a percentage of personal income fell from 46 percent to 38 percent between 1967 to 1996 as consumers shifted more of their disposable income to the purchase of personal services, housing, education, travel, and entertainment. A ***Standard and Poor's Industry Survey*** reports that consumers have reduced their number of trips to shopping malls by 35 percent since 1980, while total shopping hours are down 70 percent.

Looking ahead, mail-order retailing through electronic media, including cable television and the Internet, may be poised to gain significant market share at the expense of shopping centers. "Virtual shopping malls" such as Amazon.com, an Internet bookseller, have made headlines with their initial successes, although analysts caution that widespread adoption of high-tech shopping may be some years down the road.

***Technology has become a key to distribution and marketing.*** Faced with slower revenue growth, retailers have been investing in technology to cut their expenses and boost their bottom lines. For example, point-of-sale scanning delivers a vast amount of information that can be used to target marketing efforts and manage and control inventories—providing a distinct competitive advantage for large retail chains with vast marketing and distribution networks.

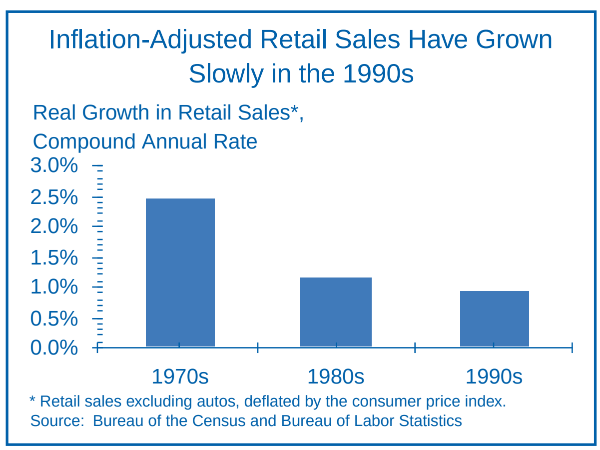
***A low cost of capital has fueled investment.*** Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise have been infeasible. Since 1991, around 1.13 billion square feet of new retail space has been added nationwide representing an increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost $33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although they are known to be sizeable.

### *Growth of the "Big Box" Format*

Leading retailers have responded to these forces with aggressive expansion in the "big box" store format. Big box retailers are typically discount stores and superstores, such as Circuit City, PetSmart, and The Home Depot, Inc., which tend to cluster in large strip malls called "power centers." In many towns and cities, the arrival of big box stores has left smaller, local retail establishments with only a small fraction of their former share of the local market.

The big box format has a number of advantages. Among the most important is the ability to offer a large, diverse on-shelf selection. This approach enables a single location to dominate that retail category in the local market, which is why the big box chains are often referred to as "category killers." Large retail chains also have more leverage over suppliers. They can negotiate more favorable prices and demand cooperative advertising from manufacturers. Large retailers typically have the financial resources to invest in the latest distribution methods and technology. Finally, unlike smaller traditional retailers, these large chains can obtain financing through the capital markets.

**CHART 2**




* Retail sales excluding autos, deflated by the consumer price index.
Source: Bureau of the Census and Bureau of Labor Statistics

### *Industry Consolidation to Continue*

Rapid expansion among the large retail chains has contributed to a highly competitive retail sector marked by intense battles for domination of the major retail categories. The result of this competition, analysts say, will be consolidation in the industry as weaker chains give way to market leaders.

One sign of this consolidation is in multibillion dollar acquisitions, such as Federated Department Stores' acquisition of R.H. Macy. The five largest department store chains (JC Penney, Federated, May, Dillard, and Nordstrom) now account for 87 percent of department store sales nationwide. The top three discount department store chains (Wal-Mart, K-Mart, and Target) account for 87 percent of full-line discount department store sales.

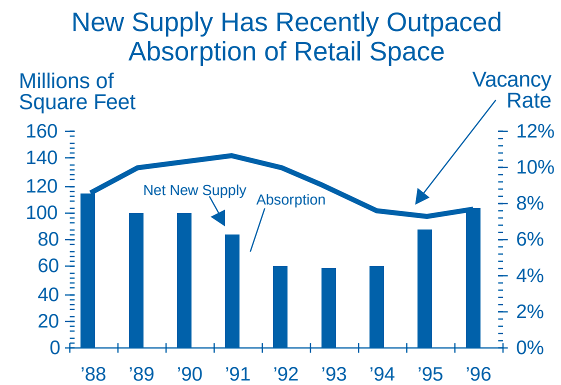
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more likely to be forced into bankruptcy. ***Dun & Bradstreet*** reports that domestic business failures among retail establishments rose in 1995 by 2.8 percent to 12,952. While most of these failures were individual stores and small chains, a number of larger chains also filed for bankruptcy during 1995, including Barney's, Bradlees Inc., Caldor, The Clothestime Inc., Edison Brothers Stores, Elder-Beerman, Herman's Sporting Goods, Jamesway, and Today's Man.

As the retail shakeout moves forward, any credit losses on commercial and industrial loans to retailers are more likely to arise from bankruptcies and restructurings than from mergers and acquisitions. Unfortunately, it is difficult to say in advance exactly how consolidation in the industry is likely to take place.

### *Overbuilding Is a Risk for Retail Real Estate*

*Retail industry analysts are particularly concerned about the potential for overbuilding of retail space.* Because of this concern, lenders and examiners should be alert to possible credit quality problems with commercial real estate loans secured by retail properties.

CHART 3




Source: FDIC, *The Real Estate Report* (Summary for 58 major markets)

Although a vacancy rate of 7.7 percent does not suggest that the U.S. retail market is vastly overbuilt at present, there are warning signs. One is that the U.S. aggregate vacancy rate has begun to tick upward since 1995 as net completions of new retail space have caught up to and surpassed the absorption of that space by retailers (see Chart 3). Another frequently cited indicator of overbuilding is a falling ratio of sales per square foot in the industry, reflecting the fact that additions to retail space have outpaced sales growth for some time. In any case, local market conditions may be somewhat more volatile than the national figures would suggest, particularly in areas where a great deal of construction activity has recently taken place (see inset, ***Retail Construction on the Rise in Memphis Region***).

Besides market conditions, underwriting is the other major determinant of credit quality in retail real estate lending. Market analysts report that many of the problems resulting from local market downturns have been on loans with 1980s-vintage underwriting, particularly those with high loan-to-value ratios. Analysts also voice concern that the rapid expansion of space may be putting downward pressure on lease rates. *In light of an ample supply of space and a number of large chains continuing to add space, any valuations that assume future growth in lease rates should be closely reviewed.* The viability of rapid expansion on the part of the large retail chains would undergo a particularly severe test in the event of a recession.

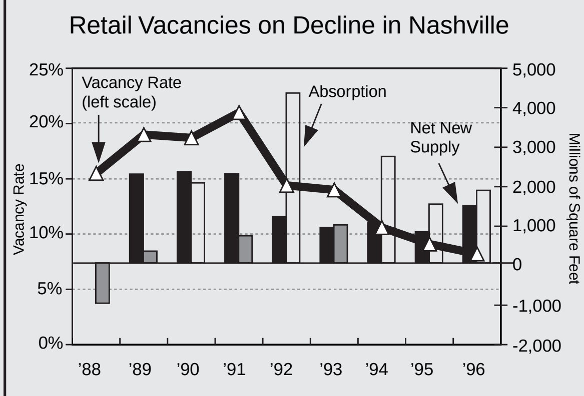
*Richard A. Brown, Chief, Economic Analysis Section*
*Diane Ellis, Senior Financial Analyst*

## Retail Construction on the Rise in the Memphis Region

Recent conditions have been decidedly upbeat in retail real estate markets over large parts of the Memphis Region. Declining vacancy rates have been observed in the major metropolitan areas, in line with the nation's overall trend during the 1990s. There are signs that the rate of new retail construction is picking up as the market for leaseable space gets tighter. However, the question remains as to whether future retail sales growth in the Region will be sufficient to support an expanding retail industry.

**Nashville** has become a leading market for new retail development. Chart 4 shows that absorption of retail space has outstripped completion of new space for the past five years. The result has been a decline in the retail vacancy rate from over 20 percent in 1991 to just 8.2 percent (0.5 percent above the national average) in 1996. An analyst with ***Trammel Crow*** describes the Nashville retail market as being "as good as it has been for a long time with overall vacancy at a 10-year low, and rental rates up 20 percent to 25 percent in some markets." Indications are that the recent rise in lease rates appears to be expanding the pipeline of new retail construction projects in Nashville. ***The Real Estate Report*** of the FDIC cited a total of 5.1 million square feet of new space in the planning stage there as of March 1997, up from only 2.1 million square feet in May 1996.

CHART 4



Source: FDIC, *The Real Estate Report*

A sharp uptick in current and planned retail construction is apparent across the Memphis Region (Table 1). Projects in the planning stages have risen by 222 percent in just under a year in the seven metro areas covered by ***The Real Estate Report***. While these figures include space in the early planning stages that could still be canceled, some significant new projects are slated to come on line this year and next year. In **Memphis**, for example, the beginning of 1997 was marked by the completion of a 1.1-million-square-foot regional mall and two "power centers" with almost a million square feet of space between them. These completions will be followed by a 575,000-square-foot addition to the Market of Wolfcreek shopping center, slated to be finished in fall 1997.

TABLE 1

**PLANNED RETAIL CONSTRUCTION TAKES OFF IN THE REGION (THOUSANDS OF SQUARE FEET)**

| | May 1996 | March 1997 | Percentage Change |
|---|---|---|---|
| Louisville KY MSA* | 1,911 | 5,221 | 173 |
| Nashville TN MSA | 2,063 | 5,131 | 148 |
| Knoxville TN MSA | 295 | 4,692 | 1,490 |
| New Orleans LA MSA | 221 | 3,635 | 1,544 |
| Memphis TN MSA | 1,187 | 2,091 | 76 |
| Baton Rouge LA MSA | 1,478 | 2,004 | 35 |
| Little Rock AR MSA | 356 | 1,422 | 299 |
| Total for 7 MSAs | 7,511 | 24,196 | 222 |

*MSA = Metropolitan Statistical Area
Source: FDIC, *The Real Estate Report*

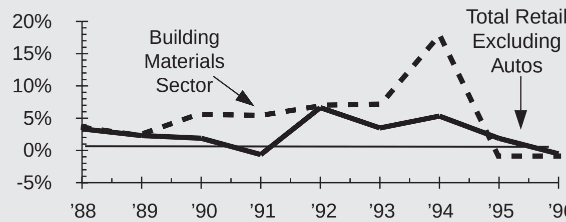
Amid these signs of a boom in retail construction is a somewhat more negative indicator in the form of declining rates of growth in inflation-adjusted retail sales (Chart 5). Annual increases in real retail sales growth (excluding autos) in the East South Central Census Region (Alabama, Kentucky, Mississippi, and Tennessee) have slipped from the 3 to 7 percent range during 1992 through 1994 to 1.9 percent in 1995 and –0.5 percent in 1996. The highly cyclical building materials sector has led this decline, registering negative growth for the past two years. Cash flow projections for prudently underwritten retail construction projects in the Region should account for this slowdown in retail sales growth.

*C. Hayward Majors, Research Assistant*

**Chart 5**

Retail Sales Growth Has Declined Lately in Memphis Region States

Annual Real Growth in Non-Auto Retail Sales in E. South Central Census Region (AL, TN, MS, KY)




Retail Sales Deflated by the Consumer Price Index

Source: Census Bureau, Bureau of Labor Statistics

# Growth in the Memphis Region Lags the Nation

- **Job growth in the Memphis Region slowed to 1.7 percent in 1996, the lowest level since 1991, and is below the national average.**

- **Labor markets in Nashville, Lexington, southern Louisiana, and southern and eastern portions of Mississippi are tight, while rural areas on or near the Mississippi River contend with double-digit unemployment rates.**

- **The divergent performance of the southern and northern halves of Louisiana likely can be traced to the concentration of the expanding oil and gas and gaming industries in the southern part of the state.**

### *Economic Growth in the Memphis Region Is Below the National Average*

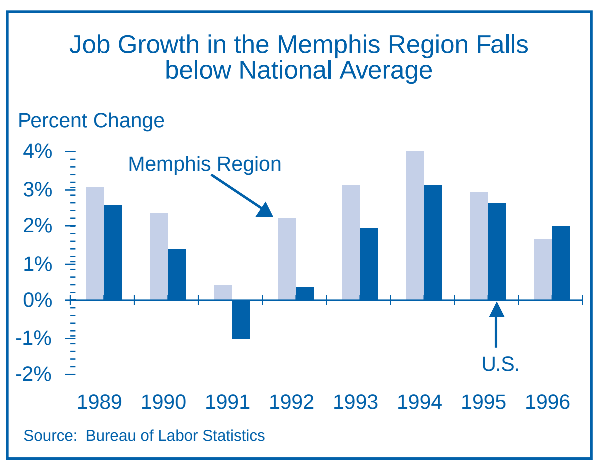
The Memphis Region's economic growth peaked in 1994, in terms of job gains, and has since declined, falling below the national average for the first time since 1987. In 1996, employment in the Region increased by 1.7 percent, the slowest gain since 1991, and below the national average of 2 percent (see Chart 1). Similarly, retail sales growth faded and was the slowest since 1991 in the Region's reporting states of Louisiana, Kentucky, and Tennessee. Sales rose by 2.3 percent in Louisiana and 2.8 percent in Kentucky during 1996, down from the double-digit gains recorded in 1994. Although Tennessee's 1996 retail sales growth of 6.5 percent was high relative to the national average of 4.9 percent, it was less than half the rate of gain at its peak in 1992.

Although the Region's economic growth has slowed since 1994, there was a slight temporary rebound in economic activity in early 1997. In January, year-over-year job growth rose to 2.2 percent, shrinking the gap with the national increase of 2.4 percent. The increase in employment growth was due largely to renewed strength in construction, services, and trade and some moderation in the ongoing decline in manufacturing. Many analysts believe that some of the stronger growth earlier in the year was weather-related. The 1996 to 1997 winter season was relatively mild, which enabled greater than normal levels of construction activity. Economic growth across all sectors has since moderated. The Region's construction industry, whose payrolls were up 5.4 percent in January from one year earlier, saw job growth slip to 1.8 percent in March. This slowdown is mirrored by the first quarter's 3.7 percent drop from one year earlier in residential permit issuance.

### *Kentucky and Louisiana Are the Fastest Growing States in the Memphis Region*

**Kentucky's** 2.4 percent job growth for the year ending March 1997 was just above the national average. Even so, Kentucky's economic performance varies geographically. In the northern half of the state, labor markets are tight in the suburban areas of **Louisville** and **Lexington**, as indicated by a comment from an officer at a machine tool company in the area that "anymore, it's hard to find anybody with even the simplest skills." Even in the eastern half of the state, where jobless rates are often in the double digits (see Map 1, next page), the unemployment rate in several counties has fallen by over 1 percentage point during the past year. Tighter labor markets in the northern half of the state contrast with economic conditions in the southern half, which is less industrialized and has suffered from the loss of textile jobs, such as the recent layoff of 800 employees of Fruit of the Loom in **Campbellsville** and **Jamestown**. With the exception of Hickman and Fulton counties, all

Chart 1



counties in the southwestern corner of the state have seen jobless rates climb by over 1 percentage point. Unemployment rates remain high as well outside of **Owensboro** and in south-central portions of the state.

The three fastest growing metropolitan areas in **Louisiana** are in the southern half of the state (see Table 1). Most parishes there have seen jobless rates decline by over 1 percentage point since the first quarter of 1996. In contrast, parishes near the Mississippi River in the northeast section are experiencing unemployment rates uniformly above 10 percent. Though gains in gaming and manufacturing boosted job growth in Shreveport-Bossier City, surrounding parishes of the metropolitan area still have unemployment rates above 10 percent.

The divergent conditions in the southern and northern halves of the state likely can be traced to the concentration of the oil and gas and gaming industries in the southern half. The importance of the oil and gas industry extends beyond employment in drilling activities. The demand for deep-water drilling equipment has helped push year-over-year manufacturing job growth in **Houma** and **Lafayette** into the double digits. The multiplier effect also extends to service industries that support the oil and gas industry.

**Map 1**

**Economic Performance Reflects Rural-Urban Dichotomy**

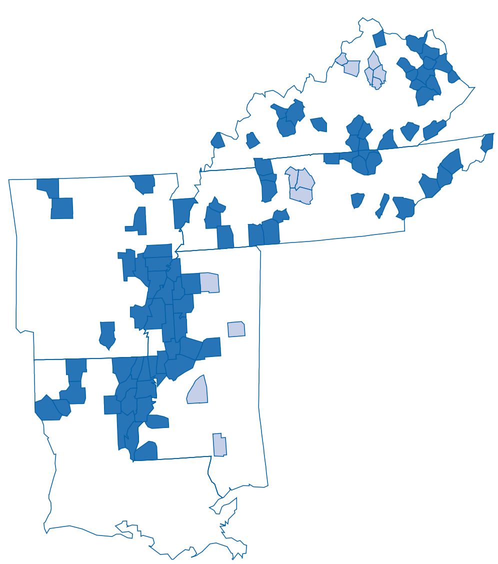



**Table 1**

**Year-Over-Year Employment Growth, First Quarter 1997, Is Higher in Southern Louisiana**

| | |
|---|---|
| Louisiana | 2.6% |
| Northern Louisiana | |
| Alexandria | 2.1% |
| Monroe | 0.7% |
| Shreveport | 3.7% |
| Southern Louisiana | |
| Baton Rouge | 4.4% |
| Houma | 5.6% |
| Lafayette | 4.6% |
| Lake Charles | 0.9% |
| New Orleans | 1.2% |

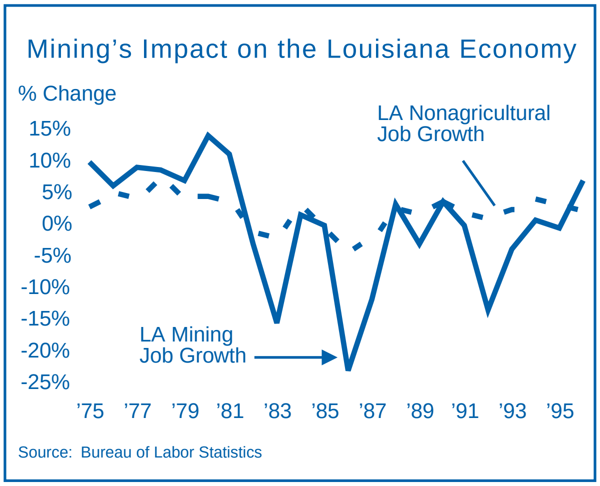
Source: Bureau of Labor Statistics

While the oil and gas industry has been a recent source of growth for southern Louisiana, another downturn in this sector would generate adverse spillover effects to the rest of the area. The impact of slower growth in the oil and gas industry could cause a ripple effect in the economy of southern Louisiana, potentially threatening credit quality across a broad spectrum. However, the economic diversification of the state's economy in recent years, particularly thanks to expansion of the gaming industry, could help mitigate the impact of another oil and gas downturn relative to the 1980s experience (see Chart 2, next page).

### *Tennessee's Economic Performance Is beyond Its Cyclical Peak*

**Tennessee**, in sharp contrast to the vigorous growth it experienced in the period 1993 to 1995 (Chart 3, next page), has become the Region's slowest growing state. March year-over-year employment growth was just 0.1 percent, as growth in all areas of the state's economy has slowed since January 1997. Construction activity in the state slowed as well during the first quarter of 1997. Residential permit issuance, after increasing by 15 per-

CHART 2

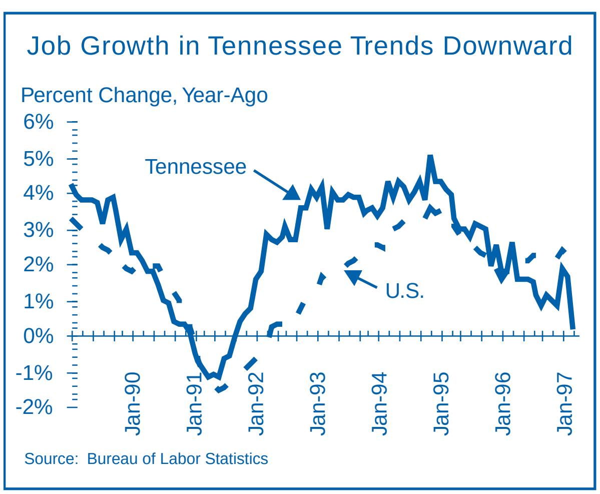



cent in 1996, was down 1 percent in the first quarter of 1997 from one year earlier.

Employment growth in Tennessee was below the national average in 1996 for the first time since 1990. Job growth in Tennessee is concentrated in the middle and western sections of the state. Year-over-year job growth in **Clarksville-Hopkinsville** was 3.6 percent in March 1997, and labor markets in the western suburbs of **Nashville** remain tight, with jobless rates below 3 percent. The eastern half of the state is seeing softer levels of growth; employment in the metropolitan areas of **Chattanooga** and **Johnson City-Kingsport-Bristol** was actually below year-ago levels in March.

Five counties along the **North Carolina** border have double-digit jobless rates. One area of the state that has seen a striking change in labor markets is a region northeast of Nashville that centers on rural Clay County. In the first quarter of 1997, the county's unemployment rate stood at 30 percent, up from 9.7 percent one year earlier. In 1996, the region suffered numerous plant closings, including an Oshkosh B'Gosh apparel manufacturing facility. Other rural counties throughout the state have witnessed similar events as large local employers relocate closer to urban centers or transportation routes or move operations offshore. Another example is Lewis County, southwest of Nashville, where jobless rates reached 17.2 percent in the first quarter of 1997. Two major manufacturers in the area, Genesco and Henry I. Siegal Co., shut down last year.

CHART 3




### *Growth in Mississippi and Arkansas Is on Par with the Region*

The other states in the Memphis Region, **Arkansas** and **Mississippi**, have seen economic growth consistent with the Region's average. Construction has been the fastest growing area of Arkansas's economy. Economic performance in Arkansas has not been geographically uniform. The Fayetteville-Springfield metropolitan area saw year-over-year job growth of 3.4 percent in March 1997 as the economy was supported by gains in trade, services, finance, insurance, and real estate. In contrast, as in other states in the Region, jobless rates in several counties along the Mississippi River remain in the double digits.

In Mississippi, labor markets over the year ending in the first quarter of 1997 have tightened throughout much of the eastern and southern portions of the state. Job growth, however, remains concentrated in the Biloxi-Gulfport-Pascagoula metropolitan area, which is being supported by construction activity and expansion of the gaming industry.

**Implications:** The Memphis Region experienced several years of rapid growth and now appears to be slowing. Accordingly, prudent bankers will carefully examine financial projections submitted by potential borrowers to determine whether the assumptions used remain valid in light of recent economic trends. In areas of declining job growth, loan demand may begin to wane. In turn, this trend could increase the pressure on some institutions to compromise pricing and underwriting standards at the expense of credit quality.

*Scott C. Hughes, Atlanta Regional Economist*
*Gary L. Beasley, Senior Regional Analyst*

# Financial Markets

- **Deteriorating credit quality trends in the rapidly growing home-equity backed securities market could portend trends in bank residential mortgage lending.**
- **Financial asset securitization investment trusts, known as FASITs, promise to change the asset-backed securities market significantly and could make securitization more accessible to community banks.**
- **The Treasury yield curve is steeper and higher than it was at year-end 1996.**
- **The Memphis Region's Community Bank Index and Regional Bank Index both failed to match the gains of the S&P 500 and S&P Composite Bank Index as of May 2, 1997.**

## *Trends in the Home-Equity Asset-Backed Market Are Important to Banks*

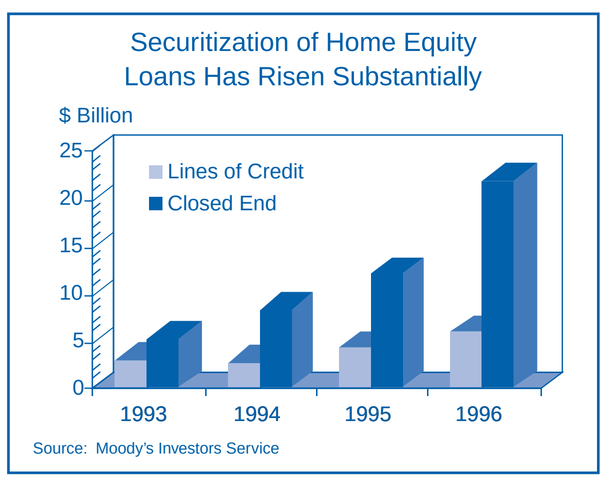
The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has been accompanied by abnormally early and high levels of delinquencies. Banks that are investing in HEL ABS, considering securitizing HELs, or lending significantly for debt consolidation should be aware of credit quality developments in the HEL ABS market.

*The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market.* The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, know as cash-out refinancing, grew substantially when home-equity borrowers were motivated by lower rates to refinance their first mortgages for amounts greater than the remaining principal balance instead of adding a second mortgage.

*Debt consolidation is the primary reason for home-equity borrowing.* Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens. According to the ***Consumer Bankers Association 1997 Home-Equity Loan Study,*** debt consolidation accounted for 36 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior to 1992, home improvement was the primary reason for home-equity borrowing. This trend toward debt consolidation as the reason for home-equity borrowing has significant risk implications because, unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance the lender's collateral value.

*The rapid growth of the HEL securitization market has been attended by signs of relaxed underwriting.* Adverse credit quality trends have been particularly prominent for loans that were originated in 1995. Chart 2 (next page) shows the total delinquency rates for closed-end loan pools originated in 1995 versus 1994. The sharp upward path of delinquency rates for loan pools originated in 1995 raises concern that aggressive competition for volume, and apparently relaxed underwriting standards, could lead to unprecedented default levels. *Furthermore, HEL originations in 1996 more than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.*

CHART 1

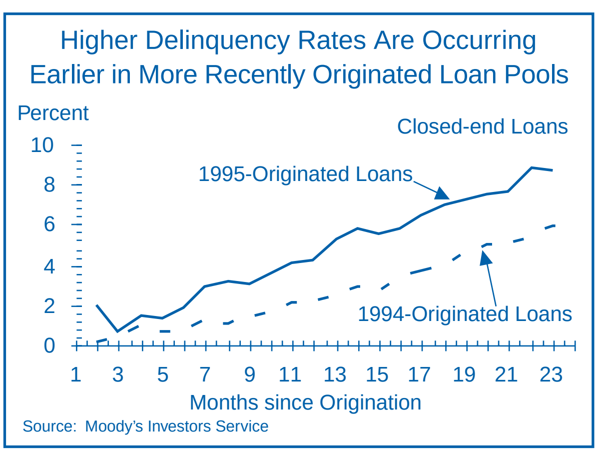


*The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing.* If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The trends would be obscured because banks report all first mortgage lending on 1 to 4 family residential properties without distinguishing between purchase mortgages and cash-out refinancings. The unfavorable trends in the HEL ABS market suggest that banks that engage in significant cash-out refinancing and other forms of home-equity lending should be able to monitor trends in the credit quality of these loans separate from purchase mortgage loans.

### *A Combination of Several Factors Could Induce More Banks to Securitize HELs*

*Although the present volume of bank-originated HEL securitizations is relatively small, banks have recently entered this finance company-dominated market, and a combination of several factors is likely to cause more to follow.* First, home equity lines of credit are currently growing at rates exceeding total consumer lending, and, by and large, the deposit growth to fund this lending is less than robust. In addition, according to ***Moody's Investors Service,*** investor demand is high for bank-originated home-equity line of credit securitizations because bank-originated lines are perceived to have lower credit risk. The funding benefits and profitability of securitizing bank-originated home-equity lines of credit could entice more banks into the securitization market. Finally, the combination of these factors with the potential cost savings provided by using the new financial asset securitization investment trust (FASIT) structure (see discussion below) could produce momentum that will result in banks, large and small, securitizing home equity loans in significantly increased amounts.

CHART 2




*Securitizing HELs can change the balance sheet and income statement of the securitizer significantly, resulting in significant servicing assets and gains on sale.* Beginning in 1997, when a company sells loans, it must comply with the requirements of Financial Accounting Standard (FAS) 125. If the company retains servicing rights on the assets sold, FAS 125 requires the seller to book an asset related to the gain on sale that represents the future income derived from servicing the loans. This asset is similar to mortgage servicing rights in that it represents the present value of future expected cash flows derived from loan servicing. One major home-equity securitizer, which indicated that FAS 125 would not materially affect its financial statements, reported servicing assets at almost 90 percent of equity, and gains associated with the sale of serviced assets at 71 percent of total revenue.

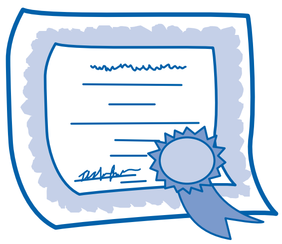
*The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets.* Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results in charge-offs or early repayment through foreclosure of serviced assets, could require the adjustment of the valuation assumptions and the write-down of the servicing assets.

### *FASITs Promise to Change the ABS Market*

The Small Business Job Protection Act of 1996 created two new sections of the Internal Revenue Code that create and govern FASITs. The FASIT provisions, patterned in part on the real estate mortgage investment conduit (REMIC) rules issued in 1986, are intended to provide tax certainty for ABS issuers and purchasers and enhance the flexibility of asset securitizations. The FASIT provisions take effect on September 1, 1997.

The advent of the FASIT is likely to change the ABS market in important ways. First, the FASIT will clarify the tax treatment of securitizations. Because of the current tax ambiguity, designing ABS structures to avoid taxation is administratively costly, and it restricts the forms that securitizations can take. The higher administrative cost associated with current securitization techniques establishes a practical minimum size for asset pools that can be feasibly securitized. With FASITs and the reduced costs associated with tax clarity, the economically feasible pool size may be significantly smaller. *The lowering of this threshold could result in more community banks entering the securitization market.*

ABS issuers believe that the market for their product has been hampered by the restrictive nature of current asset-backed tax ambiguity, which prevents them from responding to investor preferences for varying maturities, coupon types, and prepayment and credit risk profiles. FASITs allow sponsors the flexibility to create multiple-class securities that satisfy these preferences with the certainty that the securities will count as debt and that the FASIT will not be treated as a taxable corporation. This combination of flexibility and tax certainty could lead to the kind of innovations in ABS structures that followed the 1986 REMIC legislation, which brought analogous benefits to the mortgage-backed market.



There are additional innovations made possible by FASITs. FASITs will bring to the ABS market the ability to add and remove assets throughout the life of a securitization. This feature could be applied by securitizing revolving construction loans and then replacing the revolving loans with permanent financing when construction is completed. A FASIT also will be able to contain a mixed pool of assets such as real estate, non-real estate assets, and unsecured credit, allowing exposures to very different markets from the same security. Finally, a FASIT can hold swaps and other hedging instruments. Using this feature, an issuer could combine a mortgage passthrough security with a hedging instrument that is designed to offset mortgage prepayment risk, such as a reverse-index amortizing swap.

The increased flexibility that the FASIT promises to bring the ABS market comes with the potential for greatly increased complexity and risk. Banks that invest in FASIT securities will need to understand fully not only the risk characteristics existing at the outset of security but also the risk that could arise throughout the security's life if assets are to be removed and replaced.

### *Changes in Interest Rates and Bond Values*

The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained there for the next 23 days. The FOMC met again on May 20, 1997, and left the target rate unchanged.

*The model portfolio responded to the rise in rates, but only modestly (see Table 1).* The relatively short weighted average maturity of the portfolio served to moderate the effect of the 54 basis point rise in the five-year Treasury between December 31, 1996, and March 31, 1997. As discussed in ***Regional Outlook***, Second Quarter 1997, changes in the value of the model portfolio correlate more with changes in the five-year Treasury rate than with the 30-year bond rate.

The yields along the April 30, 1997, yield curve imply that the market expects the curve to continue to flatten through the remainder of the year with short rates rising somewhat. In order to gauge what affect a 25 basis point rise in the yield curve could have on bank fixed-income portfolios, the model portfolio has been "shocked" to simulate the effect of an instantaneous 25 basis point shift in the yield curve on May 28, 1997.

Chart 3

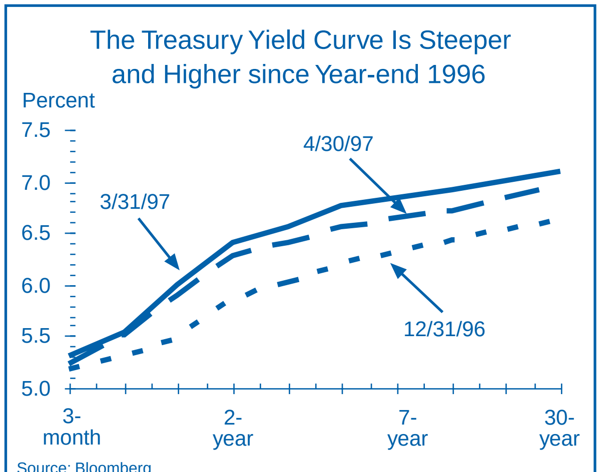


TABLE 1

| TYPE OF SECURITY | PAR VALUE | PERCENT OF PORTFOLIO | MATURITY OR WAL AS OF 12/31/96 | PERCENT CHANGE FROM 12/31/96 TO 3/31/97 | CHANGE RESULTING FROM A 25 BP RATE INCREASE ON 5/28/97 |
|---|---|---|---|---|---|
| U.S. TREASURY 5.6% | 2,000 | 20% | 1 YR | –0.30% | –0.16% |
| FNMA AGENCY 5.8% CALLABLE | 1,200 | 12% | 2 YR | –0.50% | –0.38% |
| STATE COUNTY MUNICIPAL GO 4.8% | 800 | 8% | 11 YR | –2.05% | –2.03% |
| FNMA MORTGAGE PASSTHROUGH 7.5% | 3,000 | 30% | 8 YR | –1.78% | –1.44% |
| FNMA (REMIC) 8.0% PAC | 2,000 | 20% | 2.5 YR | –1.27% | –0.50% |
| CREDIT CARD ASSET-BACKED SECURITY | 1,000 | 10% | 5 YR | –0.09% | 0.00% |
| TOTAL | 10,000 | 100% | 4.85 YR | –1.08% | –0.77% |

NOTE: PORTFOLIO COMPOSITION BASED ON ESTIMATES DERIVED FROM AGGREGATED BANK CALL REPORT INFORMATION.

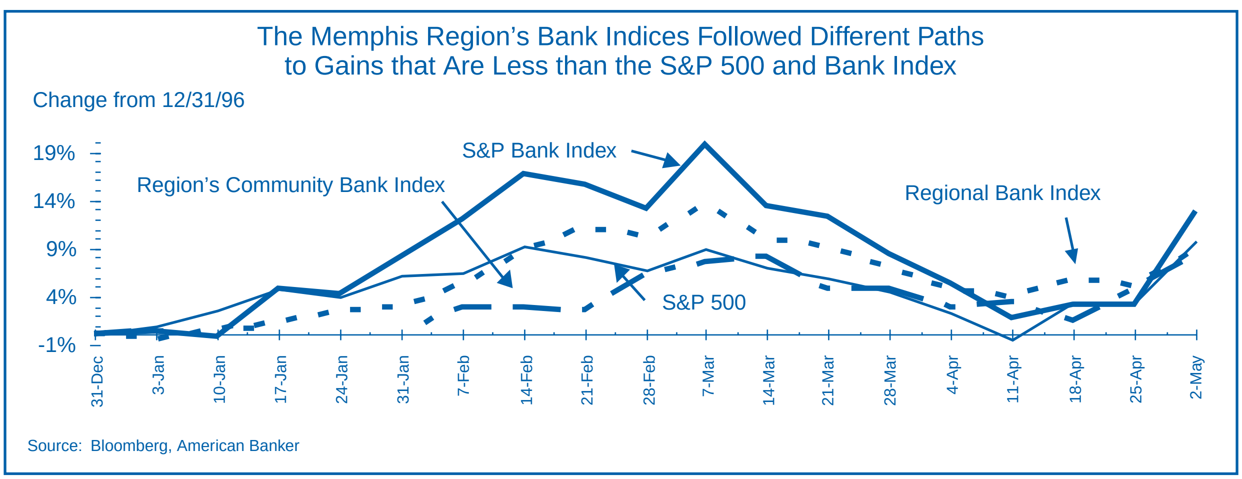
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate changes owing to its longer maturity. The mortgage passthrough security also is more sensitive to rising rates because its weighted-average life (WAL) extends as rising rates discourage the underlying mortgage holders from prepaying their loans. The decline in prepayment rates results in extending the maturity of the security while rates are rising, a combination unfavorable to the security's value.

### *The Memphis Region's Community Bank Index and Regional Bank Index Underperformed the S&P 500 through May 2, 1997*

The S&P Composite Bank Index and the Memphis Regional Bank Index have been subject to similar performance swings this year (Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, when it was up almost 20 percent on the year. The Memphis Region's Community Bank Index and Regional Bank Index followed different paths to similar performance levels of 8.51 percent and 8.94 percent, respectively, as of May 2, 1997. Both indices underperformed the S&P 500's 9.75 percent gain.

*Allen Puwalski, Banking Analyst*

CHART 4



# Current Regional Banking Conditions

- **Moderate increases in consumer loan delinquencies are the exception to otherwise favorable first-quarter operating results.**

- **The competitive landscape for Memphis Region banks is changing with a continuing trend toward fewer and larger institutions.**

- **The "year 2000" problem could be costly to insured institutions that fail to adequately assess exposure and implement timely corrections.**

- **Proposed accounting changes may eliminate the popular pooling method of accounting for mergers and acquisitions.**

### *First-Quarter Reports Reflect Overall Good Earnings, Capital, and Asset Quality*

On an aggregate basis, the Region's banks and thrifts continue to exhibit relatively strong financial conditions. During the first quarter of 1997, the Region's banks and thrifts:

- maintained leverage capital at just under 9 percent of average assets;

- improved aggregate return on assets (ROA) by 4 basis points to 1.28 percent (see Chart 1); and

- reported low nonperforming assets (0.68 percent of assets) and past due loans (2.51 percent of total loans) despite a continuation in the trend toward higher delinquencies for credit cards.

While Region-wide conditions are strong, ROAs for commercial banks were behind year-ago levels in **Louisiana**, **Kentucky**, and **Mississippi**. Louisiana banks experienced the only significant decline, with ROAs falling 17 basis points, to 12 percent below the level generated during the first quarter of 1996. The decline is primarily the result of higher provisions for loan and lease losses necessitated by rising credit card losses.

Region-wide losses on credit card loans represented 31 percent of all loan losses in the first quarter of 1997, compared to 27 percent in the first quarter of 1996.

Annualized credit card loss rates as a percentage of outstanding credit card balances were highest in institutions headquartered in **Tennessee**, at 5.6 percent, and in Louisiana, at 4.2 percent. Banks in these two states accounted for three-fourths of the credit card loans in the Region.

### *Consolidation Has Affected the Structure of the Memphis Region's Banks during the 1990s*

The national trend toward banking industry consolidation is occurring in the Memphis Region as well (see Table 1, next page). Bank failures have played little role in this consolidation. There have been only ten failures since the end of 1990, compared to a net decline of 240 institutions. Consolidation has been driven, instead, by mergers and acquisitions. This activity has contributed to the decline in the number of small banks and the increasing share of assets held by the largest banks.

CHART 1

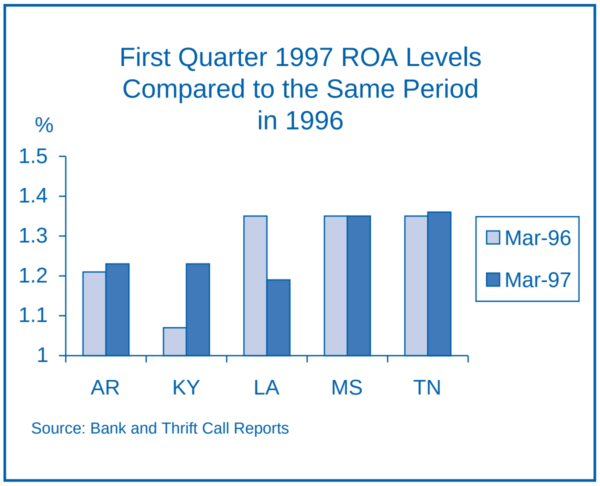


**Table 1**

| The Number of Insured Institutions in the Memphis Region Has Declined | | | | | |
|---|---|---|---|---|---|
| | Dec-90 | Dec-92 | Dec-94 | Mar-97 | % Change 90-97 |
| LA | 278 | 261 | 240 | 208 | -25% |
| KY | 393 | 367 | 339 | 314 | -20% |
| MS | 149 | 143 | 128 | 123 | -17% |
| TN | 302 | 289 | 281 | 261 | -14% |
| AR | 276 | 277 | 274 | 252 | -9% |
| Region | 1,398 | 1,337 | 1,262 | 1,158 | -17% |
| U.S. | 15,158 | 13,852 | 12,603 | 11,335 | -25% |

Source: Bank Structure Data

Small banks, those with assets below $50 million, have seen their ranks thinned by 42 percent, or 226 institutions since the start of 1991. Small institutions held just under 4 percent of the Region's total assets at the end of the first quarter of 1997, down from almost 8 percent in 1990. Conversely, institutions with total assets exceeding $1 billion increased their share of total assets to 43 percent from 35 percent in 1990.

*The reduction in the number of insured institutions would have been much greater if not for the opening of 67 new institutions during the period.* In some communities, merger and acquisition activities appear to have stimulated the formation of new banks. Tennessee and Kentucky have seen the most new institutions established since the end of 1993, 17 and 12, respectively. Louisiana did not have any new institutions open between 1991 and 1996, although two new institutions opened there during the first quarter of 1997.

Concurrent with the consolidation trend, structural changes also have occurred in the ownership of banks. Since 1990, the share of the Region's bank assets controlled by multibank holding companies has increased from 48 percent to 67 percent (see Charts 2A and 2B).

Consolidation, however, has not reduced the number of banking offices. In fact, at the end of the first quarter there were 3 percent more banking offices operating in the Region than at year-end 1991. All of this increase has been in branches owned by multibank holding companies, where the average number of branches increased threefold to almost 11 per bank. In contrast, banks operating either under a one-bank holding company or as independent banks experienced slight declines in the number of offices operated.

***Implications:*** The trend toward fewer but larger institutions is altering the competitive landscape for insured

**Chart 2A**

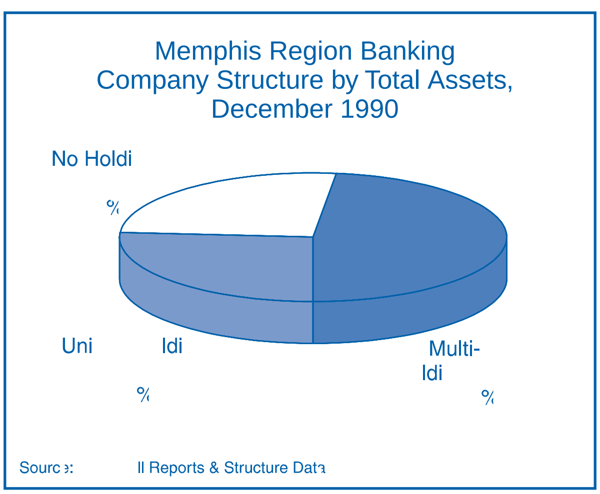
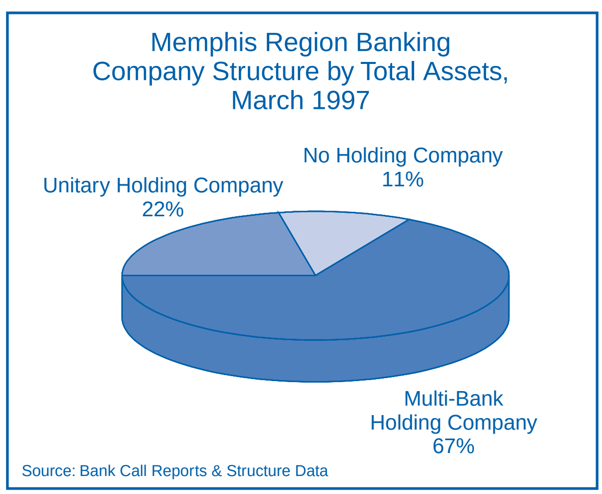



**Chart 2B**



institutions. In particular, some small community banks are coming under greater competitive pressures from larger institutions that are using an increasing number of smaller branches, such as those found in many supermarkets in the Region, to reach their retail clientele. Some money center and large regional banks also have begun recently to compete more aggressively for certain lines of business, such as small business loans and various types of consumer loans, traditionally dominated by community banks (refer to the second quarter 1997 *Regional Outlook* article, "Will Credit Scoring Transform the Market for Small Business Lending?").

*According to a 1997 survey of community bank executives by* ***Grant Thornton****, an accounting and management consulting firm, an increasing number of small institutions are looking to technology, such as the Internet, as a way to remain competitive. There were 84 banks, or 8 percent of the Region's total banks, known to have Internet sites at the end of May 1997.* Many of those institutions are community banks, and most of them currently offer limited services over the Net. While technology such as the Internet may improve competitiveness, it also has the potential to greatly complicate internal controls and can be costly when the requisite expertise is not readily available within the institution.

### *A Popular Method of Accounting for Mergers May Be Eliminated*

Increased merger activity in the nation, as well as in the Region, has increased the importance of merger accounting methods in both the regulatory and corporate arenas. Presently, merging companies have the option of accounting for the transaction using the pooling of interests (pooling) method or the purchase method of accounting.

***Merger Methods Provide Different Advantages:*** A pooling transaction is a combination of the assets and liabilities of two or more entities through an exchange of common stock. This method allows the merging companies to simply combine their assets, liabilities, and equity accounts at book value on a line-by-line basis. However, eligibility for using the pooling method requires adherence to 12 criteria outlined in Accounting Principals Board No. 16. The benefits of using the pooling method include the following:

- No goodwill is created, thus avoiding the drag on reported earnings that comes from amortizing such accounts.
- Assets with significant appreciation are booked at historical cost, so taxes are avoided.
- The expensive and frequently complex market valuation of the balance sheet is avoided.
- Regulatory capital ratios are not affected by the need to deduct goodwill.

In comparison, the purchase method accounts for a business combination as the acquisition of one company by another. The assets and liabilities of the acquired firm are transferred to the acquirer at fair market value. Any excess of the purchase price over the fair market value of the assets and liabilities acquired is first allocated to identifiable intangibles and then to goodwill. Goodwill is not recognized as an asset for regulatory capital purposes. Potentially attractive features of the purchase method include the following:

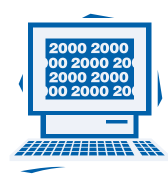
- A combination of both stock and cash may be used to complete the purchase.
- There is more flexibility in disposing of assets, which is often desirable for cost-cutting reasons.
- A recent change to the Call Report lengthened the amortization period for goodwill from 15 to 25 years.
- Stock buyback plans are not restricted by accounting requirements.

***Purchase Method of Accounting May Become More Popular:*** Recent action by the Securities and Exchange Commission (SEC) and changes being discussed by the Financial Accounting Standards Board may result in greater use of the purchase method of accounting. With Staff Accounting Bulletin No. 96, March 1996, the SEC eliminated a loophole used by some merger participants applying the pooling method and wanting to execute a stock buyback plan. Stock buyback plans have been popular as a means of reducing the dilution of earnings per share that frequently occurs when additional shares are issued to complete a merger. The purchase method of accounting does not restrict buyback programs, but the pooling method does include some restrictions. It is reported that the Financial Accounting Standards Board is considering eliminating the use of the pooling method to bring the United States in line with international accounting standards. Those standards generally allow pooling only when it is impossible to determine which company is the acquirer, such as in a merger of equals.

Historically, most mergers in the Memphis Region have used the pooling method. Poolings reached a high of 79 percent of all transactions in 1994 (see Chart 3). Beginning in 1994, banking companies in the Memphis Region have mirrored the national trend toward purchase-method transactions. This trend has occurred despite the fact that many of the mergers involve non-publicly traded institutions, suggesting that stock buy-back programs may not be a motivating factor in the accounting method selected.

### *The Banking Industry's Reliance on Automation Means the Year 2000 Problem Cannot Be Ignored*

Significant concern has been voiced in various media over the potential impact of the year 2000 on computer systems and other devices containing microprocessors. The importance of this issue has been underscored by cost estimates to U.S. business for this problem totaling in the hundreds of billions of dollars.



The year 2000 (Y2K) problem primarily relates to the fact that the year portion of dates in many computer systems is represented by just two digits. As a result, some systems may interpret the date 01/01/00 as January 1, 1900, rather than January 1, 2000.

Financial institutions may be especially susceptible to the Y2K problem because of their heavy use of computer systems to do things such as maintaining deposit and loan records. Like many businesses, financial institutions also rely on a number of devices that contain microprocessors, ranging from telephone voice mail systems to security and climate control devices. All these devices could be affected by Y2K problems.

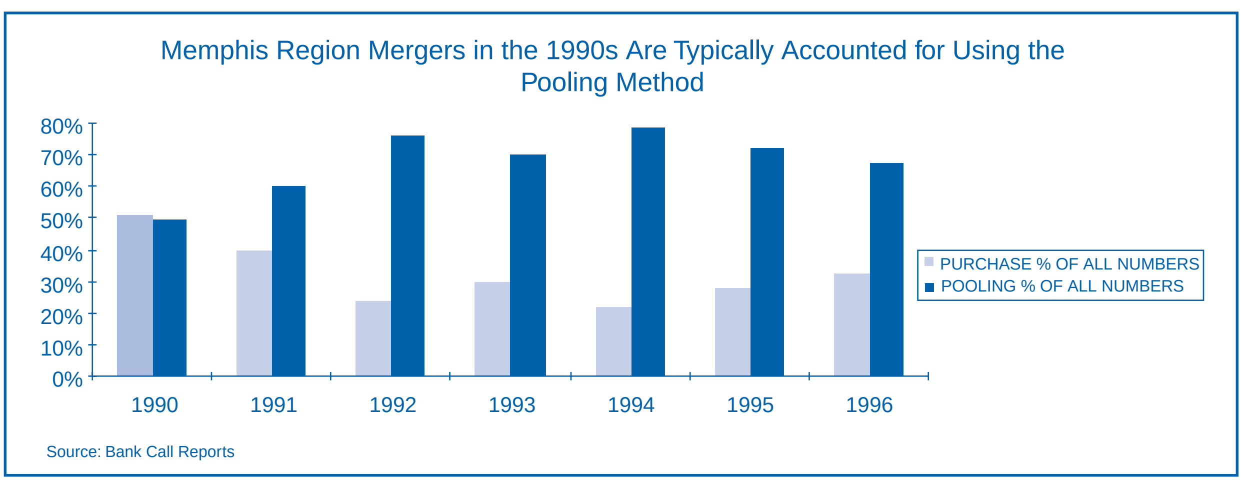
The potential risks of the Y2K problem extend beyond the direct use of computers by financial institutions. For example, loan customers could suffer serious business disruptions if electronic inventory and other control systems falter.

Correcting the problem is a relatively straightforward task but involves an enormous amount of time reviewing computer code. Alternatively, the problem may require replacing computer software and hardware. Expenditures made in modifying software to address the Y2K problem must be charged to expense as incurred pursuant to a Financial Accounting Standards Board Emerging Issues Task Force decision rendered June 10, 1996 (Issue No. 96-14).

**Implications:** *The previously noted survey by* ***Grant Thornton*** *found that most community banks consider the year 2000 problem a nonissue. According to the survey, only 7 percent of respondents indicated that it is a major concern. When asked what steps they have taken to fix the problem, 26 percent said they did not have a problem.* While indeed many institutions may not have the problem, prudent bankers will have a plan to thoroughly audit their systems and the systems of their servicers to ensure that they are in fact year 2000 compliant.

With Financial Institution Letter 50-97, dated May 9, 1997, the FDIC announced the issuance of a Federal

CHART 3




Memphis Region Mergers in the 1990s Are Typically Accounted for Using the Pooling Method

Source: Bank Call Reports

Financial Institutions Examination Council press release containing guidance for insured institutions on the Y2K problem. The document includes an examination questionnaire and procedures guide that cover the following issues:

- awareness of the problem;
- assessment of the risk posed by the problem;
- renovation of affected systems;
- validation of system changes; and
- implementation and certification.

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