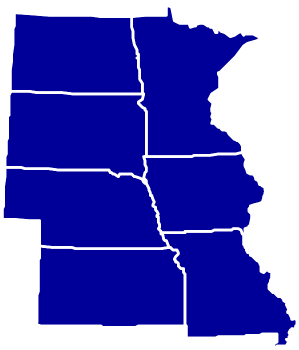
◈ Regional Outlook ◈

FEDERAL DEPOSIT INSURANCE CORPORATION | FIRST QUARTER 1997

In Focus This Quarter

FDIC KANSAS CITY REGION



■ ***Consumers Declare Bankruptcy in Record Numbers -*** **Despite favorable economic conditions, the number of consumers declaring bankruptcy is on the rise in the Kansas City Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress.** *See page 3.*

■ ***New Tax Benefits for Owners of Community Banks -*** **The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.** *See page 6.*

■ ***Savings Association Insurance Fund (SAIF) Capitalized -*** **After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF.** *See page 9.*

DIVISION OF INSURANCE

CRAIG A. RICE, SENIOR REGIONAL ANALYST

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Dear Reader,

The prototype edition of the *Regional Outlook* for the Kansas City Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial and Commodity Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook*. Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,

Arthur J. Murton
Director

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Visit the Division of Insurance online at http://fdic01/division/doi/. For more information on this publication, please call Craig Rice at (816) 234-8034 or email him at Craig A. Rice@DOI@Kansas City.

The authors wish to acknowledge the assistance provided by Don Inscoe and Jon Wisnieski of the Division of Research and Statistics in providing some of the data used in this publication. Any errors are the responsibility of the authors. We would also like to thank the employees of the Division of Supervision and Division of Compliance and Consumer Affairs in the Chicago Region for providing feedback used in the development and design of this publication.

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the Kansas City Region.**
- **Kansas has the highest filing rate among the states in the Region with the eighteenth highest per capita bankruptcy rate in the country.**
- **Credit card charge-offs are approaching recession levels.**

Despite favorable economic conditions, the number of consumers that are declaring bankruptcy is on the rise in the Kansas City Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

What Is Occurring in the Kansas City Region?

Chart 1 shows the rising trend in consumer loan losses in the Kansas City Region as well as the close relationship between these losses and personal bankruptcy filings.

Table 1 (next page) shows that personal bankruptcy rates are rising in all states throughout the Region and ranks the states on a national basis. Current filing rates are fairly moderate compared to other states in the country but recently have showed signs of rapid growth.

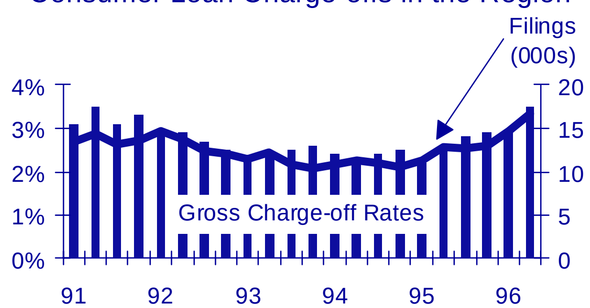
Why Are Consumer Credit Losses Rising in an Expanding Economy?

The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more willing to incur debt and banks are more willing to lend. Chart 2 shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this

CHART 1

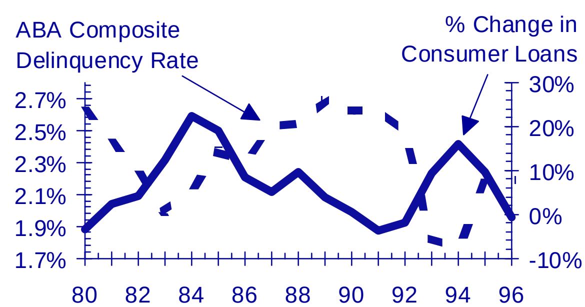
Personal Bankruptcies Correlate with Consumer Loan Charge-offs in the Region



Sources: Administrative Office of the United States Courts and Bank and Thrift Call Reports (RIS). Based on a design by the FDIC's Division of Research and Statistics.

CHART 2

U.S. Consumer Delinquency Rate Tends to Rise After Credit Growth Accelerates



Sources: American Bankers Association and Federal Reserve Flow of Funds credit expansion.

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings for 1996 will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors, many of which are interrelated.

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. For example, in Kansas, SMR attributes a high filing rate to a somewhat high self-employment business failure rate. The report identifies other factors driving up bankruptcy rates such as:

- high divorce rate;
- inadequate health insurance;
- inadequate auto insurance;
- garnishment of wages; and,
- high debt-to-income ratios.

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Implications for Insured Institutions

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 3 (next page), credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of

Table 1

Bankruptcy Rates Per Thousand Persons

	1990	1991	1992	1993	1994	1995	3rd Qtr 1996 Annual.	3rd Q 96 State Ranking
Iowa	1.7	2.0	2.0	1.7	1.8	2.1	2.8	39
Kansas	3.6	3.7	3.4	2.9	3.0	3.4	4.2	18
Minnesota	3.3	3.6	3.4	2.8	2.6	2.8	3.4	28
Missouri	2.9	3.4	3.4	2.7	2.7	3.0	3.9	24
Nebraska	2.6	2.6	2.4	2.1	2.0	2.2	3.0	35
N. Dakota	1.5	1.7	1.7	1.5	1.7	1.9	2.4	45
S. Dakota	1.7	1.7	1.7	1.7	1.5	1.8	2.4	46
United States	3.1	3.5	3.5	3.2	3.0	3.3	4.2	NA

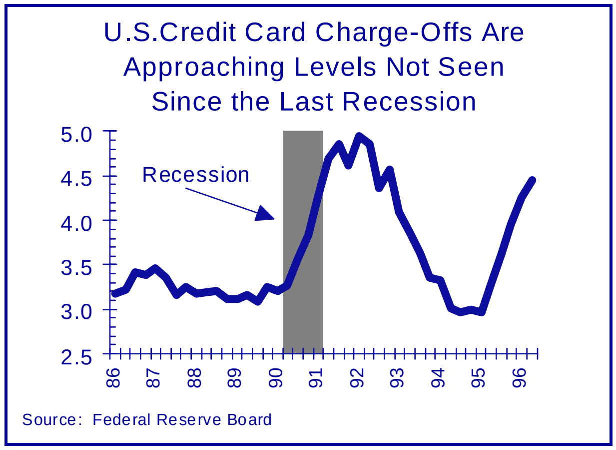
Source: Bankruptcies - Administrative Office of the United States Courts
Population - Census Bureau

managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions.

CHART 3



Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst
Craig A. Rice, Senior Regional Analyst

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- **Potential benefits are substantial. A layer of tax expense has been eliminated.**
- **Eligibility is restricted and requires care to maintain.**
- **While no application to the banking agencies is required, the new tax structure has supervisory implications.**
- **The new tax structure has some potential drawbacks.**

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts, and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes, and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions therefore may need to act quickly since changes in either of the above areas may be time consuming.

Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under $500 million in assets that are not part of a group with more than $500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals,

Table 1

Number of Banks with Under $100 Million in Total Assets

	National	Non-Member	State Member	Total
Iowa	40	318	39	397
Kansas	95	250	16	361
Minnesota	89	322	23	434
Missouri	30	285	32	347
North Dakota	12	94	2	108
Nebraska	77	199	14	290
South Dakota	12	62	15	89
Total	355	1,530	141	2,026

Source: Preliminary Bank Call Reports as of 9-30-96 estates, and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock Ownership Plans (ESOPs) and other stock bonus plans, may not hold shares in subchapter "S" corporations. Once the subchapter "S" election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Number of Eligible Institutions

While exact figures on the number of eligible institutions are not available, the number of small banks may provide insight into where the tax election may be seen. As Table 1 (previous page) shows, there are over 2,000 commercial banks in FDIC's Kansas City Region with under $100 million in assets. It is expected that a large percentage of these companies would meet the eligibility requirements. Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Benefits to Shareholders

The tax benefits of the "S" corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders' personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation's taxable income. Distributions formerly paid directly to the IRS by the institution would generally be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies.

Adding value and flexibility to the "S" corporation structure is the ability to wholly own other "S" corporations. These rules allow holding companies and their bank or savings association subsidiaries to be "S" corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to "S" corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for "Built-in Gains Tax" (BIG tax) to determine any tax at the corporate level.

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various "phantom bank mergers" or change-in-control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special expertise for the bank in tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital in situations where growth is strong or delinquent assets are rising.

Other Drawbacks

To receive the benefits of the subchapter "S" election, the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

The states of Connecticut, Michigan, New Hampshire, New Jersey, Tennessee as well as the District of Columbia do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend payments to fund debt payments on stock loans.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks and thrifts.

Ronald L. Spieker, Chief,
Depository Institutions Analysis Section *

For More Information

Subchapter S Election for Federal Income Taxes. FIL-91-96.

* Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Almost 300 banks and thrifts in the Kansas City Region paid $293 million of this total.**

- **Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.**

- **The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.**

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was $3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.

- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.

- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.

Over 75 percent of the Kansas City Region's savings institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 ...

- Disparity between SAIF and BIF premiums created strong economic incentives for institutions to transfer SAIF-assessable deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

Table 1

Kansas City Region Institutions Affected by SAIF Special Assessment

# of Institutions Affected and Total Assessment by Type	Savings Banks	S&L	State Member	National	Non-member	Total
Iowa	27	5	6	11	34	83
Kansas	5	17	0	14	8	44
Minnesota	10	11	0	5	4	30
Missouri	24	28	2	8	12	74
Nebraska	8	5	1	8	6	28
North Dakota	3	0	1	2	3	9
South Dakota	4	1	3	3	3	14
Total	81	67	13	51	70	282
Assessment (000s)	168,733	57,932	1,163	52,222	12,944	292,994

Source: Derived from early estimates from the FDIC's Division of Finance.

What Significant Actions Were Taken?

Special Assessment: In order to address the immediate problems, *the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions*. The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

- Exempted weak and other specifically defined institutions from paying the special assessment.
- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

The number of exempted institutions is expected to be small compared to the roughly 300 institutions in the Kansas City Region that collectively paid about $293 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

Table 2

Summary of 1997 Assessment Rates *			
1997 Adjusted BIF & SAIF Schedule			
Capital Group	Supervisory Subgroup A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
Exempt Institution SAIF Schedule			
1	23	26	29
2	26	29	30
3	29	30	31
FICO Annual Rates			
BIF Institutions		SAIF Institutions	
1.30		6.48	

* Cents per $100 of domestic deposits

Source: FDIC's Division of Insurance

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about $800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points* (see Table 2). As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board lowered the rates on ongoing assessments paid to the SAIF. The FDIC Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit initially from the lower SAIF assessment rates. They will pay according to the 23- to 31-basis point schedule through year-end 1999, unless they choose to make a pro rata payment of the special assessment in the interim.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, over 75 percent of the Kansas City Region's savings institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Chicago Senior Regional Analyst

For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

Kansas City Region: Tied Together by A Common Bond

- **Despite early concerns in drought plagued areas in the Region, agriculture overall enjoyed a strong year, reaching record levels in net farm income.**
- **The 1996 Farm Bill will pass additional risks to farm producers and increase the need for risk management by farmers and their lenders.**
- **Non-farm employment growth grew at the same pace as that of the nation in 1996.**

Overview

The Kansas City Region's economy experienced moderate growth during 1996, to some extent mirroring the national economy. Nonfarm payroll employment grew 1.9 percent in the Region versus 2 percent for the nation. The Region's unemployment rate remained low at only 3.6 percent. Despite population growth equal to that of the nation (0.9 percent), home building grew faster in the Region (11.1 percent) than in the U.S. as a whole (8 percent).

Agriculture

Agriculture's importance to the Region's economy is hard to overstate -- agriculture generates a significant portion of the Region's output, jobs and income (see Table 1). As measured by the ratio of gross farm receipts to total personal income, this Region has the five "most agricultural" states in the nation. The Region's farm output accounts for about 20 percent of the nation's total farm output.

The Year in Agriculture - 1996

Concerns over production and farm incomes were present as 1996 began. A persistent drought threatened the winter wheat crop in Kansas. The corn belt states of Iowa and Nebraska received excessive spring rains that delayed corn and soybean planting. These early concerns, coupled with already low grain stocks and robust foreign demand for U.S. crop exports drove grain prices to record levels. *Higher prices for feed grains and a lack of grass for grazing, coupled with cyclical lows*

Table 1

The Five "Most Agricultural" States in the Nation *

State	Rank	Percent
South Dakota	1	27%
North Dakota	2	25%
Nebraska	3	25%
Iowa	4	17%
Kansas	5	17%
Minnesota	12	6%
Missouri	19	4%
United States	-----	3%

* Measured as a percentage of gross farm receipts to total personal income.
Source: Bureau of Economic Analysis U.S. Department of Commerce

Table 2

Year-Over-Year Percent Change in Farmland Values (Sept 30, 1996)

	Cropland	Irrigated Cropland	Grazing Land
Iowa	12.0	-	-
Kansas	2.4	1.7	6.7
Missouri	3.8	2.6	1.8
Minnesota	5.9	6.8	1.7
Nebraska	2.1	4.5	3.6
North Dakota	4.8	6.7	2.5
South Dakota	4.2	5.1	3.8
Kansas City Region	5.0	4.6	3.4

Sources: Federal Reserve Bank of Chicago, Federal Reserve Bank of Kansas City, and Federal Reserve Bank of Minneapolis.

in cattle prices, put cattlemen, particularly cow-calf operators, under financial stress.

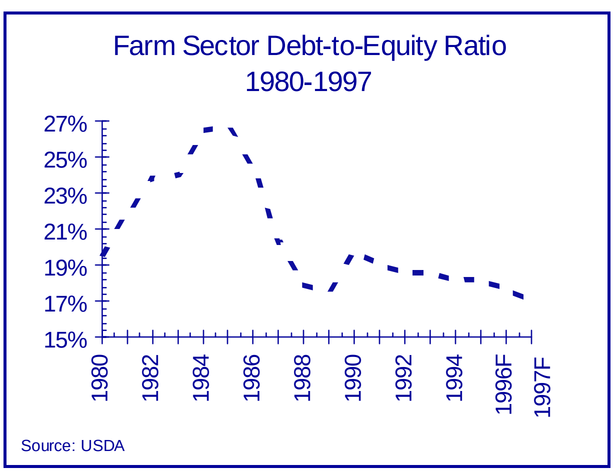
Subsequent favorable weather conditions throughout the Midwest resulted in the third largest corn harvest on record, an estimated 9.3 billion bushels. The soybean crop, estimated at 2.4 billion bushels, was the second largest on record. Iowa and Nebraska had near record corn and bean harvests. As a result of the excellent harvest, the USDA has forecast net farm income of $53 billion for the nation in 1996. The Kansas City Region shared favorably in the strong performance of the agricultural economy.

Farm Real Estate Values on the Rise

Farmland prices continued to rise across the Region. Table 2 (previous page) contains summary information by state of year-to-year percentage gains in various farmland categories. The states with higher concentrations of corn and soybeans, such as Iowa and Minnesota, enjoyed the highest gains. States with higher concentrations of wheat and grazing lands, such as Kansas and Missouri, show more modest gains.

Since farm real estate generally accounts for nearly 75 percent of the value of all farm assets, the rise in farmland prices should continue to strengthen farm balance sheets. The appreciation in farmland, when coupled with the strong farm earnings of 1996, should result in lower debt-to-equity ratios. This is expected in spite of higher anticipated loan demand. Chart 1 illustrates the improving trend in farm debt-to-equity ratios.

CHART 1



Source: USDA

It is important to note that many of the states in the Region continue to reflect aggregate farm debt-to-equity ratios that <u>exceed</u> the national average.

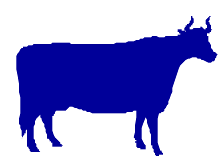
Outlook for 1997

The USDA's initial estimate for 1997 farm income projects a decline to $40 billion. Small farms (those with gross sales under $250,000) are expected to have the largest percentage declines. The disproportionately negative effect on smaller farms is due to their heavier reliance on grains such as corn and wheat. As discussed below, the outlook for corn and wheat in 1997 currently appears less favorable than for 1996.

Grains: The projected decline in 1997 farm income is driven by expectations for lower grain prices, in part a result of increased foreign supplies. While corn receipts are expected to decline in 1997, they are still anticipated to exceed the 1990-1995 five-year average of $15 billion.

The USDA estimates that the planting of U.S. winter wheat crop is at its lowest level since 1978 and down 7 percent from 1996. Kansas, the U.S. leader in winter wheat production in most years, saw farmers plant 3 percent less winter wheat than in 1995. The decline in Kansas is largely attributed to the 1996 drought. As it became apparent that wheat crops would be disappointing, farmers looked to alternatives such as cotton and grain sorghum. Late harvests of these crops precluded planting winter wheat last fall.

Livestock: In its December 1996 ***Beige Book,*** the Minneapolis Federal Reserve reported that beef prices were believed to have passed their trough and should begin trending upward sometime by mid-1997. In response to last year's low prices and high feed costs, beef cattle producers trimmed herds by 2 million head. The reduced supply of cattle should provide some support to prices in 1997. With grain prices sharply lower, cattle feeders are once again turning a profit. Higher beef prices and lower production costs are expected to ease some of the pressure cattlemen were feeling last summer.



Nonetheless, there are still concerns for many of the Region's cattle producers. *Severe weather in parts of the Region, particularly in North and South Dakota,* *is causing stress for many cattle producers.* Weather-related deaths are already in the thousands and many ranchers are running out of feed or can not reach their cattle. In addition, the cold weather increases feed usage. The full impact of this winter's weather will not be known until the effect on calving operations is determined.

Affect of the 1996 Farm Bill

The 1996 Farm Bill perhaps represents a structural change for the agricultural industry. The Bill reduces government influence in favor of free market forces. Elimination of the acreage reduction program and the allowance of full planting flexibility will eliminate many of the controls on production.

In 1997, the Farm Bill will provide direct payments to farmers in the amount of $7.6 billion, down from $7.8 billion in 1996. During the period 1990 to 1995 farmers received on average $9 billion per year in subsidy payments - an amount equal to 5 percent of farm cash income. *The effects of this decrease will be more profound in the Kansas City Region. Each of the seven states in the Region rank in the top 14 in terms of production flexibility payments received, based on USDA preliminary 1996 estimates* (see Table 3).

Since government influence on production volumes is supplanted by market forces, there is the potential for increased supply-influenced price volatility. *This could result in significant price risk to the individual producer.* This fundamental change will require greater emphasis on risk management techniques. The use of traditional techniques, such as futures contracts, is likely to increase, and new hedging products will be introduced as well. New products, such as crop yield insurance, futures and options, and crop revenue insurance, have been developed. Crop revenue insurance is a product that was widely used in areas where it was available in 1996.

The key to managing risk now that government price supports have been eliminated is education. It will be increasingly important that producers recognize the additional risk they now carry. *Lenders also will need to be aware of this risk, and assessing a borrower's ability to manage risk will undoubtedly become a greater factor in future lending decisions.*

Non-farm Industry Sectors

Manufacturing provides nearly 1.5 million jobs, or 16.2 percent of nonagricultural employment, to the Kansas City Region. Food and kindred products are the Region's largest manufacturing industry, employing over 235,000 workers. Other leading manufacturing industries by employment are: industrial machinery and equipment; printing and publishing; transportation equipment; fabricated metals; and, electronics and other electrical equipment. These five industries, along with food and kindred products, account for 62 percent of the Region's total manufacturing employment. Minnesota and Missouri are the Region's industrial states -- the two states combined are home to 58 percent of the Region's manufacturing jobs. These two states rank first and second in many industry categories.

Regional Manufacturing Employment Tracks U.S. Business Cycle

Chart 3 (next page) shows how closely manufacturing employment in the Region has tracked the U.S. industrial production index for manufacturing, one of many indicators used to measure the U.S. business cycle. As Chart 3 illustrates, manufacturing employment in the Region tracked closely changes in U.S. industrial production during the late 1980s and early 1990s. Since 1991, the relationship has not been as close, but the two indicators still continued to move together.

Manufacturing employment growth slowed in the Region during the final months of 1996. Contributing to the slowdown is the difficulty employers are having in hiring and retaining highly skilled technical workers. The seven states that make up the Kansas City Region already have some of the lowest unemployment rates in the nation.

Table 3

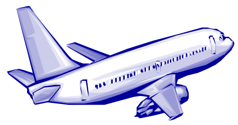
Production Flexibility Payments Received in the Kansas City Region

State	Total Payments (000s)	Rank
Kansas	422,190	2
Iowa	350,239	3
North Dakota	307,777	5
Nebraska	303,270	6
Minnesota	261,355	8
Missouri	153,246	13
South Dakota	151,876	14
TOTAL	$1,949,953	

Source: USDA

Transportation Plays Large Role in the Region

Kansas City, St. Louis and Wichita serve as major thoroughfares for agricultural and manufactured goods shipped from the Midwest to other destinations around the nation. Transportation and manufacturing are contributing important synergies to the Region's growing list of economic activities. For example, the number of air cargo loads transported through an airport is an important site selection criterion for companies looking to establish new factories and distribution centers.



The Federal Express Corporation has announced plans to build a $10 million regional hub at Kansas City's International Airport (KCI). The hub could double the number of delivery planes that land at KCI. Meanwhile, Boeing, which employs more than 15,000 workers in Wichita, expects to add up to 4,000 jobs there as a result of its planned merger with McDonnell Douglas Corp.

Residential Construction Activity Generally Robust

Housing activity was strong throughout much of the Region in 1996, spurred by employment growth and favorable interest rates. Residential building permits -- an indicator of future housing activity -- were up 10.5 percent from their 1995 level. Building permits for single-family homes increased 8.1 percent, while multifamily permits jumped 17.4 percent from the previous year. Overall, builders acquired 95,000 permits in 1996 for single- and multifamily dwellings.

Chart 3

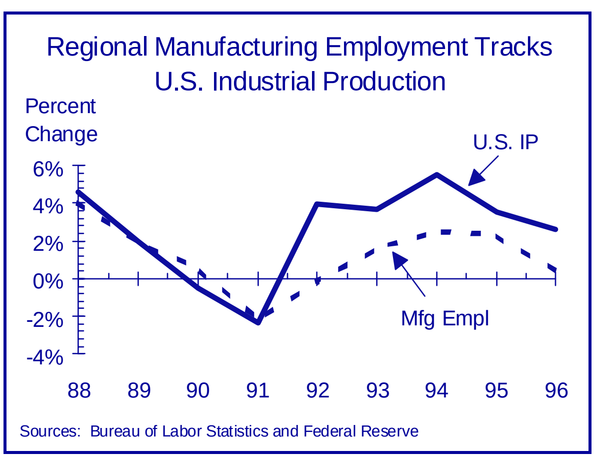


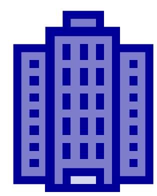
Table 4

Office Vacancy Rates Are Lowest in the Suburbs (As of September 30, 1996)	Downtown	Suburban
Kansas City	16.5%	9.4%
Minneapolis/ St. Paul	8.8%	5.3%
St. Louis	17.9%	7.5%
United States	14.4%	11.7%

Source: CB Commercial/Torton Wheaton Research

Commercial Real Estate Picture Mixed

The Region's commercial real estate markets were generally healthy in 1996, particularly in the suburban office and industrial markets of the Region's three largest metropolitan areas: Kansas City, Minneapolis-St. Paul, and St. Louis (see Table 4). On the other hand, downtown office vacancy rates continued to hover around 15 to 20 percent in Kansas City and St. Louis. By comparison, the U.S. average was 14.4 percent as of the end of the third quarter of 1996.



The difference between office vacancy rates in the suburbs versus those found in the downtown areas are striking. Plaguing the downtown areas of Kansas City and St. Louis are high vacancy rates and low levels of absorption. Many companies have chosen to relocate their businesses to the suburbs to take advantage of lower building costs, better access to labor, and better amenities. Reinforcing this advantage that suburban markets enjoy have been the changes in communications technology that no longer require firms to conduct their business in a centralized location.

Industry experts expect the supply of office space to continue increasing in 1997 for all three of the Region's largest suburban office markets. Moreover, with suburban vacancy rates below 10 percent, rental rates are expected to rise over the next few years as well. Progress, however, will be much slower in the downtown office markets of Kansas City and St. Louis, particularly if office employment growth continues to slow. The exception is Minneapolis-St. Paul, where demand for office space in the downtown area appears to be strengthening, and its vacancy rate is already at a low level (8.8 percent).

Industrial Sector May Have Room to Grow

The current expansion in manufacturing has managed to put downward pressure on industrial vacancy rates in the Region. Kansas City, for example, had the third lowest industrial vacancy rate (2.9 percent) among the 42 markets that CB Commercial tracks as of the third quarter of 1996. Similarly, Minneapolis-St. Paul and St. Louis both had vacancy rates of 4.1 percent as of the third quarter 1996 -- well below the national average of 7.7 percent.

A surge in U.S. economic growth during last year's fourth quarter could result in industrial vacancy rates moving even lower. It is too early to tell whether industrial construction will continue at its current pace in the Region during 1997. That will ultimately depend on the strength of the Region's economy and the manufacturing industry.

Finally, there has been some concern raised about the potential overbuilding of hotels in the Kansas City market. *Industry experts warn that the market is becoming saturated and that the industry may slump if developers pursue plans to add additional hotels in 1997. According to experts, supply growth already is exceeding demand growth and occupancy rates are beginning to fall.*

The cancellation of several large conventions may heighten these concerns. The Future Farmers of America Convention, the largest convention staged each year in Kansas City, announced that it was moving its annual convention to Louisville. City officials estimate that the economic loss from recent convention cancellations is more than $40 million.

Adrian R. Sanchez, Dallas Regional Economist

Financial and Commodity Markets

- **The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.**
- **The Kansas City Region's bank stock index has outperformed the S&P 500 so far this year, but it generally has underperformed the S&P Composite Bank Index.**
- **Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.**
- **New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.**
- **Favorable forecasts and a drop in exports have driven grain prices lower.**

Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost nearly 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the Kansas City Region's banks fared slightly better. The value of securities holdings for all Call Report filers in the Region declined by only 1.41 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original

CHART 1

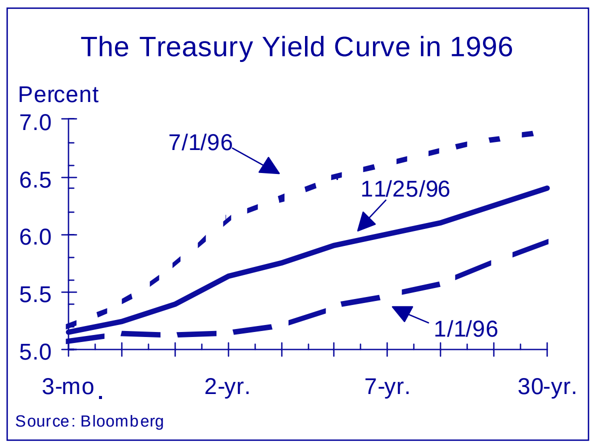


TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE

	US Treasury 30-year bond $100,000 Par 7.25% Coupon 7.75 yrs until maturity		FNMA Mortgage pass-through $100,000 Par 7.5% Coupon 7.59 yrs WAL		FNMA Callable Agency bond $100,000 Par 7.55% Coupon 7.58 yrs until maturity		TOTAL	
Date	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period
11/25/96	$107,375	3.84%	$100,280	2.19%	$102,240	2.14%	$309,895	2.74%
7/1/96	$103,406	(7.08%)	$98,130	(3.90%)	$100,100	(4.68%)	$301,636	(5.27%)
1/1/96	$111,281		$102,110		$105,020		$318,411	

SOURCE: Bloomberg

PROTOTYPE

acquisition price of each instrument.

The Kansas City Region's Bank Stock Performance

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the Kansas City Region's banks. The Kansas City Regional Bank Index (KCRBI), created by the Division of Insurance (DOI), consists of the Kansas City Region's 13 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The KCRBI, which is weighted by total market value of shares outstanding, has gained 33 percent on the year, with performance closely tracking the S&P Bank Index* (see Chart 2). The KCRBI shares its two largest institutions with the S&P Bank Index: First Bank System, Inc. and Norwest.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 (next page) plots this concept through 1995.

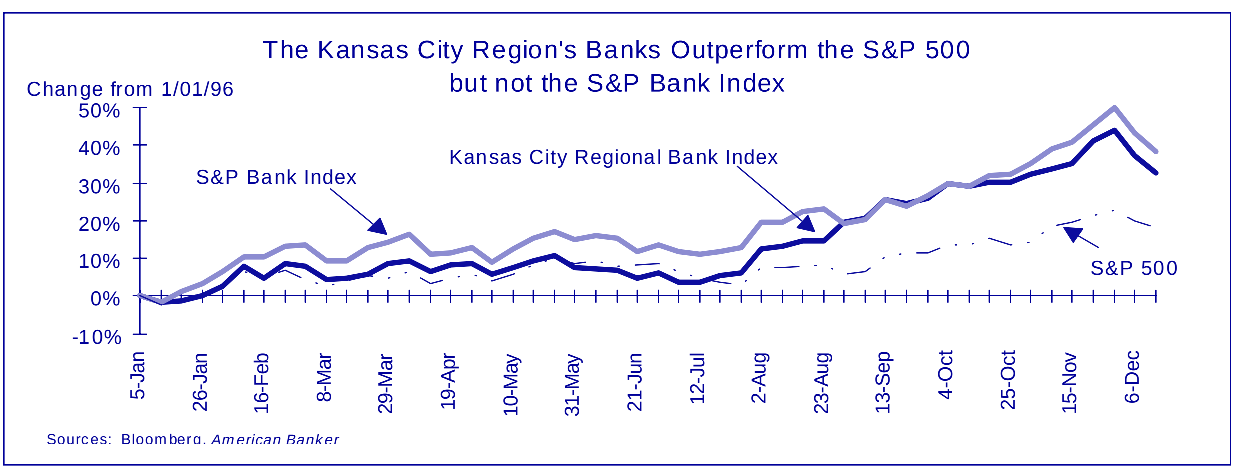
The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield

CHART 2



PROTOTYPE

Curve Twists

Managing earnings exposures to changes in the yield curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. *Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).*

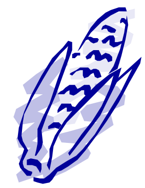
YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.

Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversified with most volume being derived from speculators and traders for proprietary accounts.

Favorable Forecasts, Fewer Exports Drive Grain Prices Lower

Many market observers were surprised by a mid-November USDA report that projected near-record corn and soybean crops this year. Favorable weather during the late harvest pushed estimated corn production for the 1996/1997 crop year to 9.27 billion bushels -- the third best harvest behind those of 1992 and 1994. *The USDA expects strong corn yields over much of the Corn Belt and record yields in **Nebraska, Kansas,** and **Missouri.*** Likewise, soybean production is forecast to total 2.4 billion bushels -- second only to the 1994 harvest.



As expected, prices for corn continued to slide from their summer highs, which were driven by fears of supply shortages, late planting, and late harvest risks. Weaker corn and soybean prices, the second largest spring wheat harvest on record, and favorable weather conditions for the recently planted winter wheat crop also have softened wheat prices (see Chart 4 next page). Further compounding price declines has been a drop in demand from abroad as global competition heightens. *Domestic corn and wheat producers are facing increased production, aggressive marketing, and foreign export subsidies from competitors including Argentina and the European Union.* Soybean exports appear more favorable as Pacific Rim purchases of soybean meal to feed expanding livestock herds accelerate and as South American competitors face lower than expected production.

CHART 3

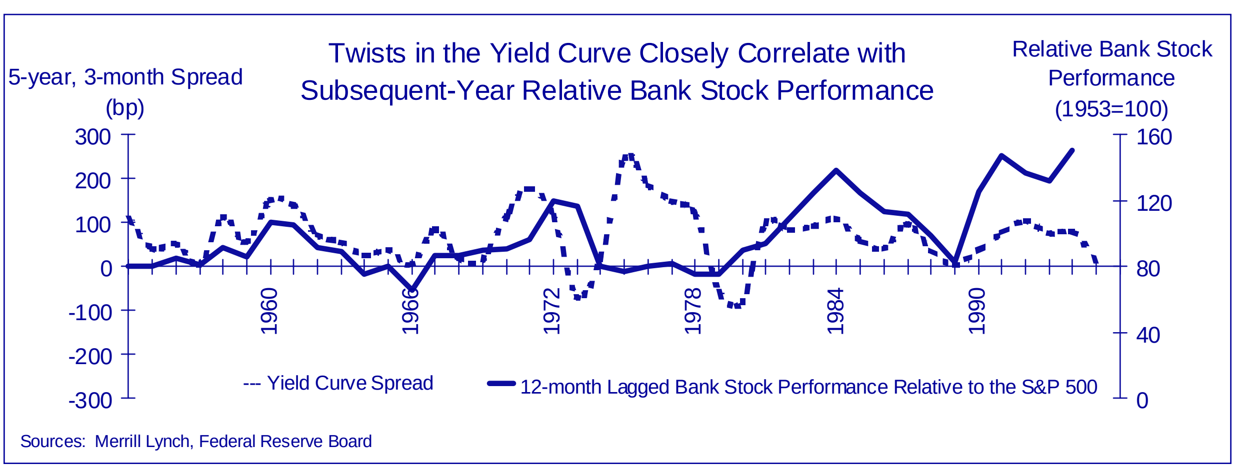


Chart 4

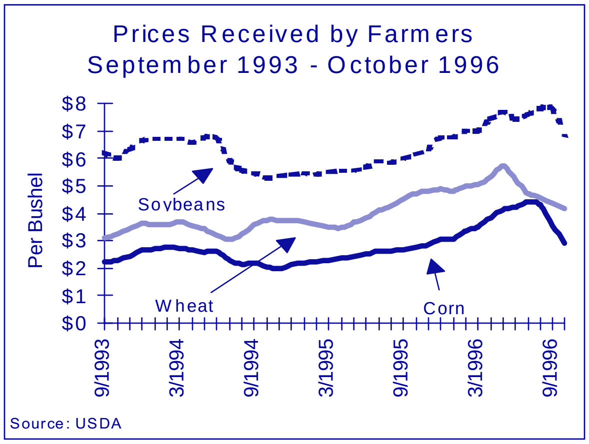


Table 2

Major Commodity Rankings Based on 1994 Cash Receipts	IA	KS	MN	MO	NE	ND	SD
Cattle	4	1	4	1	1	2	1
Corn	1	3	3	4	2		2
Soybean	3	4	2	2	4		3
Hogs	2		5	3	3		5
Wheat		2			5	1	4
Dairy	5		1	5			
Sorghum Grain		5					
Barley						3	
Sunflowers						4	
Sugar Beets						5	

Source: USDA

According to the USDA, average prices for all three crops for the current marketing year are expected to fall from the average of the previous year, but should remain favorable relative to the average price received over the previous five marketing years. Futures markets generally agree with these predictions with some contracts that mature over the 1996/1997 marketing year recently trading approximately 30 percent below their respective contract highs reached earlier in the year.

Provided livestock and milk prices continue their recent ascent or stabilize, declines in feed costs should improve profit margins for livestock and dairy farmers. This is especially good news for cattle operators who faced falling cattle prices and rising feed costs earlier in 1996. Table 2 shows the major agricultural commodities for states in the Kansas City Region.

The prospect for timely repayment of production loans to the Region's agriculture banks appears good based on the current expectations for operating income. Cash flows for many crop producers also should be supported by the first of seven fixed-support payments under the 1996 Farm Bill.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

Current Regional Banking Conditions

- **Institutions in the Kansas City Region in the aggregate are profitable, well capitalized, and have strong asset quality**.
- **Loan charge-offs are rising and now exceed the national average. The increase primarily is attributed to increased losses in consumer debt, which is most dramatic in the credit card portfolio.**
- **Agriculture lending, the mainstay for a majority of the Region's banks, continues to be profitable.**
- **Mergers continue the shift of deposits from small banks to medium and large institutions.**

Favorable economic conditions have assisted in maintaining the financial health of the Kansas City Region's banks and thrifts. Both balance sheets and examination ratings portray a strong industry. Nevertheless, there are some areas of special interest this quarter.

Earnings in the third quarter of 1996, though healthy on an aggregate basis (year-to-date 1.4 percent return on assets (ROA) versus 1.2 percent nationally) have been substantially reduced at some institutions. For example, the effect of the SAIF special assessment was especially noticeable in North Dakota, where the aggregate ROA dropped to 0.70 percent, primarily due to this one-time event (see ***SAIF Capitalized***). In addition, South Dakota's large credit card banks are showing the effects of deterioration in consumer loan quality.

Consumer credit, especially credit card lending, remains an area of potential concern as discussed below.

Credit Card Delinquencies in the Region are on the Rise

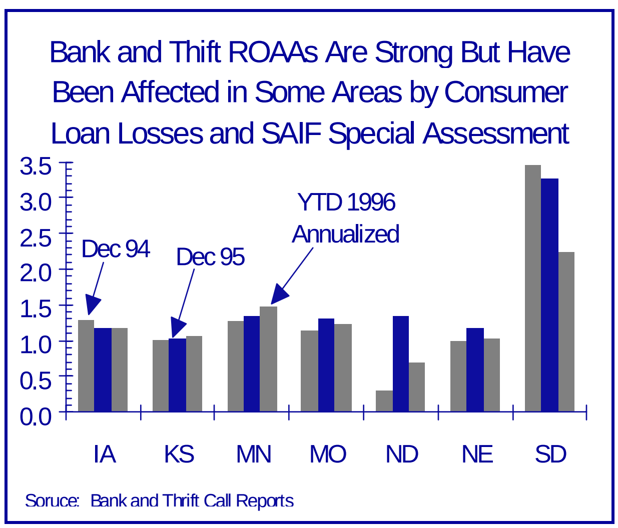
Loan charge-offs in the Kansas City Region increased to 0.66 percent of total loans as of September 30, 1996, up from 0.49 percent at year-end 1995. The increase was driven, in large part, by charge-offs in credit card portfolios. The charge-off rate for credit card loans in the Kansas City Region was 5.24 percent during the third quarter, higher than the national average of 4.31 percent and significantly higher than the 3.75 percent and 3.57 percent reported for year-end 1995 and year-end 1994, respectively. Credit card delinquencies also increased from 4.3 percent at year-end 1995 to 4.89 percent as of September 30, 1996.

Geographically, most credit card activity in the Region is concentrated in affiliates of larger banking organizations and financial service companies in the **Sioux Falls field office.** Collectively, banks in that field office hold about 64 percent of the Region's credit card outstandings and, not surprisingly, reflect the highest charge-off rates in the Region.

On a regionwide basis, the largest banks (assets exceeding $10 billion) hold about 58 percent of the Region's credit card receivables. However, *it is medium sized banks, those with assets of $1 billion to $10 billion, that showed the most deterioration in their portfolios*. In the aggregate, this group of banks, which controls 28 percent of Region's credit card outstandings, charged off 5.46 percent of credit card loans during the past 12 months.

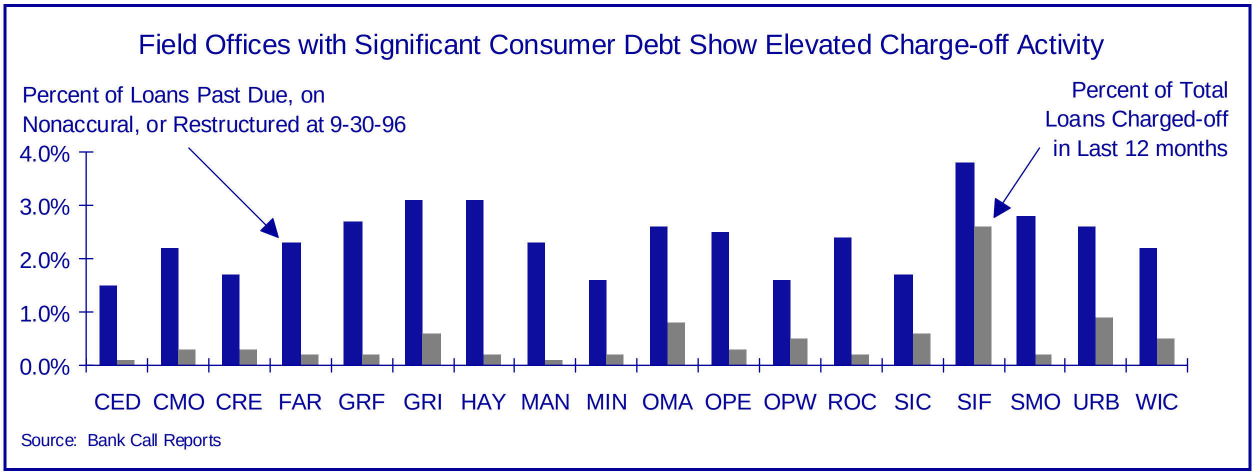
Given all of the recent publicity over consumer debt levels and the negative performance trends of the Re-

CHART 1



PROTOTYPE

CHART 2



gion's consumer loan portfolios (see ***Consumers Declare Bankruptcy in Record Number***), credit card portfolios warrant continued close attention by bank management and regulators. In that regard, the OCC issued additional guidance to banks during the third quarter, focusing on maintaining prudent underwriting standards and controls. Suggestions such as these may already be having some effect, as Moody's recently reported that the rate of growth in credit card losses has declined for three consecutive months.

A Profitable Year for Farmers Contributed to the Good Performance for Insured Institutions

The health of the agriculture industry significantly influences the performance of a majority of the Kansas City Region's commercial banks. Fifty-eight percent of the Region's banks have 25 percent or more of their loan portfolio in agriculture-related operating and real estate loans.

In general, 1996 was a good year for agricultural producers, and examiners indicate that most farm borrowers continue to enjoy relatively strong financial condition. Nevertheless, some wheat farmers and cattle ranchers are suffering. A drought that extended into parts of Kansas resulted in poor winter wheat yields for the second year in a row. In addition, cattle ranchers suffered throughout the Region from high feed costs and low prices. These conditions likely influenced recent surveys conducted by both the Minneapolis and Kansas City Federal Reserve banks. They reported that *forced liquidations are increasing for cattle ranchers in Nebraska, North Dakota and South Dakota.*

This suggests that some insured institutions in these areas could experience declining credit quality and reduced earnings, especially if conditions do not improve in 1997.

Another area of interest for the Region's farm banks involves hedge-to-arrive contracts. Recently, the Commodities Futures Trading Commission lodged complaints against three firms that have marketed the contracts. If the contracts in dispute are deemed illegal, the immediate losers will be the elevators and cooperatives and potentially their lenders. On a positive note, an informal survey of examiners *did not* uncover any insured institutions holding affected cooperative or elevator debt.

Unfortunately, there is still uncertainty over how the cooperatives owners -- who are mostly farmers -- may be affected. For example, in the case of the Grain Land Cooperatives of Blue Earth, Minnesota a few farmer members (150 of 3,000) have banded together to challenge the contracts. Should they win, the $28 million in dispute will more than eliminate the capital of the cooperative. The consequences would include wiping out the equity of the other 2,850 members, which for many was earned over a lifetime of farming. The financial effect on most farmer and owners is uncertain and, therefore its effect upon their repayment ability can not be estimated at this time.

Merger activity heats up

The number of insured commercial banks in the Region has declined by 480 in the last five years, but total assets in the remaining banks have increased by $60 billion.

This consolidation trend continued with significant merger activity in 1996. Homeland Bankshares, Mark Twain, Boatmens, First Tier, Roosevelt Bank, and Bank IV, to name a few, were all acquired. Nationsbank, with the purchase of Boatmens, became the largest bank in Missouri and Kansas only to be subsequently passed by Mercantile's acquisition of Roosevelt Bank. Very few of the remaining large banks within the Region are immune to takeover, according to industry analysts.

The effects of mergers and acquisitions are apparent in a shift in deposits from institutions having less than $500 million in total assets to institutions with assets exceeding $500 million. For the quarter ending September 30, 1996, banks with total assets of less than $500 million experienced annualized asset shrinkage of 0.93 percent. At the same time, banks with total assets exceeding $500 million had an annualized growth rate of nearly 20 percent. Despite the shift toward larger banks, deposits in banks with total assets of less than $500 million still account for 55 percent of the total deposits in the Region.

Craig A. Rice, Senior Regional Analyst