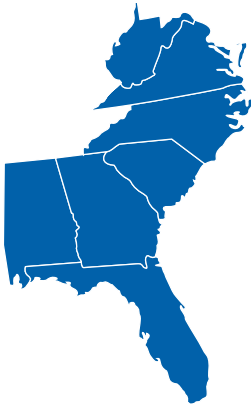

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

THIRD QUARTER 1997

In Focus This Quarter

FDIC ATLANTA REGION



◆ ***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. Kalsner, 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

Regular Features

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FINANCIAL ANALYST

◆ ***Regional Economy***—Job growth in North Carolina, Virginia, and Florida exceeds national average . . . rural-urban dichotomy in economic performance is widespread . . . the Region's economy increases its ties with global markets . . . increasing trade and tourism could fuel demand for financial services. *See page 11.*

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By Jack M.W. Phelps, Pamela R. Stallings, Scott C. Hughes

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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 credit-worthy 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, non-prime, 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 close-

ly 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.

An informal survey of examiners in the FDIC's Division of Supervision shows that insured institutions and their affiliates in the Atlanta Region appear to be involved in subprime lending to a greater extent than insured institutions and their affiliates in most other parts of the United States. Subprime activity by insured institutions or their affiliates in the Atlanta Region is concentrated mostly in automobile and home mortgage lending. Over the past two years, several regional and super-regional banking companies headquartered in the Atlanta Region have acquired nonbanking companies that specialize in subprime lending.

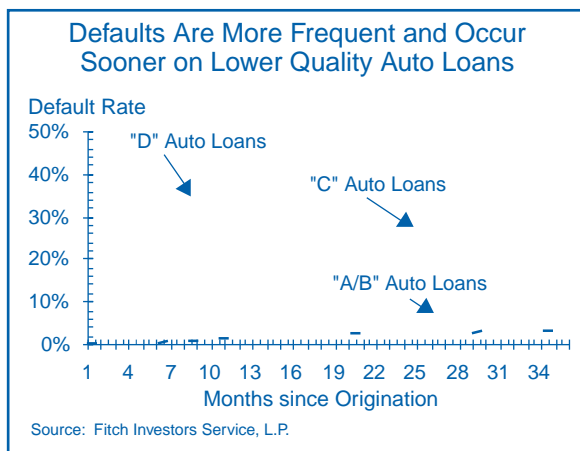
Risks Associated with Subprime Lending Need to Be Considered Carefully

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.

CHART 1



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.

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.

*Kathy R. Kalser, Chief
Financial Sector Analysis Section
Debra L. Novak,
Division of Resolutions and Receiverships*

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.

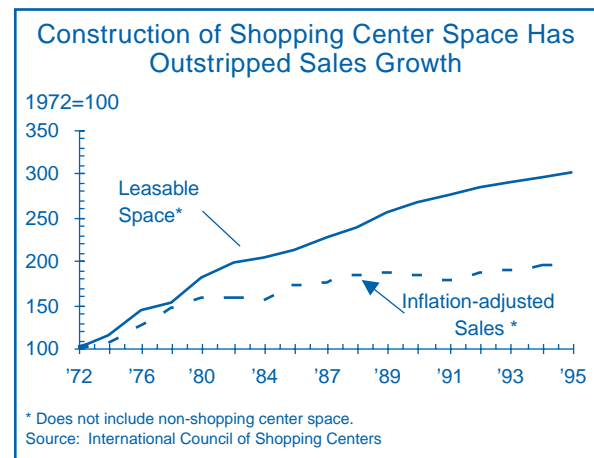
Based on signs of “overstoring,” a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate,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

CHART 1



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 book-seller, 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

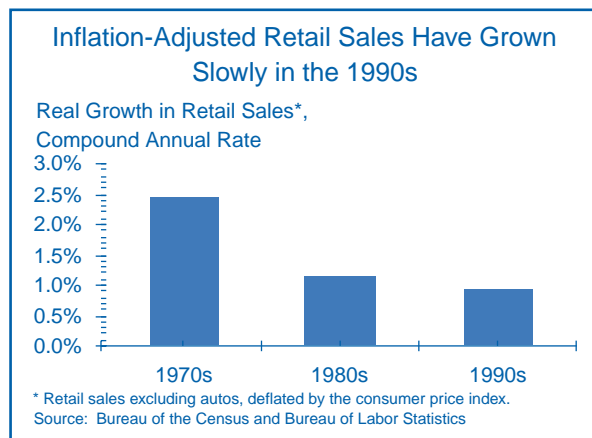
increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost \$33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although 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 super-stores, 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



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.

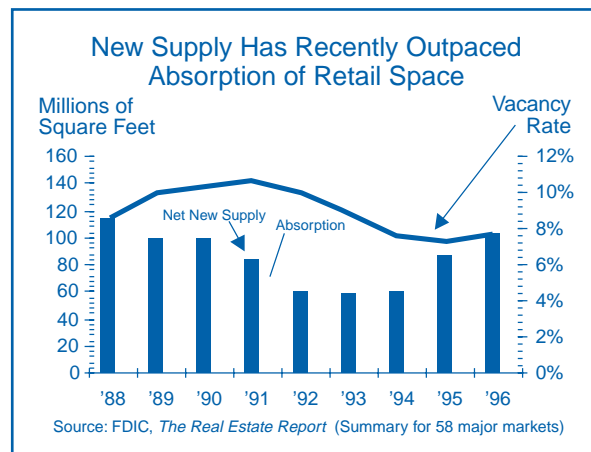
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more 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 Clotheshime 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



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 Vacancy Rates Reflect Different Trends in the Atlanta Region's Retail Real Estate Markets*).

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.

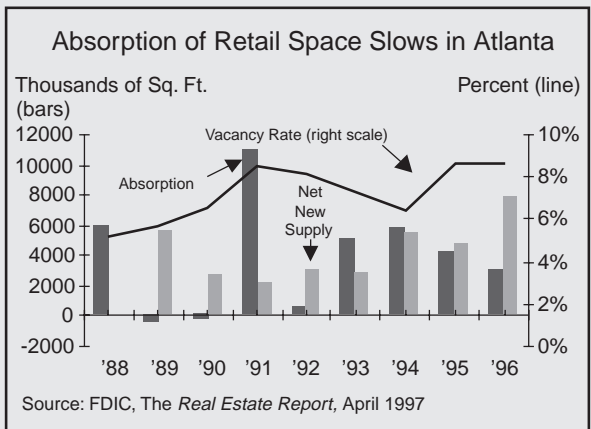
*Richard A. Brown, Chief, Economic Analysis Section
Diane Ellis, Senior Financial Analyst*

Retail Vacancy Rates Reflect Different Trends in the Atlanta Region's Retail Real Estate Markets

Retail real estate market conditions vary widely across the Atlanta Region. Outside of **Florida** and Northern Virginia, vacancy rates in most metropolitan areas have risen since 1994 (see Table 1). In fact, vacancy rates in several of these metropolitan areas are above the previous peak that occurred during the 1990-1991 recession. Much of the increase appears to be the result of continued increases in net new supply while absorption of new space has declined.

The **Atlanta, Georgia**, metropolitan area is displaying signs that it has the potential to become overbuilt (second quarter, **Regional Outlook**). Retail vacancy rates in both 1995 and 1996 exceeded the previous peak of 8.5 percent, which occurred during the 1991 recession (see Chart 4). Since 1994, the absorption rate has steadily fallen, while net new supply in 1996 was more than double absorption. Planned retail construction in the Atlanta area is for more than 18.6 million square feet of new space.

CHART 4



Retail real estate conditions in Orlando, Florida, are similar to those in many of Florida's other metropolitan areas, where retail vacancy rates have steadily declined since the early 1990s, when they were uniformly in the double digits. One possible explanation for the continued downward trend in retail space availability while the rest of the Atlanta Region has seen rising vacancy rates is that Florida is still recovering from the overbuilding of the 1980s. Even with the ongoing declines, Orlando's vacancy rate of 8.5 percent in 1996 (see Chart 5, next page) remained

TABLE 1

VACANCY RATES RISE IN MOST OF THE ATLANTA REGION'S RETAIL REAL ESTATE MARKETS				
METROPOLITAN AREA	1993	1994	1995	1996
ATLANTA, GA	7.3%	6.4%	8.7%	8.6%
BIRMINGHAM, AL	7.3%	6.4%	8.7%	8.6%
CHARLOTTE, NC-SC	6.4%	7.0%	7.3%	7.3%
FT LAUDERDALE, FL	11.5%	9.9%	8.4%	8.5%
GREENSBORO, NC	8.3%	9.0%	9.0%	10.5%
GREENVILLE, SC	8.4%	9.0%	10.1%	10.9%
JACKSONVILLE, FL	16.8%	14.2%	11.8%	11.3%
MIAMI, FL	10.5%	8.4%	7.4%	8.1%
NORFOLK, VA-NC	11.4%	13.0%	12.4%	13.4%
ORLANDO, FL	16.2%	13.4%	8.8%	8.5%
RALEIGH, NC	5.2%	5.3%	7.3%	6.7%
RICHMOND, VA	6.6%	9.2%	7.7%	6.8%
TAMPA, FL	10.8%	11.0%	9.2%	8.7%
WASHINGTON, DC-MD-VA-WV PMSA*	7.9%	7.7%	7.2%	7.7%
WEST PALM BEACH, FL	13.7%	13.1%	11.8%	10.2%

*PMSA = PRIMARY METROPOLITAN STATISTICAL AREA
SOURCE: FDIC, THE REAL ESTATE REPORT

above the national average (58 markets reporting nationally) of 7.7 percent. Although vacancy rates are above average, some areas of Orlando's retail real estate market are tight. For example, according to *Valuation International LTD*, the mall vacancy rate in 1996 was 1.6 percent, compared with 6.5 percent nationally. Orlando has 10.1 million square feet of retail space construction in the planning stages, which is five times the level of net new supply in 1996. About 90 percent of the planned construction is only in the early stages, however, and thus is subject to cancellation.

Norfolk, Virginia, is the only metropolitan area in the Atlanta Region to have seen generally rising retail

vacancy rates for one decade. In 1995, there was a slight decline in vacancy rates as absorption exceeded net new supply for the first time during the 1990s (see Chart 6). Nevertheless, absorption fell in 1996 simultaneously with a continued rise in net new supply, forcing vacancy rates up again. According to *The FDIC Real Estate Report*, 3.8 million square feet of construction is planned in the Norfolk area, over three times the amount of net new supply that came on-line in 1996. Even if only the final stage of planning (plans completed/bid) is considered, planned construction is for 0.85 million square feet—still in excess of the 0.68 million square feet of new supply in 1996.

Scott Hughes, Regional Economist

CHART 5

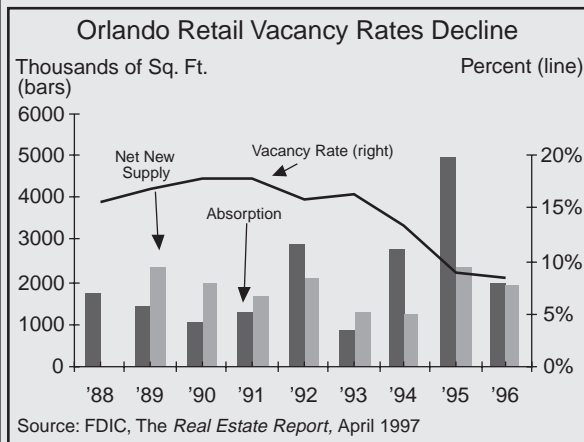
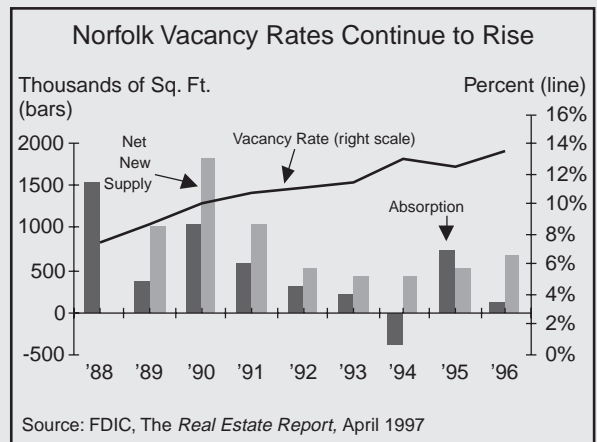


CHART 6



Growth in the Atlanta Region, Though Slower, Remains above the Nation

- Job growth in North Carolina, Virginia, and Florida continues to exceed the national average.
- While state information indicates continued growth in Georgia, gains are restricted to a few metropolitan areas.
- Like the nation, the Atlanta Region's economy is becoming more closely connected with global markets.
- Growth, fueled by rising tourism and trade, could help push demand for financial services.

Regional Overview

Growth in the Atlanta Region continues to slow despite a modest rebound at the beginning of the year. In March 1997, year-over-year job growth in the Region had slowed to 2.6 percent from January's pace of 3.4 percent. In January 1997, the Region's economy strengthened temporarily, experiencing an increase in employment comparable to levels last seen during the Olympic-induced gains in summer 1996. In contrast to the Olympic period, however, **Georgia** did not lead the increase in growth. Rather, all other states in the Region saw a strong rise in job growth in January, led by gains in the construction and services industries. Subsequently, however, job growth has slowed in all states. Only employment growth in **North Carolina**, **Virginia**, and **Florida** continued to exceed the national average (see Chart 1).

North Carolina Sees Fastest Growth

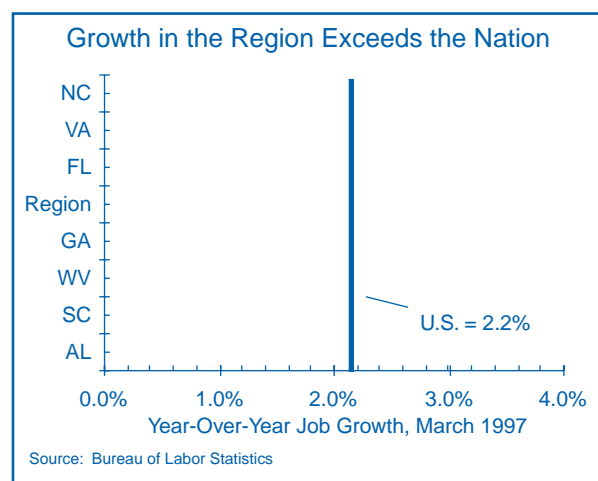
North Carolina is the Atlanta Region's fastest growing state, with year-over-year job growth in March 1997 measuring 3.4 percent. With the exception of non-durable goods manufacturing, all areas of the economy are experiencing gains in employment. The fastest gains are occurring in the state's construction industry, where residential permit issuance was up 12 percent in the first quarter of 1997 from one year earlier. Speculative construction activity also is emerging. According to a recent *Dow Jones Real Estate Report*, Carolina Power & Light Co. now has a program to stimulate speculative construction in the 59 counties that the utility serves. Growth in North Carolina also is widespread geographically, as reflected by tightening labor market conditions in several North Carolina counties. Labor shortages

have emerged in the Raleigh-Durham-Chapel Hill and Charlotte-Gastonia-Rock Hill metropolitan areas, where first-quarter 1997 jobless rates in many component counties were below 3 percent (see Map 1, next page). In some rural areas, by contrast, unemployment rates remain in double digits.

Job Gains in Virginia above Average

Virginia also is witnessing above-average levels of growth. As in North Carolina, the fastest gains are in services and construction, though other areas of the economy are seeing growth as well. Growth remains concentrated along the I-95/I-64 corridor, commonly known as the "Golden Crescent." Year-over-year job growth in the Norfolk metropolitan area and Northern Virginia is above 4 percent. Unemployment rates in Northern Virginia, as well as around the Richmond area, are below 3 percent. Economic development has

CHART 1



radiated outward from Northern Virginia as businesses and residents seek more space. While the eastern half of the state generally has seen expansion, growth in western and south-central areas has been weaker as Virginia's coal counties continue to see high levels of unemployment.

Florida's Economic Performance Slowing

Florida's economic growth, although slowing since 1994, continues to exceed that of the nation. In March 1997, year-over-year employment growth in the state was 2.9 percent, with the fastest gains occurring in the services industry. Orlando remains the fastest growing metropolitan area in the state, with March 1997 year-over-year job growth at 5.6 percent. The metropolitan area saw record levels of tourism last year, as reflected by the 14 percent increase in passenger traffic through Orlando International Airport. Tourism traditionally has been a key driver for the metropolitan area. According to the *First Union's Regional Economic Review*, over the 20-year period ending July 1995, Orlando was the nation's tenth fastest growing metropolitan area, with employment expanding at an annual rate of 3.6 percent. Tourism has the potential to continue to play a large role in **Orlando**, as Universal Studios plans a \$2.6 billion expansion. Walt Disney World also is undergoing a multibillion-dollar expansion.

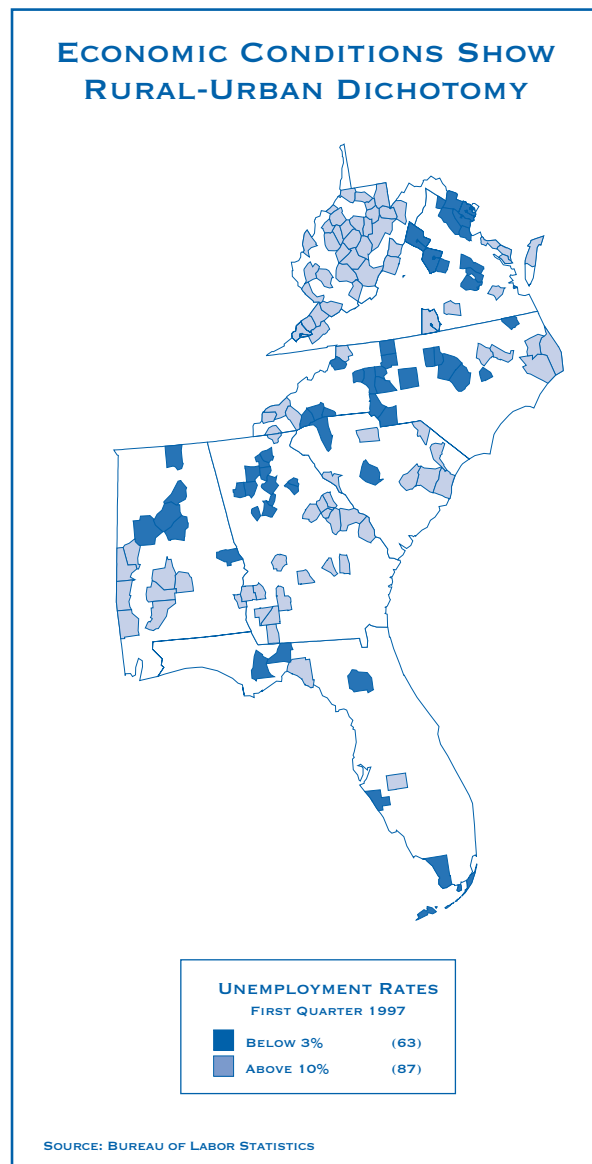
Rural-Urban Dichotomy in Georgia

Growth in the Atlanta Region's other four states (**Alabama, Georgia, South Carolina, and West Virginia**) is below the average for both the Region and the nation. In Georgia, year-over-year employment growth was 2.1 percent in March 1997. This marked the first time since the end of 1991 that the state's economic performance, in terms of job growth, was below the national average. Gains in the state have decelerated across all areas of the economy since the start of 1997.

Georgia's growth, however, appears to be partitioned generally along rural-urban lines. Of the state's seven metropolitan areas, only Columbus experienced year-over-year job growth below the state average in March 1997, while five of the state's metropolitan areas, including Atlanta, witnessed job growth above 3 percent. In total, Georgia's metro areas added 75,000 jobs over the year ending March 1997, while its rural areas lost jobs. (Note that two of Georgia's metro areas,

Columbus and Augusta, overlap with other states, so three non-Georgia counties are counted in the metropolitan area employment summation.) Indeed, in the first quarter of 1997, unemployment rates in several southwestern Georgia counties were up more than 1 full percentage point from one year earlier. In counties to the south and west of Augusta and west of Albany, jobless rates in the first quarter were generally in the double digits. This rate contrasts with counties within metropolitan areas such as Atlanta and Athens, where labor market conditions have been tight and jobless rates have been below 3 percent.

MAP 1



West Virginia's Labor Market Mixed

West Virginia's economic performance remains mixed. Year-over-year job growth in the state has declined since January but remains above levels of growth seen in 1996. Some metropolitan areas, such as Charleston and Wheeling, saw growth above the national average during the year ending March 1997, while employment levels in Parkersburg-Marietta and Huntington-Ashland remained virtually unchanged. In contrast, Steubenville-Wiarton might be considered in a recession, as year-over-year job growth has been negative since September 1996. Several nonmetropolitan areas of West Virginia retain persistently high unemployment rates. However, labor markets in these areas have shown some signs of tightening for the year.

Pockets of Growth in Alabama and South Carolina

South Carolina and Alabama are the slowest growing states in the Atlanta Region in terms of year-over-year employment growth. Nonetheless, some pockets in each state continue to gain. In South Carolina, **Greenville's** and **Columbia's** economic performance remains above the state average. Greenville's economy has benefited from the presence of BMW's automobile manufacturing facility, which has plans to expand. Gains in transportation equipment have helped offset the long-standing decline in the textile and apparel industry. Labor markets in both Greenville and Columbia have tightened over the past year ending in the first quarter of 1997. Jobless rates, likewise, have fallen throughout much of Alabama. Areas of economic weakness in Alabama do exist, however. Employment in the Anniston metropolitan area has been in decline for more than one year, and rural counties to the south and west of Montgomery continue to contend with double-digit jobless rates.



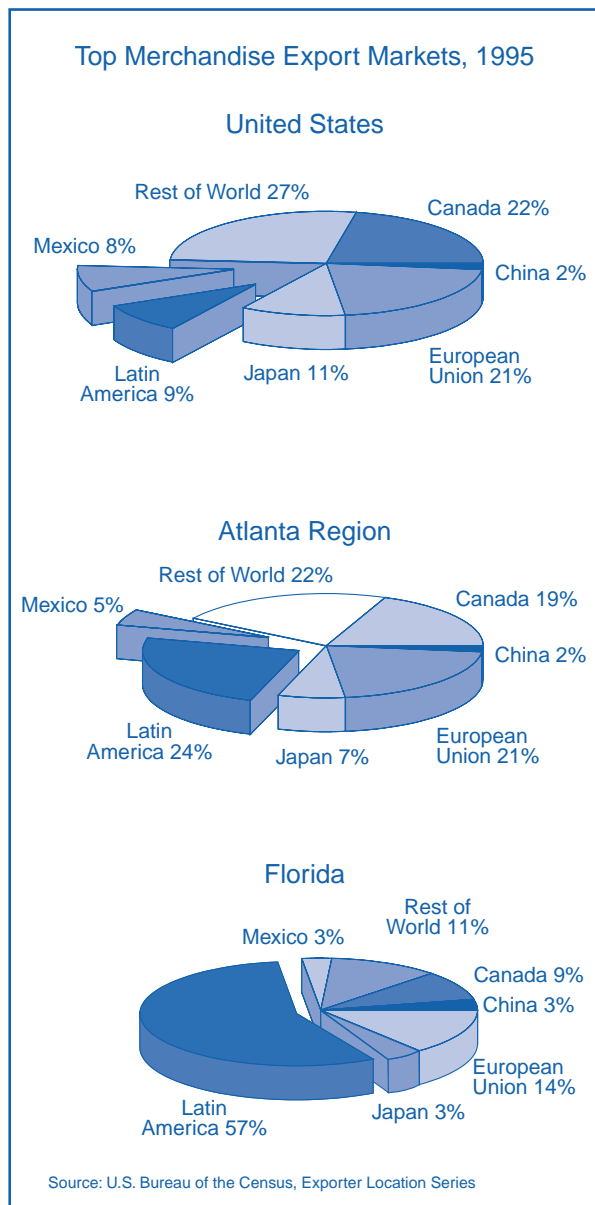
Global Economic Trends: International Linkages in the Florida Economy

Like the nation's, the Atlanta Region's economy is becoming more closely connected with global markets. Between 1993 and 1995, U.S. merchandise exports grew at a compound annual rate of 12 percent. During

the same period, compound annual merchandise export growth (by point of export, not point of production) in the Atlanta Region was over 15 percent.

While both the nation and the Region have seen strong growth over the past few years, the geographic focus of trade is somewhat different. At the national level, over half of all exports are destined for Canada, the European Union, and Japan (see Chart 2). The combination of Mexico and Latin America accounts for 17 percent of total exports. In contrast, in the Atlanta Region, Mexico and Latin America account for nearly 30 percent of total exports.

CHART 2



Florida is the Atlanta Region's largest merchandise exporter, accounting for one-third of exports in 1996. Florida's export markets have an even greater Latin American orientation than the rest of the Region. With six of its top ten export destinations in the Caribbean or South America, Latin American merchandise exports account for nearly 60 percent of Florida's total exports. Miami is currently the nation's ninth busiest port in dollar value. (Detroit and New York currently duel for first place.) The Miami Customs District accounted for nearly 70 percent of the state's trade in 1995. Most shipments through Miami are bound for Latin American countries, although exports to China and East Asia's newly industrialized countries have seen rapid growth as well.



Over half of Florida's exports to Latin America are industrial machinery and equipment, electric and electronic equipment, and transportation equipment. Industrial and electronic equipment are among the fastest growing areas for Florida exports. Total manufactured exports from Florida have risen by more than 25 percent over the past three years. According to the U.S. Department of Commerce, transportation, aerospace, health care technology, environmental technology, infrastructure development, information technology, energy, and financial services are the key emerging markets in Latin America, particularly in Brazil.

Trade linkages with Brazil are expected to grow in importance over the next several years. Brazil is the nation's third largest trading partner in this hemisphere

after Canada and Mexico and is the largest economy, after the United States, in the Western Hemisphere. Moreover, many analysts believe that Brazil is likely to be the fastest growing major economy in Latin America through the year 2000. Comparatively strong growth there could further fuel demand for U.S. exports.

The benefits of international trade to the Florida economy extend beyond the jobs created by manufacturing and growing products for export. Products need to be shipped out of the country, providing employment in the wholesale trade and transportation services industries. Construction also benefits from Florida's trade ties. As trade grows, according to the *South Florida Business Journal*, so does demand for new warehouse space. Moreover, both domestic and foreign companies have come to regard Florida, and the greater Miami metropolitan area in particular, as a gateway for trade with Latin America. As such, Canadian and European firms have been investing in the state to open regional headquarters or administrative offices.

Implications: With growing trade links and international tourism comes greater exposure to international political and economic developments. Increases in tourism and international trade could help push demand for financial services. (For a more detailed discussion of Florida banking and its international ties, see *Current Regional Banking Conditions*.) Conversely, lenders should remain alert to the possibility that a sharp disruption in trade or tourism could have an adverse effect on credit quality across several sectors of the economy.

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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.
- During the first quarter of 1997, the Atlanta Regional Bank Index outperformed the S&P Composite Bank Index. The Atlanta Region's Community Bank Index moved ahead fairly steadily but gained less than the S&P 500 and the other bank indices.

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.

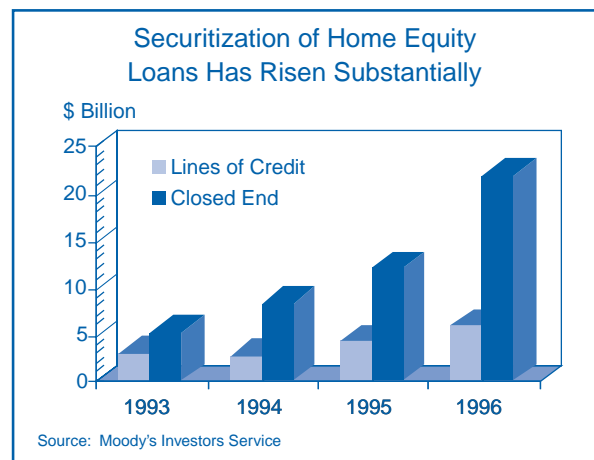
The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market. The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, known 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*

CHART 1



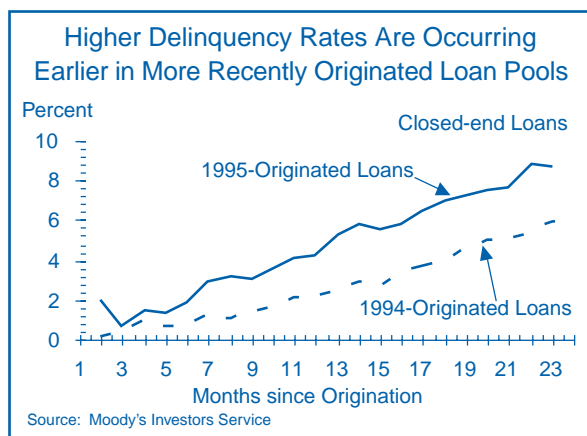
than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.

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

CHART 2



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.

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.



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

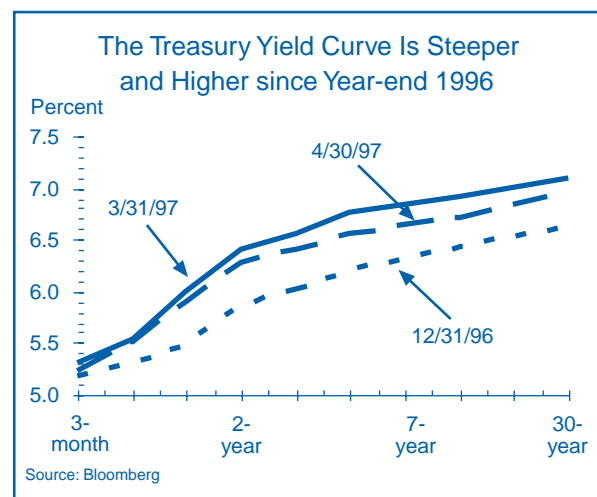


TABLE 1

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.

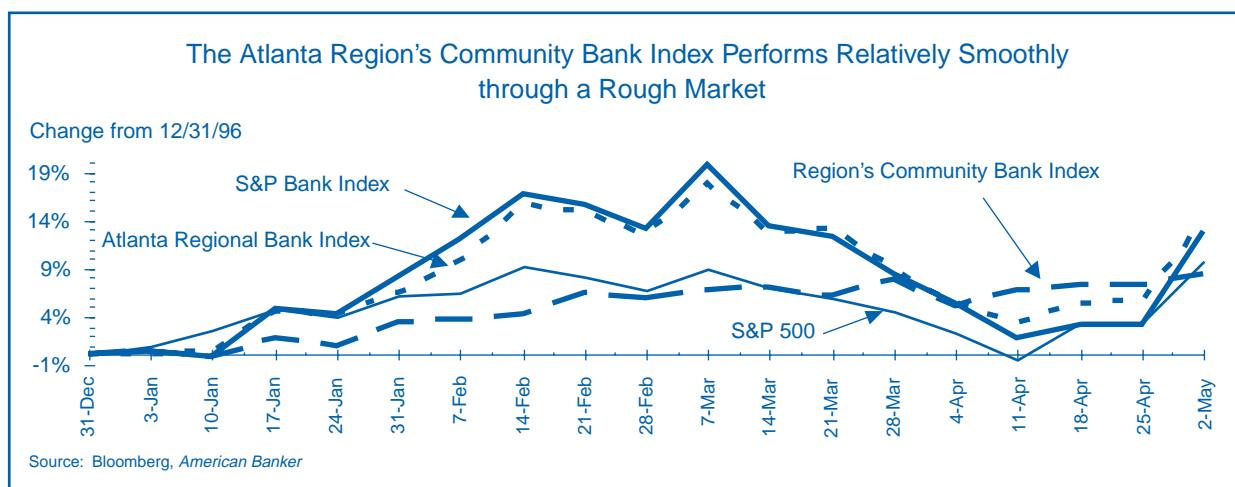
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate 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 Atlanta Region Community Bank Index Was Spared from Most First Quarter 1997 Market Downturns but Still Underperformed the Atlanta Regional Bank Index

Both the S&P Composite Bank Index and the Atlanta Regional Bank Index have been subject to similar performance swings this year (Chart 4). The S&P Composite Bank Index, with a 12.77 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The Atlanta Region's Community Bank Index was spared much of the influence of a gyrating market, rising in value fairly steadily to an 8.35 percent gain through May 2, 1997. Its gain, however, fell short of the Atlanta Regional Bank Index's 13.83 percent gain, which was sufficient to outperform the S&P Composite Bank Index's gain by more than a full percentage point through May 2, 1997.

Allen Puwalski, Banking Analyst

CHART 4



Current Regional Banking Conditions

- Most commercial banks in the Atlanta Region reported strong performance during the first quarter of 1997.
- Even after adjusting for the one-time Savings Association Insurance Fund (SAIF) assessment in 1996, the Region is host to a disproportionate share of unprofitable thrifts.
- Florida-based banks and special-purpose entities increase their international banking activities.

Profits Rise at Commercial Banks

Commercial banks in the Region posted strong earnings gains during the first quarter of 1997. The average return on assets (ROA) increased to 1.25 percent from 1.15 percent in the year-earlier period. As a comparison, the ROA at the national level for the first quarter was 1.26 percent this year and 1.12 percent last year. As shown in Chart 1, banks in **Georgia, North Carolina, and Virginia** had the largest year-over-year improvement in ROA, while modest declines were recorded in **Alabama and West Virginia**.

Average loan growth was a very strong 11.6 percent, but “top line” revenue growth did not keep pace, as interest income grew only 7.1 percent. Hence, the average net interest margin slipped 6 basis points from last year, to 4.11 percent. Robust fee income growth, up 19.7 percent, in conjunction with overhead expense growth of only 5.5 percent, was the main driver in the ROA expansion. The positive trends in fee income and overhead expense led to a significant improvement in the average efficiency ratio—59.8 percent versus 62.9 percent one year ago. The efficiency ratio, which derives from dividing overhead expense by revenue, simply measures

how much it costs a bank to generate each dollar of revenue. A lower efficiency ratio generally implies more efficient operations.

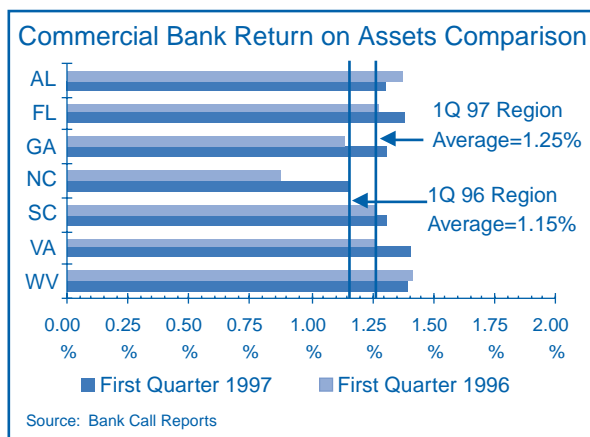
Capital ratios remain very strong with an average equity-to-asset ratio of 8.12 percent, despite many stock repurchase programs and higher dividend payout ratios. The dividend payout ratio of 74 percent in the first quarter of 1997 is almost twice as high as the 48 percent ratio a year earlier. Asset quality measures remained strong, as the ratio of noncurrent loans improved to 0.79 percent from 0.87 percent and net charge-offs remained stable at 0.43 percent compared with 0.44 percent last year. Overall, most commercial banks in the Region reported superb results in the first quarter.

Unprofitable Thrifts in Region Well above National Average

The Atlanta Region has had a disproportionately large and growing share of unprofitable thrifts¹ since 1990. As depicted in Chart 2, next page, the Region’s share of all thrifts in the nation has been declining since 1990, while its share of unprofitable thrifts has been increasing. In 1996, 46 thrifts in the Atlanta Region had negative earnings, up from 24 in 1995. The current total is the highest since 1991, when 78 thrifts had negative yearly earnings.

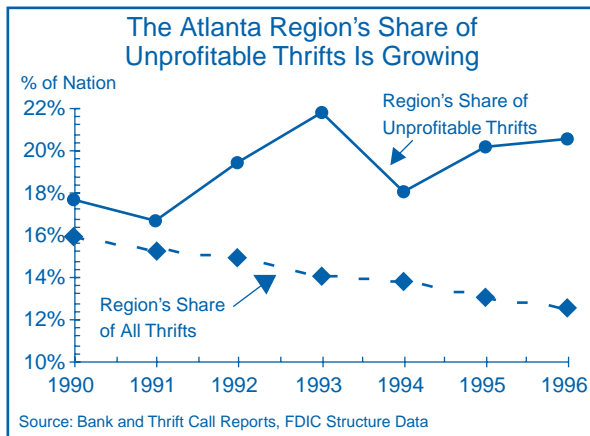
The primary driver in the rise in unprofitable thrifts in 1996 was the one-time Savings Association Insurance Fund (SAIF) assessment in the third quarter. After adjusting for the SAIF assessment, however, 27 thrifts still had negative earnings. The core group of unprofitable thrifts, the 27 thrifts with negative earnings after adjusting for the SAIF assessment, have a median asset

CHART 1



¹ Thrifts are defined as institutions regulated by the Office of Thrift Supervision and state savings banks supervised by the FDIC.

CHART 2



size of \$43.8 million compared with \$101 million for all thrifts in the Region. Geographically, most of the core unprofitable thrifts are located in metropolitan statistical areas (MSAs). Moreover, 13, or nearly half of the 27 unprofitable thrifts in the core group, are located in **Florida**. This is not surprising, as Florida has been home to most of the unprofitable thrifts in the Region for some time.

The returns on equity of all thrifts were further analyzed using a modified Dupont Formula. Traditionally, the Dupont Formula is used to analyze the return on equity (ROE) of a nonfinancial firm. Although many variations exist, its basic form for nonfinancial firms is shown in Table 1. Insight can be gained about the pre-

TABLE 1

DUPONT MODEL FOR NONFINANCIAL AND FINANCIAL FIRMS	
<p>BASIC DUPONT MODEL FOR NONFINANCIAL FIRMS</p> $ROE = \text{PROFIT MARGIN} \times \text{ASSET UTILIZATION} \times \text{LEVERAGE} \times \text{INTEREST BURDEN} \times \text{TAX BURDEN}$ $\frac{\text{NET INCOME}}{\text{EQUITY}} = \frac{\text{EBIT}^*}{\text{SALES}} \times \frac{\text{SALES}}{\text{ASSETS}} \times \frac{\text{ASSETS}}{\text{EQUITY}} \times \frac{\text{PRETAX NET INCOME}}{\text{EBIT}^*} \times \frac{\text{NET INCOME}}{\text{PRETAX NET INCOME}}$	
<p>BASIC DUPONT MODEL FOR FINANCIAL FIRMS</p> $ROE = \text{LEVERAGE (EQUITY MULTIPLIER)} \times \text{ASSET UTILIZATION} \times \text{PROFIT MARGIN}$ $\frac{\text{NET INCOME}}{\text{AVERAGE EQUITY}} = \frac{1}{\text{AVERAGE EQUITY} / \text{AVERAGE ASSETS}} \times \frac{\text{GOI}^{**}}{\text{AVERAGE ASSETS}} \times \frac{\text{NET INCOME}}{\text{GOI}^{**}}$	
<p>EXPANDED ASSET UTILIZATION FOR FINANCIAL FIRMS</p> $\frac{\text{GOI}^{**}}{\text{AVERAGE ASSETS}} = \frac{\text{INTEREST INCOME}}{\text{AVERAGE ASSETS}} + \frac{\text{NONINTEREST INCOME}}{\text{AVERAGE ASSETS}} + \frac{\text{SECURITIES GAINS (LOSSES)}}{\text{AVERAGE ASSETS}}$	
<p>EXPANDED PROFIT MARGIN FOR FINANCIAL FIRMS</p> $\frac{\text{NET INCOME}}{\text{GOI}^{**}} = 1 - \frac{\text{INTEREST EXPENSE}}{\text{GOI}^{**}} - \frac{\text{NONINTEREST EXPENSE}}{\text{GOI}^{**}} - \frac{\text{LOAN LOSS PROVISION}}{\text{GOI}^{**}} - \frac{\text{TAX EXPENSE}}{\text{GOI}^{**}}$	
<p>GROSS OPERATING INCOME COMPONENTS FOR FINANCIAL FIRMS</p> $\text{GOI}^{**} = \text{INTEREST INCOME} + \text{NONINTEREST INCOME} + \text{SECURITIES GAINS (LOSSES)}$	
<p>*EBIT = EARNINGS BEFORE INTEREST AND TAXES **GOI = GROSS OPERATING INCOME</p>	

dominant forces that drive a firm's ROE by analyzing the level and trend of the formula's underlying ratios. As further displayed in Table 1, a simple Dupont Formula for financial firms can be created by using three components or ratios. For further explanatory value, the simple Dupont Formula for financial firms can be expanded by exploding asset utilization into three parts and profit margin into four parts.

After adjusting for the one-time SAIF assessment, the modified Dupont Formula was applied separately to all thrifts and to the core group of unprofitable thrifts in the Region. Results are shown in Table 2. Three thrifts in operation less than two years were removed from the core group, as *de novo* institutions typically need several years before they become profitable. *After removal,*

the 24 thrifts remaining in the core group had a negative ROE of 12.22 percent, while all thrifts had a positive ROE of 6.02 percent. Generally, both groups had about the same amount of leverage, yield on assets, and loan loss provisions. The core group of unprofitable thrifts had about half as much noninterest income, higher funding costs, and significantly higher overhead.

Interest expense absorbed 50 percent of gross operating income for the core group, compared with 46 percent for all thrifts. *Most of the unprofitable thrifts in the core group are small in asset size and are operating in MSAs where competition is very intense.* In these markets, asset and deposit pricing is frequently tight. For that reason, offered rates on intermediated products must be attractive to maintain or gain market share. This situation is particularly evident in Florida, where four large superregional banking companies have dominant market shares. The core group generated substantially less noninterest income, at 0.70 percent of average assets compared with 1.37 percent for all thrifts. Generally, most of the small thrifts in the core unprofitable group do not have a product array or delivery system as extensive as their larger competitors. Moreover, given their small asset size, expanding their product line or delivery system may be costly. Finally, overhead expenses absorbed 63 percent of gross operating income for the core group versus only 39 percent for all thrifts. *The small asset size of most thrifts in the core group may be a factor driving high overhead expense, as product, delivery, and customer service costs are spread over a smaller base, and a larger portion of expenses are fixed.*

TABLE 2

DUPONT FORMULA COMPONENTS FOR 1996 ADJUSTED FOR SAIF ASSESSMENT		
COMPONENT	ALL THRIFTS	UNPROFITABLE THRIFTS*
RETURN ON EQUITY = (A x B x C)	6.02%	(12.22%)
A. EQUITY MULTIPLIER	1 ÷ 9.59%	1 ÷ 10.69%
B. ASSET UTILIZATION	9.06%	8.48%
= INTEREST INCOME ÷ AVG ASSETS	7.49%	7.31%
+ NONINTEREST INCOME ÷ AVG ASSETS	1.37%	0.70%
+ SEC GAINS (LOSSES) ÷ AVG ASSETS	0.20%	0.47%
C. PROFIT MARGIN	6.37%	(15.41%)
= 100%		
- INTEREST EXPENSE ÷ GOI	46.08%	50.20%
- NONINTEREST EXPENSE ÷ GOI	38.51%	62.74%
- PROVISION EXPENSE ÷ GOI	4.87%	5.50%
- TAX EXPENSE ÷ GOI	4.17%	(3.03%)
*CORE GROUP INCLUDES 24 THRIFTS; 3 DE NOVO THRIFTS ARE EXCLUDED. ADJUSTED BY USING A 36% TAX RATE—NET INCOME AND AVERAGE EQUITY WERE INCREASED BY 64% OF THE SAIF ASSESSMENT PAID. GOI = GROSS OPERATING INCOME; SEE TABLE 1 FOR DEFINITION.		
SOURCE: THRIFT CALL REPORTS AND FDIC DIVISION OF INSURANCE		

International Banking Trends in Florida

Over the past decade, the Florida economy has witnessed strong growth in global trade, particularly with Latin America. (For an analysis of the economic impact of global trade on Florida's economy, see *Growth in the Atlanta Region, Though Slower, Remains above the Nation.*) Concurrently, financial intermediaries in Florida, as would be expected, have increased their international activities. International financial services in Florida are delivered through a variety of legal entities such as insured commercial institutions, Edge Act and Agreement corporations, Agencies, and International Banking Facilities (IBFs). Also, a number of Florida commercial banks operate representative offices overseas. Although representative offices cannot function as financial intermediaries, they are a business development and information source. With a few exceptions, an

Why Analyze Return on Equity?

ROA has traditionally been the primary benchmark for assessing financial performance for banks and thrifts. However, ROE is becoming an increasingly relevant measure as many institutions have entered into a wide variety of nontraditional business lines. Some of these new activities have lower profit margins than traditional intermediation, but they also require less capital. Hence, institutions can still generate high ROEs even with a large number of low-spread businesses.

ROE is closely followed by investors and analysts, which tends to add pressure on management to deliver a competitive return. While robust profitability since the last recession has bolstered equity accounts, this greater capital has made future earnings per share growth and higher returns on equity more difficult to attain. In response, many institutions are actively managing their equity accounts to improve shareholder return. Frequently, excess capital is being redistributed to shareholders through stock repurchase programs. This is in contrast with prior eras, when institutions would often redeploy excess capital in investments with returns below the institution's hurdle rate of return. All stakeholders need to monitor ROE performance, because the value of an institution cannot appreciate over the long term if it is unable to earn a risk-adjusted return in excess of its cost of capital.

IBF, Edge Act, Agreement corporations, or Agency can transact business only with nonresidents.

The trends in the number of IBFs, Edge Act and Agreement corporations, and Agencies are shown in Table 3. Commercial bank IBFs have generally fallen out of favor as their primary benefits—no deposit insurance assessment and reserve requirement—have lessened relative to holding a deposit in the general bank. Recently, several large New York money center banks have “rolled up” their Edge Act corporations into their parents in an effort to allocate capital more efficiently.

Volume and trend data on international product offerings by these various entities are sparse and difficult to obtain. However, the trends in the limited data sources that are available suggest that these entities are strongly participating in the international arena. According to the *Florida International Bankers Association, Inc.*

(*FIBA*), new highs were reached in assets and deposits at Agencies and Edges in 1996. *At international entities, the aggregate assets exceeded the \$20 billion threshold for the first time at \$21.5 billion, and deposits finished the year at \$14.3 billion, up from \$13.7 billion. FIBA further reports that loans grew by a record 46.9 percent in 1996 at Florida international banks.* Much of the loan growth is attributable to a consolidation in Latin American lending by traditional commercial banks located in Miami and the transfer of lending operations by one Agency. *In the 1990s, FIBA estimates that loans at Agencies have grown by 261 percent and that the loan-to-deposit ratio has moved from 29 percent to 94 percent.*

Financial services most commonly being provided by these entities include loans, deposits, letters of credit, bankers acceptances, international clearing, risk management products, and private banking. Another innovative product being offered by some entities is a “payable through” account (PTA). A PTA is generally a checking account marketed to a foreign bank, which in turn solicits customers outside the United States. The customers or subaccount holders then become signatories on the foreign bank's account with the ability to write checks and make deposits at the U.S. entity. Usually, the domestic bank issuing the PTA does not know the customers or subaccount holders. Regulatory agencies are concerned that PTAs may facilitate unsafe and unsound banking practices and other misconduct, including money laundering and related criminal activities. Supervisory guidance was issued by the FDIC in Financial Institution Letter #30-95 entitled *Warning, Guidelines Issued to Protect Against Improper or Illegal Use of “Payable Through” Accounts* on April 7, 1995.

TABLE 3

TRENDS IN THE NUMBER OF SPECIAL PURPOSE ENTITIES HEADQUARTERED IN FLORIDA THAT DELIVER INTERNATIONAL BANKING SERVICES					
ENTITY	1992	1993	1994	1995	1996
INT'L BANKING FACILITY	32	31	31	29	27
EDGE ACT/ AGREEMENT	16	14	15	13	13
AGENCY	47	49	48	47	43
SOURCE: FEDERAL RESERVE BANK OF ATLANTA, FLORIDA DIVISION OF BANKING					

Special-Purpose Entities That Deliver International Banking Services

Edge Act Corporation. Issued a permit by the Federal Reserve. Deposits are not FDIC-insured. Requires separate capitalization and can be owned by a domestic or foreign banking company.

Agreement Corporation. Similar to an Edge Act, except that it is incorporated by the state and enters into agreements with the Federal Reserve. Deposits are not FDIC-insured. Requires separate capitalization and can be owned by a domestic or foreign banking company.

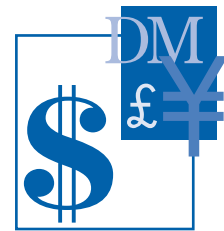
Agency. Licensed by the state. Deposits are not FDIC-insured. Does not require separate capitalization. Essentially a branch of a foreign banking company.

International Banking Facility. A subset for accounting books. Can be operated by a domestic or foreign banking company or any of the special purpose entities. Deposits are not FDIC-insured. Does not require separate capitalization.

Another recent development in the international area in Florida is an increase in "parallel banking," which is the cross-border common ownership or control of two or more banks by nonresidents. Specifically, parallel banking occurs when a nonresident investor(s) owns or controls a bank in their native country and a bank in the United States. Domestically, this type of banking structure is more commonly known as "chain banking." Supervisory concerns about parallel banking primarily revolve around the shifting of assets and other funds between the foreign and domestic banks. Low-quality assets may be moved among the banks to avoid detection by regulators and auditors. Identification of asset-shifting by domestic regulators is hindered by the inability to conduct concurrent examinations of all members of the parallel banking organization. Finally, adverse developments in the foreign bank's home country could trigger a rapid inflow or outflow of deposits at the domestic bank or prevent the foreign bank from providing capital and other support to the domestic bank.

Competition among international financial services providers has intensified, leading to a tightening in pricing. Also, the dramatic improvement in the sovereign debt ratings of many Latin American countries over the past decade has put downward pressure on pricing. The compression in spreads has shifted lending away from low-margin government-backed (domestic or foreign) loans, letters of credit, and short-term trade financing receivables to short-term correspondent bank and direct asset-based loans. *Some providers are starting to lend to smaller asset-size foreign banks. The correspondent banks are seeking longer term debt structures, but so far, lenders have not acquiesced to the demand.* Moreover, providers are attempting to carve out niches to sustain profitability. The most popular niche at the moment is global private banking, offering customized services to high net worth customers.

International transactions can add a new layer of risks that are not normally embedded in domestic transactions. One of these risks is commonly referred to as country risk. Developments in a foreign country could lead to foreign exchange controls, confiscation, nationalization, rapid inflation, and currency devaluation. Any of these developments could influence the behavior and financial condition of a nonresident customer. Hence, entities involved in international transactions must have a strong internal risk identification system that evaluates the extra layer of risks arising from foreign transactions.



Risks on the liability side of the balance sheet should not be ignored. Developments in a foreign country could lead to the repatriation of deposits or other funds on very short notice. Also, negative events surrounding the credit standing of the financial service entity could trigger a run by foreign depositors. The most recent and prominent example is the nearly \$1 billion of foreign deposits that fled Miami-based Southeast Bank in the year preceding its failure in 1991. Hence, liquidity risk may be heightened when nonresident funding is used.

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