Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1997

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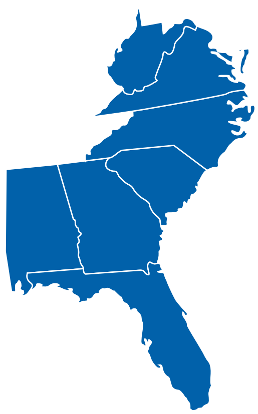

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In Focus This Quarter

◆ ***Bank Earnings: Competitive Pressures and Cyclical Risks***—**Intense competition to preserve or attract business can lead to relaxed underwriting standards and other changes to risk management practices that can reduce banks' ability to weather a downturn. As this economic expansion reaches an advanced age, prudent bankers will evaluate their lending standards and reserve adequacy with an eye to possible adverse changes in economic conditions.** *See page 3.*

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◆ ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***—**Commercial real estate markets in many parts of the United States have rebounded, and commercial banks are once again actively pursuing lending opportunities. Banks are not alone, however, as a broader and more competitive financing market has emerged. Securitization vehicles such as commercial mortgage-backed securities and real estate investment trusts are changing how real estate is owned and paid for.** *See page 9.*

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

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Bank Earnings: Competitive Pressures and Cyclical Risks

- **Rapid loan growth, record low credit losses, vigorous expansion of income sources, and cost-cutting continue to propel bank earnings to record levels.**

- **Intense competition to preserve and attract business can lead to aggressive loan pricing, relaxed loan underwriting standards, increased portfolio concentrations, and other changes to risk-management practices that can reduce banks' ability to sustain earnings and capital through a downturn.**

- **As this economic expansion approaches an advanced age, prudent bankers will allow for the possibility of an adverse change in economic conditions.**

As the U.S. economic expansion continues through its seventh year, the banking industry continues to run at full throttle. Earnings climb to ever-higher levels, driven by rapid loan growth, record low credit losses, aggressive expansion of income sources, and vigorous cost-cutting. Some analysts argue that banking has entered a new era in which the development of non-interest income sources and new risk-management techniques will insulate banks from swings in the business cycle.

Yet banks face risks that should not be overlooked. Assertions that bank earnings will be less sensitive to business cycles remain untested. Meanwhile, competition to attract and maintain business can result in relaxed underwriting standards and easing of loan terms, or increased focus on business lines whose risks are difficult to manage. Policies that boost short-term shareholder returns, including high dividends and stock repurchase programs, can reduce banks' capacity to weather a future downturn. There is evidence that these things are occurring to varying degrees in banking today. Accordingly, as this expansion reaches an advanced age, prudent bankers will give careful regard to the quality and sustainability of the earnings generated by today's strategic decisions.

Credit Quality

Variations in credit quality have been and are likely to remain for some time the primary source of large swings in bank earnings (see Chart 1). Banks manage the risks of large swings in credit quality by adjusting underwriting standards and loan terms, by diversifying loan portfolio exposures, and by supplying adequate amounts to the allowance for loan losses. In large part, the degree to which bank earnings can be sustained during a downturn will depend on decisions made about these factors during the expansion.

Some perspective on the cyclical nature of credit quality can be gleaned from Charts 2 and 3 (next page). As shown in Chart 2, bank loan growth has exceeded growth in gross domestic product (GDP) for ten of the past twelve quarters, even without considering the substantial volume of loans originated and sold in securitized pools. Moreover, Chart 3 shows that growth in loan losses has tended to follow episodes of rapid loan growth.

Credit standards are important tools for individual banks to manage these cyclical fluctuations in credit quality. According to the Federal Reserve's August 1997

CHART 1

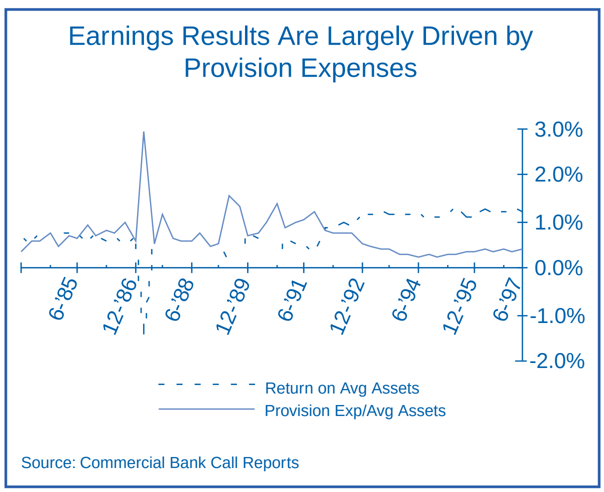


CHART 2

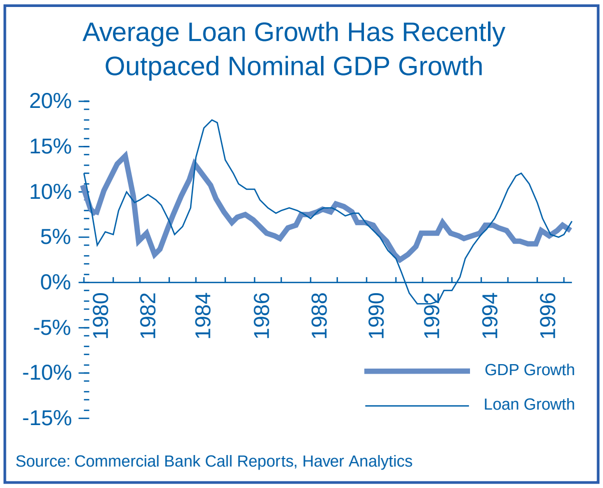
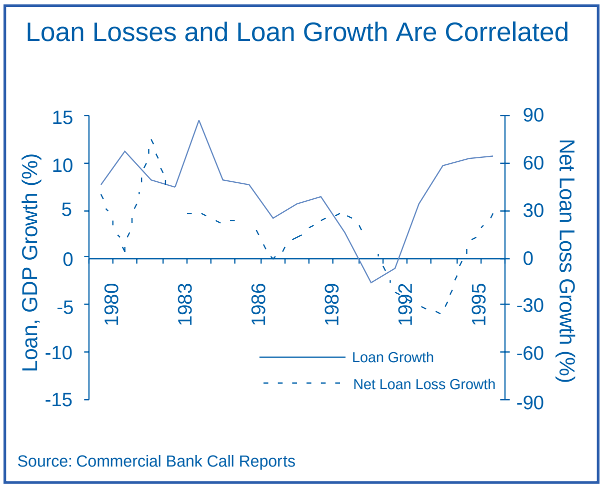


CHART 3



Senior Loan Officer Survey, during the preceding three months, a large percentage of banks had eased terms on commercial and commercial real estate loans, including reducing loan interest rates, increasing credit lines, and easing loan covenants and collateralization requirements. A "small but significant" share reported willingness to accept increased levels of risk on commercial real estate loans. In a similar vein, the Federal Deposit Insurance Corporation's (FDIC) ***Report on Underwriting Practices*** (second quarter 1997) did not note any widespread problems with underwriting practices but reported that about 24 percent of institutions examined that were actively involved in construction lending were "frequently or commonly" funding speculative construction projects. About 18 percent of institutions examined that were actively involved in business lending "frequently or commonly" made unsecured business loans that lack documentation of financial strength.

Maintaining an adequate allowance for loan losses is another important way for banks to sustain earnings and capital during downturns. The aggregate allowance held by commercial banks has decreased from 2.74 percent of total loans in the first quarter of 1992 to 1.90 percent in the second quarter of 1997; 166 banks reported negative loan loss provisions in the second quarter.

Although in the aggregate these reserve numbers remain high relative to the early to mid-1980s, when reserve levels ranged from 1.20 percent to 1.74 percent, the Office of the Comptroller of the Currency (OCC) recently issued an advisory letter expressing concern about declining reserve levels and the need to maintain an adequate allowance. This letter was a response to weakness in the credit card sector and to trends in the market for syndicated commercial loans, including increasing leverage, declining spreads, and a weakening in other underwriting terms, all stemming from increasing competitive pressures.

Diversifying loan portfolios is another way for banks to help reduce susceptibility to economic downturns. It has often been noted that the trend toward interstate banking and branching may improve loan diversification. It should also be noted, however, that many banks retain high concentrations of credit exposure to specific economic sectors. For example, commercial real estate lending and construction lending has been a source of volatility in bank earnings since the real estate investment trust (REIT) crisis of the 1970s. As discussed in ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***, banks are leading a resurgence in commercial real-estate lending. As Table 1 shows, 28 percent of FDIC-insured institutions grew their total commercial real estate and construction portfolios more than 30 percent from mid-1996 to mid-1997, and 16 percent had total commercial real estate and construction exposures[1] exceeding 200 percent of equity and reserves. Concentrations and rapid growth do not necessarily portend difficulties, but the greater the concentration of credit to a specific sector, the greater the importance of strict adherence to sound underwriting policies and standards and the maintenance of adequate loss reserves.

The most immediate concerns about credit quality have been expressed regarding credit cards and some other

[1] Includes loans secured by multifamily dwellings and nonfarm nonresidential structures, as well as construction loans.

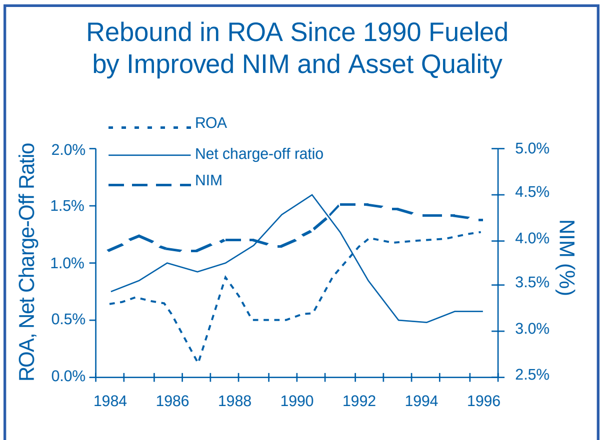
consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 1991. Noncurrent rates on these loans are at near-historic highs of 1.94 percent, and some examiners are commenting that these rates would be even higher were it not for some of these balances being rolled over into home equity debt consolidation loans with loan-to-value ratios as high as 135 percent. Home equity lines are a rapidly growing business for some banks; 25 percent of banks and thrifts grew their home equity lines by more than 30 percent during the year ending mid-1997 (see Table 1).

Except for credit cards and some other consumer loans, loan losses are at historically low levels. Nevertheless, lending decisions that assume a continuation of favorable economic conditions should be closely examined this far into the expansion. Institutions that maintain strong underwriting standards, an adequate allowance for losses, and prudent diversification of the loan portfolio will be best positioned to sustain earnings and capital during a downturn in credit quality.

Net Interest Margin

Net interest margin (NIM) is another primary driver of bank earnings. Indeed, a sharp improvement in NIM

CHART 4



Source: Commercial Bank Call Reports

helped lead the banking industry's dramatic recovery from the last recession (see Chart 4). Commercial banks' NIM has declined slightly in recent years, but at 4.23 percent still remains near the top of the range within which it has fluctuated since 1984 (see Table 2, next page).

The banking industry's rapid loan growth in recent years has been one of the factors supporting the current high NIM. (Since loans generally yield more than securities, a higher proportion of loans generally results in a higher yield on the total portfolio of earning assets.) Economic fundamentals cannot sustain rapid loan growth indefinitely, however. Accordingly, a

TABLE 1

Rapid Loan Growth Is Occurring at a Significant Number of Institutions (4 qtrs growth ending 6/97)	Percentage of Institutions with Loan Category Growth Approximating		
	20% to 30%	30% or More	Total Over 20%
Total Loans and Leases	11	13	24
Construction Loans	4	36	40
Commercial Real Estate Loans	9	27	37
Total CRE	10	28	38
1-4 Family Residential Loans	11	17	29
Home Equity Lines	4	25	29
Total Residential	12	18	29
Credit Card Loans and Related Plans	4	17	21
Other Consumer Loans	9	18	27
Total Consumer Loans	9	18	27
Commercial Loans	9	26	35

Source: Bank & Thrift Call Reports

Table 2

1997 Commercial Bank Performance Compared with Historical Averages			
	6/30/97	Industry Averages 1984-1996	
	Annualized (%)	Low (%)	High (%)
Net Interest Income/Average Earning Assets	4.23	3.89	4.36
X Average Earning Assets/Average Assets	86.50	86.21	88.42
= Net Interest Income/Average Assets	3.66	3.36	3.89
+ Noninterest Income/Average Assets	2.13	1.10	2.13
– Noninterest Expense/Average Assets	3.50	3.05	3.90
– Provision Expense/Average Assets	0.40	0.28	1.28
+ Other Items/Average Assets	0.03	–0.02	0.15
– Taxes/Average Assets	0.68	0.18	0.64
= Net Income/Average Assets (ROA)	1.25	0.10	1.20

Source: Bank & Thrift Call Reports

risk in the current environment is that in the effort to support their NIM by generating new lending, banks may make compromises in loan underwriting, pricing, and portfolio diversification.

Recent pricing trends have tended to weaken NIM, offsetting to a degree the effects of rapid loan growth. On the liability side, over the past six years, commercial banks' average annual deposit growth rate of 3.2 percent has been outpaced by the 4.9 percent average annual growth rate of earning assets. As a result, nondeposit borrowings have increased significantly in importance, rising from about 12.6 percent of earning assets in 1991 to 19.1 percent at mid-1997. Since the average cost of nondeposit borrowings has exceeded the average cost of deposits over the period by an average of 135 basis points, the greater use of relatively higher cost borrowings to fund earning asset growth has been an obstacle to wider margins. The slower deposit growth can perhaps be attributed to the increasing array of choices available to small savers; its effect is that bank funding is becoming more expensive and more interest-rate sensitive.

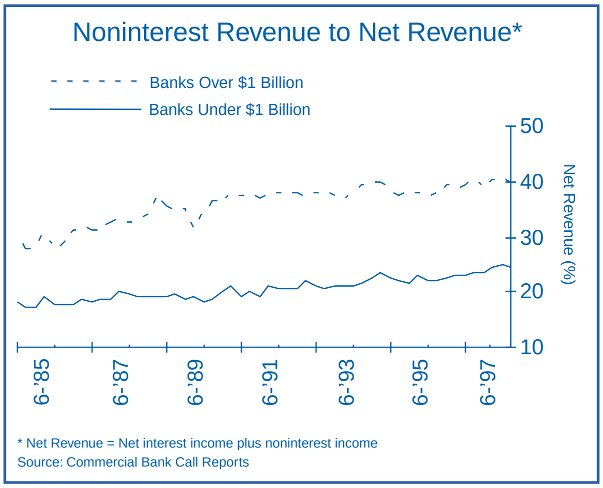
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads on investment-grade debt are at all-time lows. Reportedly, some deals are being done at minimal or no risk-adjusted spreads simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures on institutions not able to achieve the volumes necessary to efficiently utilize this new funding vehicle.

The thin spreads available from high-quality lending may tempt some institutions to finance higher yielding, riskier credits in an effort to preserve or boost profit margins. For example, recent forays by some banks into subprime lending (see ***Subprime Lending: A Time for Caution***, Third Quarter 1997) may be one indication of how competitive pressures on NIMs are affecting bank behavior. Over the long term, institutions that manage their NIMs with a prudent regard for how their newly booked business may fare during a cyclical downturn will have a better chance of sustaining earnings performance through the business cycle.

Growth in Noninterest Income

Industry analysts often cite the increasing contribution of fees and other sources of noninterest income as evidence of the evolution of the banking industry. As Chart 5 (next page) illustrates, for commercial banks with over $1 billion in assets, noninterest income now averages over 40 percent of net revenue (net interest income plus noninterest income). In contrast, banks

CHART 5



with under $1 billion show a profile of reliance on more traditional banking activities, with only 25 percent of revenue from these noninterest sources.

Noninterest income growth is being driven both by new business lines and higher deposit-related fees. Examples include fees from sales of mutual funds and other nondeposit products, investment banking activities such as securities underwriting and asset management, and increases in traditional fee sources such as from automated teller machines. Increasing securitization of assets, in which the accounting conventions convert interest income to noninterest income, has also affected the growth in reported noninterest income.

With the exception of trading revenue, noninterest income has historically shown a growth trend that has not been especially sensitive to economic cycles. However, newer fee-based businesses such as mortgage banking, mutual funds, and securities underwriting may ultimately share the same cyclical characteristics as traditional bank lines of business, and therefore may not reduce banks' historical exposure to economic cycles.

The Effect of Expense Control on Earnings Performance

Cost-cutting efforts in banking continue to show their effects. Since 1991, commercial banks' efficiency ratio,[2] a measure of an institution's effectiveness in generating revenue, has steadily improved (see Chart 6).

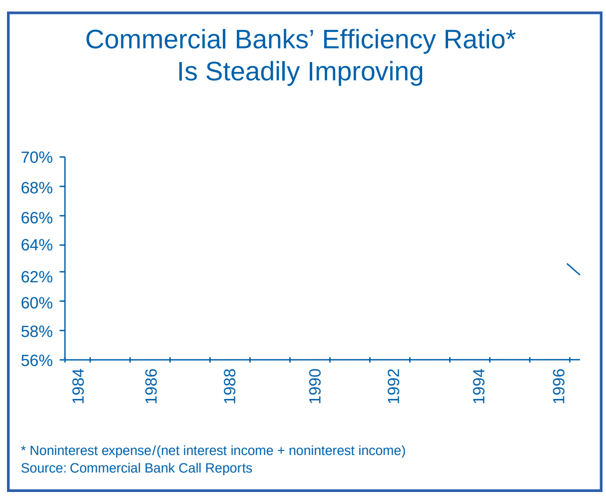
[2] The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

Other measures of productivity have shown similar improvement. For example, commercial banking assets per employee doubled, from $1.5 million to $3 million, between 1984 and 1997.

Growth in overhead expense has been contained largely through consolidation, technological advances, and low levels of problem assets. Mergers have resulted in the wringing out of redundant expenses. Information technology (IT) has been deployed to trim underwriting expense, manage customer relationships, speed back-office processing, and facilitate the creation of new products and services. Favorable economic conditions have reduced costs associated with loan collection and asset workouts.

Whether the downward trend in overhead expenses will continue is an open question. Should problem loans increase from their cyclical lows, collection and workout costs will increase (evidence of this effect can be discerned for the late 1980s in Chart 6). The rapid change in information technology may prompt increasing expenditures. The 1996 Atlantic Data Services/Tower Group ***Survey of Information Technology Services in Banking*** noted that the banking industry is "faced with an aging IT infrastructure." The survey suggests that most technology-related expenses could increase at a 5.6 percent compounded growth rate until the year 2000 and that expenses for outside services could increase 11 percent over the same period. The ability to generate future revenue gains may depend on additional bank investment not only in technology but also in the development of new products and services.

CHART 6



In any event, cost-cutting is not without its risks. For example, reductions in personnel, or excessive reliance on automated underwriting procedures (see ***Will Credit Scoring Transform the Market for Small-Business Lending?*** Second Quarter 1997), may raise concerns about the effectiveness of internal administration and control processes. Cost-cutting that cuts too deeply into customer service can erode franchise value. Mergers can reduce redundant expense, but at some point there may be diseconomies to managing a large organization.

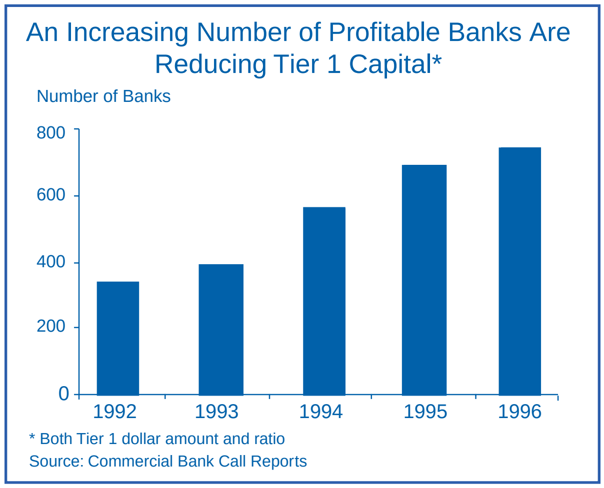
The Role of Capital in the Management of Earnings

Management, shareholders, and analysts often evaluate earnings in relation to the level of capital using measures such as return on equity (ROE) and earnings per share (EPS). One result has been pressure on banks to continue to grow ROE and EPS; these objectives have been made progressively more difficult to attain by the significant level of capital that has built up over the past five years.

Finding effective ways to deploy historically high capital levels appears to be one driving force behind the recent rash of mergers and acquisitions, high dividend payout ratios, increased stock repurchases, and the development of alternative types of hybrid capital such as trust preferred stock (see ***Financial Markets***). For example, during 1995 and 1996, major merger and acquisition deals included some $835 billion in bank and thrift assets. During 1996, commercial banks with over $1 billion in assets had an average dividend payout ratio over 89 percent, up significantly from the 67 percent payout rate of 1994. Banks with under $1 billion in assets averaged 55 percent for 1996 and 52 percent for 1994. In addition, banks and bank holding companies have issued some $21 billion in trust preferred stock during the last nine months, some of which has been used to fund the almost $42 billion in share repurchase programs announced by large banks during 1996 and early 1997.[3]

While the book value of equity and other capital ratios has increased at the aggregate industry level, a number of banks are reporting declines in equity capital and leverage capital ratios despite positive earnings (see Chart 7). For all institutions, the ability to actively manage capital accounts going forward will depend largely on having earnings available above the levels needed to fund dividends and growth, after assuming capital protection adequate for the level of business risk. Bankers and examiners will need to carefully review strategies that increase bank leverage or increase business risk without considering the potential effects of a downturn in credit quality or other weakening in the economy.

CHART 7



Summary

The most profitable period for U.S. banks in the post-World War II era is paradoxically occurring during a time when banks' traditional business lines are coming under greater competitive pressure than ever. While the industry as a whole is adapting well to these competitive pressures, there may be a tendency for some insured institutions to respond by accepting greater risks to preserve or gain business.

The nature of banking is to profit by taking calculated risks, and naturally more profits will be made during the expansionary phase of a cycle than during a downturn. Nevertheless, the institutions that are best able to sustain their earnings and capital over the complete cycle will be those that allow for the possibility of an adverse change in business conditions, and prudently balance the levels of risk taken with the expected returns.

Ronald Spieker, Chief, Depository Institutions Section
Steve Linehan, Assistant Director, Analysis Branch
George French, Deputy Director

[3] Salomon Brothers.

Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets

- **Commercial banks are leading a resurgence in commercial real estate financing; many metropolitan markets are experiencing rapidly rising rents and single-digit vacancy rates, suggesting the likelihood of further development.**

- **New funds directed toward commercial real estate are being increasingly supported by commercial mortgage-backed securities and real estate investment trusts.**

- **Some analysts have expressed concern that these financing vehicles may serve to heighten competitive pressures that will lead to more aggressive loan pricing.**

In the wake of declining values and the large losses of the late 1980s and early 1990s, commercial real estate is making a comeback. There are two stories here of interest to lenders. The first entails the remarkable resurgence in commercial real estate demand. The second involves the major changes taking place in how real estate is owned and paid for and—of greater interest to banks—who is financing this expanding activity.

Commercial Banks Show Renewed Interest in Commercial Real Estate

Strong evidence of commercial real estate's rebound can be seen in its renewed attractiveness to lenders. ***Federal Reserve*** figures show that nearly $58 billion of new commercial mortgage debt was added to the market in 1995 and 1996 (see Table 1). While this new net lending pales in comparison with that of the late 1980s—when nearly $74 billion in net new debt was added in 1987 alone—it positively shines when compared with the $89 billion *shrinkage* of commercial real estate loans from 1991 to 1994. Table 1 shows that commercial banks are leading this resurgence with a $37 billion net increase in mortgage lending during 1995 and 1996.

Perhaps the most convincing evidence of commercial real estate's recovery comes from the market itself. Rising prices and tightening supplies of space in most major markets and for most property types suggest a growing demand for new commercial property stock. Numerous indices and market studies support this notion:

- As measured by ***Koll/NREI*** national composites, prices and rents turned up sharply after 1993, with rents surpassing their 1988 to 1989 levels by 1995 (see Chart 1, next page). For office properties in particular, the ten fastest-growing cities in terms of rental rates saw increases exceeding 20 percent in 1996.[1]

[1] Those cities are, in order, Minneapolis, Columbus, Dallas, Portland, Salt Lake City, Atlanta, San Jose, Phoenix, San Francisco, and San Diego.

Table 1

Banks Are Increasing Their Flow of Funds into Commercial Real Estate ($ Billions)

	1991	1992	1993	1994	1995	1996
Net New Borrowing, All Sources	$ –15.6	$ –47.1	$ –21.5	$ –4.4	$ 22.6	$ 35.1
Commercial Banks	3.1	–8.4	–4.3	7.5	18.0	18.7
CMBSs	1.3	8.7	10.3	11.3	10.6	16.1
Savings Institutions	–22.4	–18.5	–7.5	–6.8	–1.8	0.8
Life Insurance Companies	–5.6	–15.1	–13.4	–10.5	–3.3	–2.5
All Other Sources	8.0	–13.5	–6.6	–5.9	–0.9	2.3
Equity Capital Flow, All Sources	$ 4.9	$ 3.1	$ 17.4	$ 21.6	$ 21.5	$ 30.3
REIT Equity Offerings	1.6	2.0	13.2	11.1	8.2	13.0
Pension Funds	–4.8	–4.3	–0.7	9.6	13.8	14.3
All Other Sources	8.1	5.4	5.0	0.9	–0.5	3.0

Sources: Federal Reserve, National Association of Real Estate Investment Trusts (NAREIT), LaSalle Advisors Investment Research

- Property capitalization rates, which measure the annual income generated by a property as a percentage of its purchase price, are falling (see Chart 2). These falling rates indicate that investors are paying higher prices for each dollar of current income generated by the property. Overall, however, prices have not yet caught up with rents, which now exceed their previous highs in some markets, suggesting that the current recovery is not yet peaking.

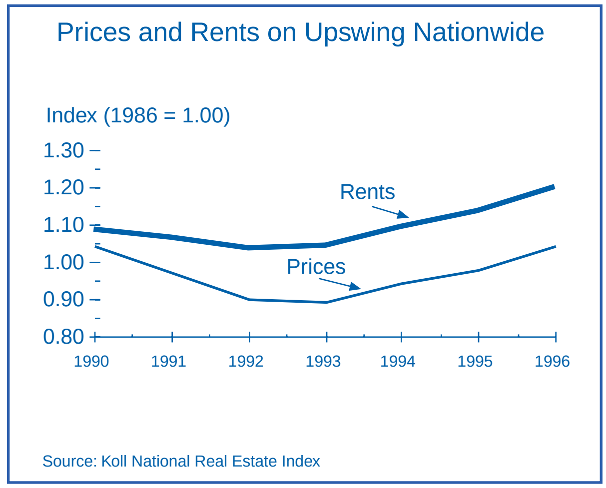
- Declining vacancy rates reflect strong demand for office properties, which ***Grubb & Ellis*** cast as the hottest sector in its 1997 forecast. Nationwide, office vacancies have fallen dramatically, by 5 to 10 percentage points during the last four years (see Chart 3). Moreover, ***Torto-Wheaton Research*** estimates that 21 of the 56 metropolitan areas it tracks had single-digit vacancy rates at the end of first quarter 1997. Not surprisingly, many of the tightest markets are those with the greatest rent inflation.

While the unrestrained commercial development of the 1980s continues to cast a shadow over the industry, that shadow is fading as declining vacancy rates and rising rental rates for existing properties fuel optimism among lenders and investors and strengthen the case for new development. Lenders, examiners, and analysts, however, must be diligent in monitoring commercial real estate markets to identify possible imbalances between supply and demand. It is particularly important that lending decisions be made on the basis of economic feasibility and realistic property cash flow projections rather than solely on the basis of competitive pressures.

Borrowers' Financing Options Expanding

Although banks are clearly the largest source of financing for resurgent commercial real estate markets, a broader and more competitive financing market has emerged. In this market, financing often bypasses banks, being funneled instead through entities that purchase and securitize commercial real-estate-secured debt or the properties themselves, parceling them into smaller, more standardized, and thus more liquid pieces that are attractive to institutional and individual investors alike. This trend is illustrated in Table 1, which shows the increasing roles commercial mortgage-backed securities (CMBSs) and real estate investment trusts (REITs) have played in funding commercial real estate over the past five years. This increase in public

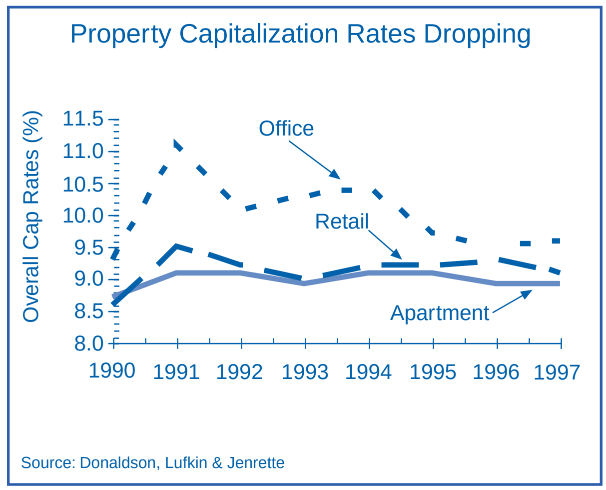
CHART 1



Prices and Rents on Upswing Nationwide

Source: Koll National Real Estate Index

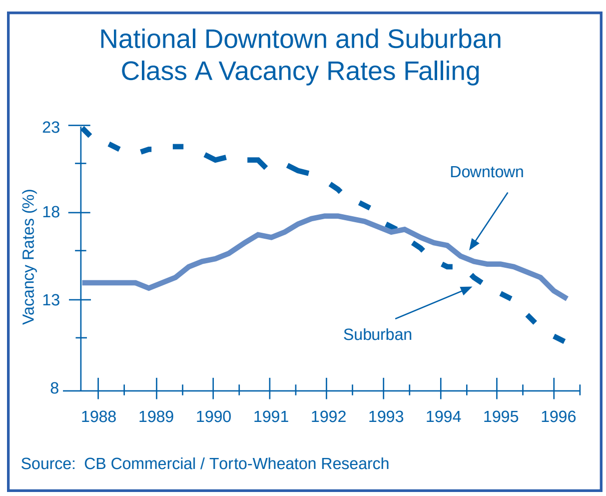
CHART 2



Property Capitalization Rates Dropping

Source: Donaldson, Lufkin & Jenrette

CHART 3



National Downtown and Suburban Class A Vacancy Rates Falling

Source: CB Commercial / Torto-Wheaton Research financing left financial institutions in 1996 with approximately a one-third share of all new net commercial real estate financing, down from well over half just a decade before.

From a lender's perspective, CMBSs offer several advantages over traditional portfolio lending. Most significantly, lenders can generate fee income from loan production and servicing activities while avoiding the excessive concentrations of credit risk that plagued lenders during the last real estate downturn.[2] According to ***Commercial Mortgage Alert***, outstanding CMBSs reached $125 billion in 1996 on a record $30 billion of new issuance. While outstanding volume is still dwarfed by the $3 *trillion* market for residential mortgage-backed securities (MBSs), the growth in CMBS volume has been remarkable considering that such securities were virtually nonexistent prior to 1991.

At present, most commercial banks are not active in issuing CMBSs, accounting for only $2.6 billion of CMBS issuance in 1996, according to ***E&Y Kenneth Leventhal Real Estate Group***. Rather, the primary source of these securities is investment banks, which generate substantial fees by converting existing loans into securities. CMBS issues also are being increasingly underwritten by *conduits*, which are entities created to originate mortgage loans for distribution to investors in the secondary market. ***Nomura Securities International*** estimates that such conduits accounted for over one-third of CMBS issuance in 1996, nearly double the volume of 1995. Only a handful of the largest commercial banks have set up conduit programs—the five largest banks accounted for $3.3 billion of the $10.2 billion in conduit issuance during 1996. Aside from this relatively small number of bank competitors, investment banks are among the largest and most active conduit issuers.

There is no fundamental reason why banks cannot take greater part in the rapidly growing CMBS market. In fact, they possess many distinct advantages over investment banks. Their distribution networks, lending experience, and back-office capabilities are naturally suited to facilitating loan demand, evaluating repayment risk, servicing loans, and monitoring a project's development. Obstacles of scale may preclude smaller institutions from directly issuing CMBSs ($500 million in volume is often cited as a minimum for efficiently assembling a deal). However, if the CMBS market develops like that for MBSs, standardized underwriting may enable small institutions to remain competitive either by cooperatively forming their own conduits or by selling their loans to existing conduits.

Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array of funding options. Moreover, the costs of public financing reflect efficiencies born of standardization and liquidity. In short, investors, including banks, can price, enter, and exit their positions in securitized debt more easily than could be done with whole loans. While improved efficiencies are a positive aspect of the growth in securitized investments, these efficiencies threaten to dictate bank pricing, thereby potentially reducing margins or driving institutions to lend on less economically feasible projects in an effort to preserve margins and market share.

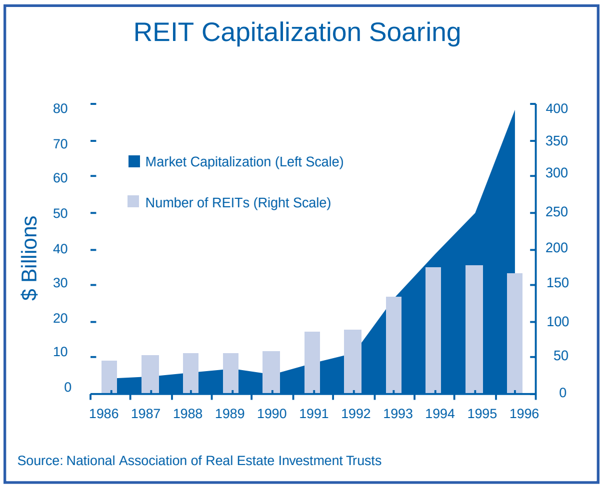
REITs: An Alternative to Traditional Capital Sources

Commercial real estate financing is evolving in other ways. REITs have become major players in the industry since 1993, accounting for fully one-fifth of funds flowing into real estate in 1996. REITs are much like mutual funds in that they allow indirect investment in real estate through purchases of equity in the REIT. The REIT itself holds title to the underlying properties and, provided it meets certain requirements, can directly pass through its earnings to investors without any intermediate tax. Although ***Moody's*** estimates place REIT holdings at less than 3 percent of all U.S. commercial real estate, outstanding REIT shares have grown considerably, with market capitalization doubling nearly three times in just four years (see Chart 4, next page). Accompanying this rise in capitalization has been an equally dramatic rise in bank lending to REITs. According to ***Loan Pricing Corporation***, bank lending to REITs surged to $12.8 billion in 1996, a 16 percent increase over 1995's then-record volume and more than a tenfold increase over the period 1990 to 1992.

The rise in REIT capitalization can be attributed in part to pent-up institutional demand for real estate. REITs

[2] While securitization of loans purports to shift credit risk to investors, many analysts and rating agencies have recently expressed concern over recourse arrangements, both contractual and voluntary, whereby the seller/servicer effectively assumes all or most of losses experienced by the security.

CHART 4



have a particular appeal to fund managers since they offer the benefits of investment diversification without the dual headaches of property management and asset illiquidity. Aside from the direct credit risk posed by lending to REITs, their rising popularity confronts banks with an indirect threat as well—the threat that banks could be crowded out of lending opportunities if investors find REIT funding structures more attractive from a cost and control standpoint. The degree to which this crowding out may occur is unclear, for according to ***Nomura Research***, REITs historically have borrowed 40 cents for each dollar of real estate held. However, well over half of this borrowing takes place through public offerings of secured and unsecured debt, leaving only a small portion to be financed by banks and other private lenders. Because REITs tend to focus on the highest quality projects, their increasing presence also creates concerns that banks may be driven to lend to less attractive or more risky properties to preserve market share.

Many analysts have also expressed unease over the rapid rise in the valuations of REITs, some of whose shares are priced at a considerable premium to the properties themselves. Anecdotal evidence suggests that premiums as high as 40 percent over market value have been paid for some REIT shares in recent months. Such market-based valuations create concern over the extent to which an REIT's capital structure allows it to pay more for properties than an investor who employs greater financial leverage. Accordingly, while REITs may make up a fairly nominal amount of overall real estate holdings, they may be quite influential in determining how commercial properties are being valued or appraised.

Commercial Real Estate Securitization: Some Broader Implications

Maturing CMBS markets could eventually improve the overall stability of commercial real estate markets not only by improving market liquidity but also by enabling investors to diversify and share their credit exposures among a greater number of participants. In addition, loan performance could become increasingly transparent to the general marketplace, thereby encouraging more uniform and prudent underwriting standards. However, concern naturally arises because CMBSs are a major source of commercial real estate market funding that has not been tested through a serious market downturn. This situation leads to questions concerning the impact they will have on property values and market liquidity and whether today's underwriting terms, driven largely by competitive factors, will stand up to tomorrow's market downturn. Another question is whether the standardized structures underlying these securities offer enough flexibility to borrowers to renegotiate loan terms—a critical workout tool during times of financial stress. The answers to these questions will ultimately determine the extent to which lenders and investors suffer as a result of the inevitable cyclical swings in commercial property values.

There are also questions about how REITs will affect commercial real estate markets. One argument is that the appetite for REIT investments, combined with the premiums that the trusts can pay for properties, will push the price of commercial space beyond sustainable levels. Those who hold this view see REITs, and other Wall Street innovations that increase the supply of funding, as potentially amplifying cyclical swings in real estate values. The contrary view holds that REITs will improve market efficiency by providing continuous pricing benchmarks through daily share price movements and thus enforce discipline upon developers and lenders. This discipline, it is argued, will prevent excessive development and dampen the severity of real estate cycles.

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estate-based instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose how best to compete against—or participate in—these new real estate financing strategies.

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Commercial Real Estate in the Atlanta Region: The Atlanta Metropolitan Area's Retail Market

Commercial construction activity, particularly in retail markets, in the Atlanta Region has been strong over the past few years. Although vacancy rates have started rising in nearly one-half of the Region's metropolitan areas, nowhere has the upward pressure been more noticeable than in **Atlanta**. In the first quarter of 1997, the retail vacancy rate in this metropolitan area was 9.6 percent, *up 3 percentage points from one year earlier*. The rise in Atlanta's retail vacancy rate is largely a product of two diverging trends: continued growth in retail space construction and declining levels of absorption.

Supply Forces

Retail space construction has increased substantially since its cyclical trough in 1991 at 2.13 million square feet of net new supply. In 1996, 7.76 million square feet of net new supply was injected into the Atlanta metropolitan area market. First quarter 1997 construction activity also was above the levels from one year earlier. There are indications that retail space expansion may continue. As of June 1997, retail projects totaling more than 22 million square feet were in the planning stages, with three new regional malls slated for development over the next few years in the Atlanta metropolitan area.

Demand Forces

While retail building has continued to rise, the increase in occupied space has declined from its peak of 5.76 million square feet in 1994 to 3.0 million square feet in 1996. In the first quarter of 1997, this rate of absorption fell to an annualized, seasonally adjusted 2.1 million square feet—less than half the increase in net new supply during the same period. Retail space absorption is driven, in part, by economic and demographic factors as faster job, income, and population growth fuels consumer spending. Since its peak in 1994, and particularly in the wake of the Summer Olympics of 1996, economic growth, like absorption, in the Atlanta metropolitan area has slowed markedly. A recent forecast by the ***American Metro/Study Corporation*** sees this trend continuing through the end of 1998. Although population growth remains three times the national average, in-migration is slowing, constraining faster gains in population.

Continued strong retail construction may be occurring at a time when the Atlanta metropolitan area's economic growth is slowing, increasing the risk that the market may become overbuilt. Already Atlanta's retail vacancy rate has increased dramatically, and the threat of a shakeout in the market may be on the rise. The potential impact of weakening economic and population growth may warrant more cautious lending strategies.

Scott C. Hughes, Regional Economist

Growth in the Atlanta Region Continues to Slow

- **Job growth in the Atlanta Region continued to slow through the middle of 1997 as its economy moved further away from its cyclical peak.**
- **If not for the continued growth in Florida, the Atlanta Region's economic performance would be below the national average.**
- **Georgia's decelerating growth has spread from rural to urban areas as residential construction activity and retail employment growth have weakened.**
- **Forecasters argue that the Atlantic Basin has entered a new era of greater hurricane activity, similar to that seen during the 1940s and 1950s. Even if hurricanes are not more frequent, damage from the storms could escalate because of the greater levels of economic development and larger populations in coastal areas.**

Quarterly Update

Job growth in the Atlanta Region peaked in November 1994, with a year-over-year employment increase of 4.1 percent (see Chart 1). Gains thereafter moderated before edging upward during 1996, partly because of preparations for the Olympic Games in Atlanta. Since the outset of 1997, however, growth has once again decelerated, with year-over-year job growth falling from 3.4 percent in January to 2.2 percent in June. During the first half of 1997, all states except Florida have seen a gradual slowdown in job growth.

Although growth has slowed in all areas of the Atlanta Region, decelerating employment gains have been most acute in the construction industry, in which year-over-year job growth in June 1997 stood at 3.1 percent, compared with 7.4 percent in January. This level of growth was the lowest since December 1992. Although construction activity in multifamily and commercial real estate in most areas of the Region remains comparatively strong, single-family home building weakened in all states during the first half of 1997. Some of the declines in single-family construction could be attributable to the Atlanta Region's slowing population growth. Though still above the national average of 0.9 percent, annual population growth in the Region was only 1.34 percent in 1996. With the exception of 1990, the increase was the lowest since 1980.

If Not for Florida…

Florida is the Atlanta Region's fastest-growing state, with year-over-year job growth in June 1997 of 3.6 percent (see Chart 2). Moreover, growth in the state gener-

CHART 1

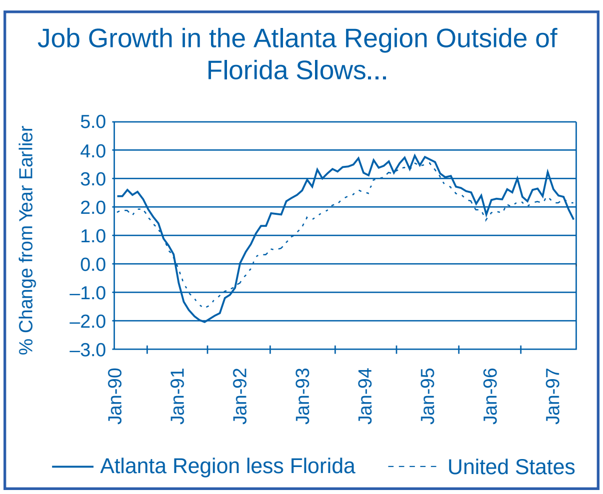
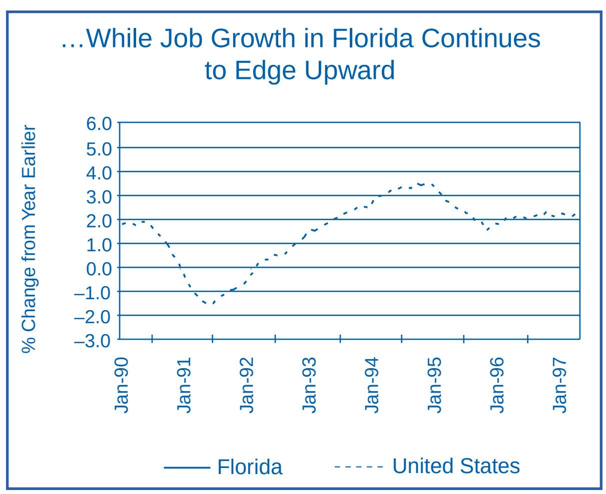


CHART 2



ally has remained above 3 percent throughout 1997. Because Florida accounts for 31.6 percent of the Region's population, its growth dominates the economic landscape. Without Florida's inclusion, year-over-year employment growth in the Atlanta Region would have stood at 1.6 percent, below the national average (see Chart 1).

Florida's divergence from the rest of the Atlanta Region may be a result of its economic structure. Tourism, which plays an important role in the state's economy, is included in the service sector, the fastest-growing segment of the economy. Moreover, Florida's construction industry also is benefiting from the growth in tourism as new theme parks are being built in the **Orlando** area. The importance of tourism is reflected geographically throughout the state. **Fort Lauderdale**, **Jacksonville**, Orlando, and **Sarasota** all recorded year-over-year job growth in excess of 4 percent; gains in less tourist-dependent metropolitan areas, such as **Gainesville** and **Pensacola**, were not as strong. In Orlando, year-over-year job growth in June was 5.6 percent.

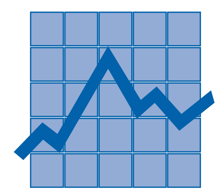
Florida's strong growth in 1997 has come despite a slowing in single-family home building. At midyear 1997, year-to-date single-family permit issuance was down 0.2 percent from the same period during 1996. As in the Region as a whole, annual population growth in Florida has slowed. From 1980 to 1990, population in the state increased at an annual rate of 2.9 percent. Since then, however, gains in population have been decelerating. In 1996, the number of residents in the state rose by 1.5 percent.

Despite continued growth in the economy, Florida's jobless rate has hovered at nearly 5 percent for the past three quarters. One reason for the lack of improvement may be that the state's jobless data are somewhat skewed by **Miami**, which accounts for 15 percent of all employment statewide. Labor markets in Miami are not as tight as those in the rest of the state, even considering record tourism in the metropolitan area. In June 1997, year-over-year job growth in the metropolitan area was 1.9 percent, and the unemployment rate was 7.8 percent. Part of the reason for Miami's weaker performance relative to the state may be its economic diversity. While other Florida metropolitan areas rely more heavily on the fast-growing tourist trade, Miami has had to contend with events such as thousands of job losses in its textile and apparel industry.

Unemployment rates statewide were also elevated by weaker economic conditions in **Panama City** and adjacent counties to the east. In April 1997, the Port St. Joe Paper Mill (Gulf County) shut down, idling 1,300 employees. Consequently, **Gulf County** saw unemployment rates rise to 16.8 percent in the second quarter of 1997. Surrounding counties also saw an increase, though less dramatic, in jobless rates. Local economic conditions have improved, however, as the facility reopened in phases throughout the month of September.

Growth in Virginia Slows but Remains above Average

Virginia's job growth slowed in the first half of 1997, although its growth continued to exceed the national average and is second only to Florida's in the Atlanta Region. Year-over-year employment growth declined from a 4.1 percent pace at the beginning of the year to a 2.4 percent pace in June. With the exception of finance, insurance, and real estate (FIRE) and services, all areas of the state's economy have experienced lower levels of growth. Gains also vary geographically, remaining concentrated along the so-called Golden Crescent that arcs from **Northern Virginia**, through **Charlottesville** and **Richmond**, and over to **Norfolk**. Northern Virginia remains the fastest-growing component of the Golden Crescent, posting year-over-year job growth of 3.7 percent. Norfolk and Charlottesville have seen above-average gains as well. However, outside the Crescent and particularly in south-central portions of the state, many counties have seen deteriorating performance. Jobless rates in counties to the west of the Richmond metropolitan area have risen over the past year. Some of this loosening in labor markets may be attributable to a retail slowdown in nearby Richmond, where many local residents are employed. On the North Carolina border, **Halifax County** has seen unemployment rates rise into the double digits as Georgia-Pacific and smaller textile and apparel mills have shut down.



North Carolina—Construction Activity Slows

Although on a par with the regional average of 2.2 percent job growth, North Carolina's economic performance has weakened in recent months. In January 1997, year-over-year job growth was at 4.4 percent, ranking North Carolina as the Atlanta Region's fastest-growing state. Gains in all areas of the economy have since abated. Construction activity has seen the largest drop in growth—from double-digit year-over-year job gains in January to 4.2 percent in June. Some of the decrease in construction may stem from single-family home building, where permit issuance growth has been slowing in recent quarters. *Overbuilding in some metropolitan areas' multifamily markets eventually may exacerbate the situation. Some analysts expect vacancy rates in* ***Raleigh's*** *multifamily market to climb to 10 percent this year given the current level of construction activity.*

Slower commercial building activity also may be contributing to weaker construction employment growth. Statewide, the square footage of nonresidential starts in the first quarter of 1997 was down 44 percent from one year earlier, according to ***F.W. Dodge***. In **Charlotte**, the square footage of nonresidential construction starts was down by 33 percent during the same period. Although the retail vacancy rate has remained stable at 7.3 percent, there is a risk that it could rise. Charlotte still has about 10.2 million square feet of retail space in the planning stages, while absorption of retail space has declined from an annualized 1,632,000 square feet in the first quarter of 1996 to 836,000 square feet in the first quarter of 1997.

West Virginia—Slow but Stable Gains

The West Virginia economy continues to perform below the national average, with year-over-year job growth in June 1997 at 1.5 percent. Nonetheless, current levels of growth have been more than strong enough to absorb new entrants to the state's labor force. At 6.5 percent, the state's unemployment rate is at its lowest since the third quarter of 1979—before the energy bust of the 1980s hurt the state's coal mining industry. Mining still plays a large role in the state, as does manufacturing. Since its peak in the late 1970s, at nearly 70,000, employment in mining has fallen by more than half, to 25,700 jobs in 1996. Manufacturing has lost approximately 40,000 jobs during the same period. Although both sectors remain in decline, the slowdown may have eased, with employment stabilizing at just over 80,000 in manufacturing and just over 25,000 in mining. The downward drag on the economy could lessen if industry consolidation continues to abate.

Slower Growth Spreads in Georgia

Nowhere in the Atlanta Region has decelerating growth been more apparent than in Georgia. Since April 1997, year-over-year job growth in the state has been below the national average. In June 1997, job growth in the state was 1.2 percent. By contrast, job growth was at its height in January 1997, at 3.1 percent.

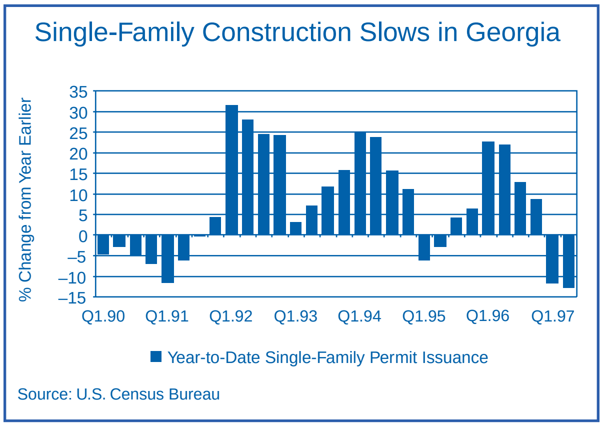
In the previous edition of the ***Regional Outlook***, it was noted that much of the deceleration in economic growth was confined to rural counties, while Georgia's metropolitan areas continued to experience largely above-average levels of job growth. Several rural counties, particularly in the southern half of the state, continue to see double-digit unemployment. Some of the slower growth in rural areas can be explained by recent job losses in the textile and apparel manufacturing industry. Not only have manufacturers relocated production overseas, but the automation of some remaining facilities also has reduced the need for labor.

More recently, *weaker levels of economic growth have appeared in Georgia's metropolitan areas*. In June 1997, year-over-year job growth in all of Georgia's metropolitan areas was below the nation's increase of 2.1 percent: Job growth was 2.0 percent in **Albany**, the state's fastest-growing metropolitan area; 1.9 percent in **Atlanta**; and 0.1 percent in **Athens**. The Atlanta metropolitan area is seeing slower growth in its tourist industry and slower gains in retail and residential construction activity.

Year-over-year construction job growth has been negative since April 1997 throughout the entire state. Some of the construction industry's weakness can be traced to single-family home building in Georgia, which slowed during the first half of 1997 (see Chart 3). Growth in permit issuance peaked in 1992 at 24 percent annually and has since declined. In the second quarter of 1997, single-family permit issuance was 12.8 percent below levels from a year earlier. According to ***Donald Ratajczak*** of Georgia State University's Economic Forecasting Center, the state has seen population growth begin to slow, which is likely reducing growth in demand for new housing.

Georgia's construction industry, especially in Atlanta, may be further constrained in the future by the threat of overbuilding in retail real-estate markets (see ***Regional Outlook***, second quarter). Year-over-year retail employment growth, one proxy for market absorption, has

CHART 3



declined from 3.7 percent in January 1997 to 0.3 percent in June in the state. Meanwhile, *Atlanta's retail vacancy rate increased by nearly 3 percentage points in one year, to 9.6 percent in the first quarter of 1997. Despite the increase in vacancies, the metropolitan area still has over 22 million square feet of retail space in the planning stages.* (At the end of 1996, the Atlanta retail market consisted of 99.7 million square feet.) According to the ***Atlanta Business Chronicle***, weakening conditions also may be emerging in the industrial market, where speculative building is outpacing absorption.

Alabama's Economic Performance

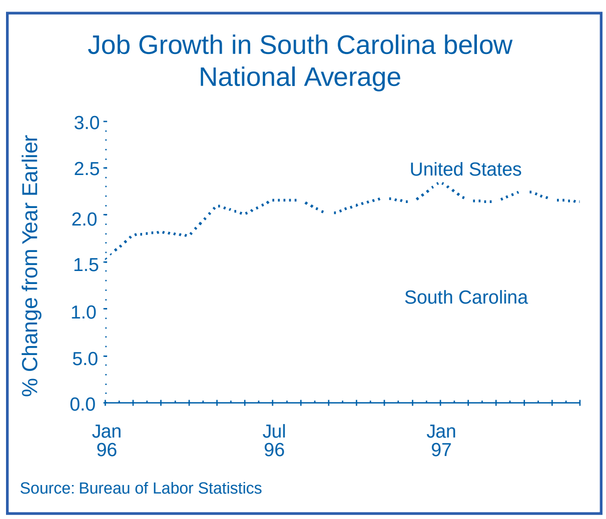
After remaining stable through the first quarter of 1997, year-over-year job growth in Alabama has fallen. In June 1997, year-over-year job growth in the state was 1 percent, less than half the 2.1 percent increase at the national level. Growth in the state, however, has been fast enough to apply downward pressure to jobless rates statewide. In the second quarter of 1997, Alabama's jobless rate was 4.6 percent, the lowest in more than 20 years. Even in rural areas, such as southwestern Alabama, where double-digit jobless rates have been the norm, labor markets have been tightening. Construction remains the fastest-growing area of the state's economy, with gains of 6.1 percent during the same period, mostly driven by increases in multifamily and, to a lesser extent, commercial projects. Through midyear 1997, year-to-date multifamily permit issuance was 20.6 percent above the same period one year earlier. Commercial (office, industrial, and retail) space construction in the state varies, however. In the faster-growing metropolitan areas of **Birmingham** and **Tuscaloosa**, square footage of nonresidential starts was up in the first quarter from one year earlier. Tuscaloosa's growth may be largely attributable to Mercedes-Benz's new $300 million automobile production facility. In contrast to the strength in multifamily and commercial construction, single-family residential permit issuance in the second quarter of 1997 was down 7 percent from one year earlier. Demand for new housing may be constrained by Alabama's low rate of population growth; in 1996, the population rose by 0.6 percent.

Gains in South Carolina Slow

Job growth in South Carolina is the slowest in the Atlanta Region. In June 1997, year-over-year employment growth in the state was 0.6 percent (see Chart 4). Since January, growth in several areas of the state's economy has slowed. The most marked decrease in job growth has occurred in South Carolina's construction industry. In January 1997, year-over-year job growth in construction stood at 8.2 percent. Performance since then has steadily eroded to June's growth of 1.8 percent. Weakening single-family construction may be the source of the industry's current slowdown: Permit issuance was up only 0.8 percent in the second quarter from one year earlier. This contrasts with the double-digit gains experienced throughout 1996. South Carolina's textile and apparel industries also have constrained faster growth in the state, with employment levels in June down 3.4 percent from one year earlier.

Implications: With the exception of Florida, the Atlanta Region's economic growth has slowed throughout 1997. Part of the Region's slower growth is the result of weakening levels of construction activity, espe-

CHART 4



cially in single-family home building. The Region has enjoyed five years of above-average growth. In light of slowing momentum, however, lending decisions that are based on assumptions of continued rapid growth should be examined carefully. Moreover, Georgia and parts of North Carolina must still contend with the implications of possible overbuilding and speculative construction in their multifamily and commercial markets.

Just Another Hurricane Season?

During the 1970s, 1980s, and early 1990s, hurricane activity stood at historically low levels even though the period was punctuated by infrequent large storms that caused considerable damage. According to ***William M. Gray*** and other researchers at Colorado State University, by the mid-1990s, hurricane activity began to accelerate. Moreover, this higher frequency and severity of Atlantic hurricanes may persist well into the future, resembling the level of storm activity seen in the 1940s to 1960s.

Even if the frequency of hurricanes does not increase, the probability of escalating damage from storms is likely to rise because of the ongoing rapid development in coastal areas of the Atlanta Region. According to the ***U.S. Census Bureau***, the population in the Atlanta Region's coastal[1] areas has more than doubled, from 10.6 million (43 percent of the total population of the Region) in 1960 to 22.9 million (52 percent of the total population) in 1994. More than half of these coastal residents are located in **Florida**, and they account for 97 percent of that state's population. Even after adjusting for inflation, the impact of a storm on the scale of 1992's Hurricane Andrew would likely have been smaller in 1960 because the coastal areas were less developed economically and had lower population densities. Hurricane Andrew is estimated to have caused more than $30 billion in direct damages to Florida and has had long-term implications for the ability of residents to insure against damages from future storms (see ***Current Regional Banking Conditions***). This season's Hurricane Danny was a Category 1 storm (the weakest type of hurricane). Even though its effects were limited to the **Mobile**, **Alabama**, area, the storm caused more than $6 billion in damages. Along its overland track through the interior of the Atlanta Region, the storm caused several million dollars in additional damages. A succession of smaller storms could thus incur costs similar to that of a single intense hurricane.

Implications: The rapid coastal development over the past few decades may have been encouraged partly by the relative infrequency of hurricane strikes. If the Atlantic Basin is entering an era of greater storm activity, there are many targets on the U.S. Eastern Seaboard. Greater storm activity also could place development in the interior of the Atlanta Region at risk. Many homeowners discovered in the wake of Hurricane Danny that they were not insured for floods. Lack of or inadequate insurance coverage could jeopardize homeowner solvency in the event of a storm, in turn adversely affecting credit quality for some insured institutions, especially small institutions that specialize in lending in coastal areas.

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

[1] Coastal counties are defined (in 1992) by the National Oceanic and Atmospheric Administration (NOAA) as those counties with at least 15 percent of their land area either in a coastal watershed or in a coastal cataloging unit.

Financial Markets

- **Bank holding companies of all sizes have issued trust preferred stock following the Federal Reserve's decision in October 1996 to count these tax-advantaged capital securities toward Tier 1 capital.**

- **Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget this year, there still exists the possibility that the Internal Revenue Service may alter the tax treatment of trust preferred dividends.**

- **Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the potential risks associated with excessive reliance on debt-like capital instruments.**

Bank holding company capital requirements were effectively relaxed in October 1996 when the Federal Reserve ruled that trust preferred stock may be included in the portion of cumulative preferred stock that can compose up to 25 percent of a bank holding company's Tier 1 capital. In the wake of this decision, financial institutions moved quickly to issue trust preferred stock. Trust preferred stock can be a less expensive form of Tier 1 capital for bank holding companies because of the tax deductibility of the dividend payments paid on this type of preferred stock.

Approximately 90 banking organizations issued an estimated $21 billion of trust preferred shares from October 1996 through June 1997.[1] The dollar amount of trust preferred stock issued represented almost 95 percent of the incremental amount of Tier 1 capital added by those institutions during the period. A number of these institutions used the proceeds of trust preferred stock issues to fund stock buyback programs. As an example of the relative importance of these stock buyback programs, one large bank holding company's Tier 1 capital ratio would be 7.25 percent excluding the trust preferred shares, and 8.34 percent including the shares.

Rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital because of its limited life and debt-like characteristics. These characteristics include the tax treatment of trust preferred dividends,[2] the limited life of the shares, and the ability of investors to accelerate their claims against the bank holding company. Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the possibility that excessive reliance on debt-like capital instruments could increase their financial fragility during times of economic stress.

Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative

Trust preferred shares, also known as capital securities, are traded under different names depending on the underwriter, payment terms, and maturity. Some of the more common acronyms include TOPRS (Trust Originated Preferred Shares), QUIPS (Quarterly Income Preferred Shares), and MIPS (Monthly Income Preferred Shares).

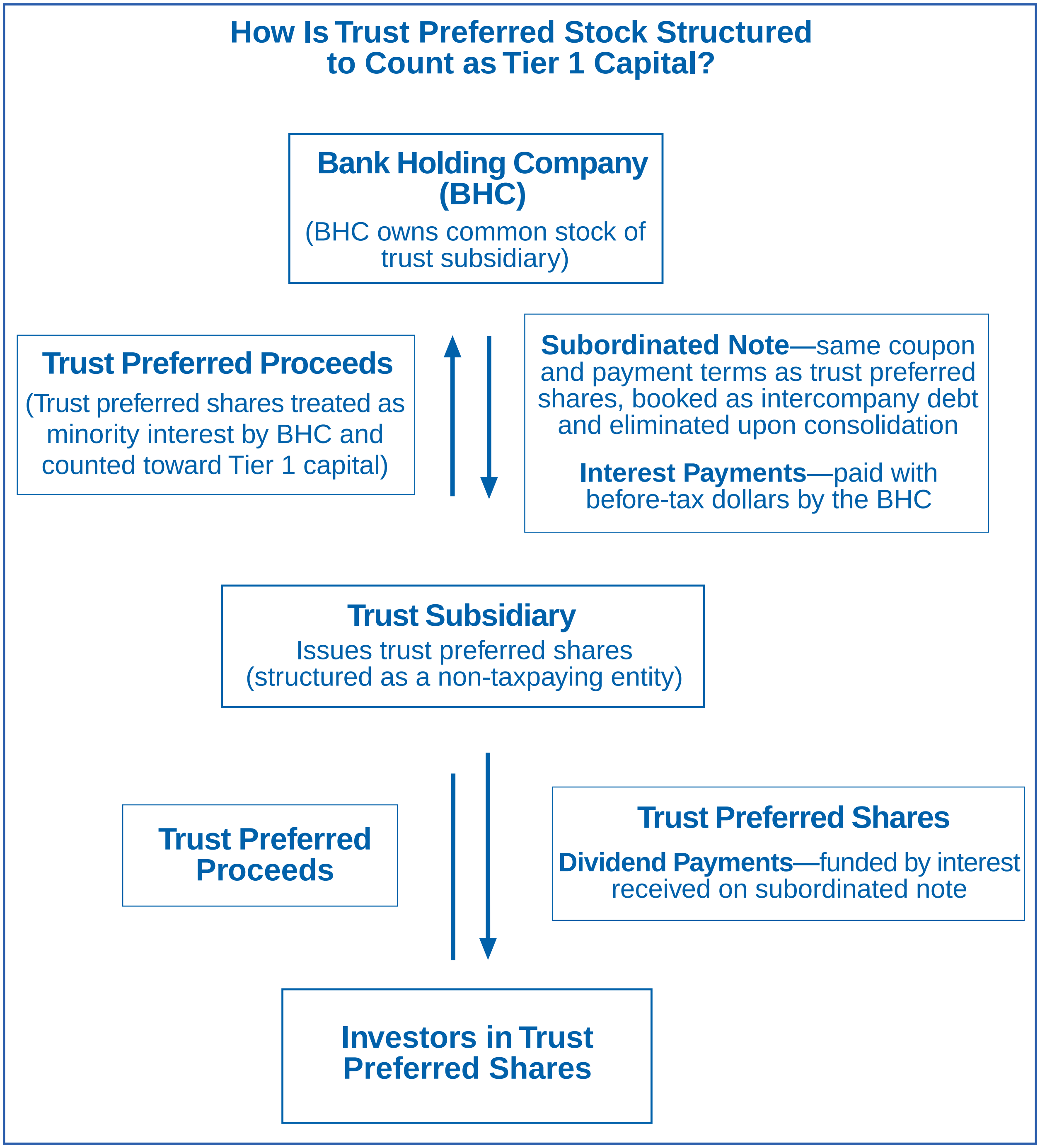
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary is owned by the bank holding company, and the trust preferred stock is sold to investors. The trust upstreams the proceeds from the sale of the preferred shares to the bank holding company in exchange for a long-term, deeply subordinated note with terms identical to the trust preferred shares. (The subordinated note must be the sole asset of the trust and subordinated to all other debt of the bank holding company.)

On a consolidated basis, the trust preferred stock is treated as a minority interest of the bank holding company, and the subordinated note is eliminated as inter-

[1] The amount of trust preferred stock outstanding is not delineated in Call Reports.

[2] Trust preferred dividends, unlike dividends on traditional preferred stock, are treated as a tax-deductible expense at the bank holding company level and as taxable income by investors of the trust preferred shares.

CHART 1


How Is Trust Preferred Stock Structured
to Count as Tier 1 Capital?
Bank Holding Company
(BHC)
(BHC owns common stock of
trust subsidiary)
Trust Preferred Proceeds
(Trust preferred shares treated as
minority interest by BHC and
counted toward Tier 1 capital)
Subordinated Note—same coupon
and payment terms as trust preferred
shares, booked as intercompany debt
and eliminated upon consolidation
Interest Payments—paid with
before-tax dollars by the BHC
Trust Subsidiary
Issues trust preferred shares
(structured as a non-taxpaying entity)
Trust Preferred
Proceeds
Trust Preferred Shares
Dividend Payments—funded by interest
received on subordinated note
Investors in Trust
Preferred Shares

company debt. The interest paid by the bank holding company on the subordinated note, which is tax-deductible at the bank holding company level, is used to fund the dividends on the trust preferred shares. In short, the issuing trust serves as a conduit for exchanging cash flows between the bank holding company and the investors in the trust preferred shares.

To be eligible for Tier 1 capital treatment, trust preferred dividends may be cumulative, but dividends must be deferrable for a minimum of five years. If the dividends are not paid for more than five years, the trust preferred shares could be exchanged for junior subordinated debt of the trust. After the exchange, the trust preferred holder could declare an event of default and accelerate the claim against the bank holding company. Trust preferred shareholders would then be treated similarly to deeply subordinated debt holders or preferred stockholders of the bank holding company.

Trust preferred shares typically have maturities of 30 years or more and contain call options and redemption provisions. The redemption provisions, which are subject to Federal Reserve approval, permit the issuer to redeem or buy back the preferred shares prior to maturity upon an adverse event such as the loss of Tier 1 capital treatment or the tax deductible status.

Banks are not permitted to count trust preferred stock toward Tier 1 capital because of the cumulative feature of trust preferred dividends. While bank holding companies are permitted to include up to 25 percent of Tier 1 capital as cumulative preferred stock, including trust preferred shares, banks must exclude cumulative preferred stock from Tier 1 capital ratios pursuant to the Risk-Based Capital Standards set by the Basle Accord.

Bank Holding Companies of All Sizes Have Issued Trust Preferred Stock

The flood of trust preferred stock issuance was prompted in part by the threat of extinction under the 1997 federal budget. Bank holding companies rushed to take advantage of a potentially short-lived tax loophole, while investors were attracted by the opportunity to earn higher rates than on similarly rated bank debt. Bank holding companies have used proceeds from trust preferred stock to retire or call more expensive outstanding preferred issues, to provide capital to bank subsidiaries, to finance acquisitions, and to buy back common stock.

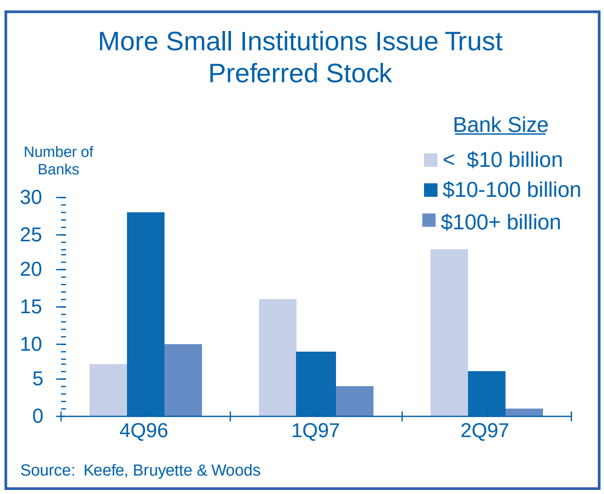
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated $4.3 billion in the first quarter of 1997 to just under $2.5 billion in the second quarter. Trust preferred issuance by larger banks declined as some approached their limit on Tier 1 trust preferred, while more smaller banks took advantage of the market for trust preferred stock. (See Chart 2 for a distribution of the number of banks in various size categories that have issued trust preferred stock in recent quarters.) Investment bankers are reportedly working on new structures that may make it easier and more cost effective for smaller institutions to issue these capital securities, perhaps through some pooling arrangement.

REIT Preferred Stock—Another Type of Tax-Advantaged Tier 1 Capital

Prior to the Federal Reserve's announcement last October, the REIT (real estate investment trust) preferred stock structure was the chosen way for financial institutions to issue tax-advantaged preferred shares. Bank-issued REIT preferreds lost favor once trust preferreds debuted, because the trust structure is less costly and easier to administer than REIT preferreds.

In an REIT preferred structure, the issuer establishes a corporation that elects REIT tax status. Proceeds from the preferred shares that are sold to investors are used to purchase qualifying real estate assets such as mortgage-backed securities or equity interests in real property. Cash flow from the real estate assets funds the REIT's

CHART 2



operating costs and preferred dividends. As long as the subsidiary continues to qualify for REIT tax status,[3] dividend payments on the common and preferred shares are tax deductible by the holding company.

Will the Tax-Advantaged Status of Trust Preferred Stock Continue?

Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget, the possibility still exists that the Internal Revenue Service (IRS) may alter the tax treatment of trust preferred dividends. (In the first half of 1997, the IRS issued a ruling that eliminated the tax-advantaged status of a specific type of preferred stock known as Step-Down preferred stock.) If the tax advantage is eliminated, REIT preferred shares might again become a more popular means of raising tax advantaged Tier 1 capital.

Issues and Concerns

A number of bank holding companies have embarked on stock buyback programs financed by trust preferred stock issuance, thereby boosting earnings per share by reducing the number of common shares outstanding, while maintaining Tier 1 regulatory capital ratios. Rating agencies and investment analysts, however, generally view trust preferreds as analogous to preferred stock or deeply subordinated debt of the issuer. *In fact,* ***Standard & Poor's*** *has announced that bank holding companies with trust preferred stock in excess of 10 percent of Tier 1 capital may be subject to a ratings review.* This announcement reflects the view of some analysts that trust preferred stock is a weaker form of Tier 1 capital than other forms of capital such as common and perpetual preferred stock, because of its limited life and treatment upon a liquidation of the trust.

A recent regulatory interpretation has underscored the debt-like nature of trust preferred stock. The Office of the Comptroller of the Currency (OCC) has determined that investments by banks in trust preferred stock should be treated as investments in debt securities.[4] The OCC cited a number of similarities between trust preferred stock and debt securities, including the fact that an investment in trust preferred securities is functionally equivalent to an investment in the underlying subordinated debt issued by the bank holding company, and that the trading characteristics of trust preferred securities are similar to traditional debt securities.

Banking organizations should be aware of the views of rating agencies and bank analysts toward trust preferred stock. In times of economic stress, excessive reliance on debt-like capital instruments could result in increased financial fragility of the overall organization, a higher cost of raising new capital, and potential ratings downgrades. In extreme scenarios, pressures on the bank to service the obligations (explicit or implicit) of the holding company could attract the attention of bank regulators.

Kathy R. Kalser, Chief
Financial Sector Analysis Section

[3] To qualify as an REIT, the subsidiary must comply with Section 856 of the U.S. Federal Income Tax Code, which requires that 75 percent of the REIT's income come from real property rents, interest income from mortgage debt on real property, and other related sources. In addition, the REIT must distribute at least 95 percent of its net income to shareholders.

[4] In a letter dated April 8, 1997, the OCC stated that subject to applicable rating and marketability requirements, bank investments in trust preferred stock would be treated as Type III investments under 12 CFR Section 2 1.2 (k).

Current Regional Banking Conditions

- **Although the Atlanta Region's economy is showing signs of slowing, most commercial banks reported strong second-quarter earnings. However, many small banks had second-quarter earnings lower than last year's.**

- **During the quarter, the Atlanta Region gained commercial banking assets from other sections of the country as superregional banks in North Carolina consolidated out-of-state operations.**

- **Given the length of the current economic expansion, insured institutions may wish to reassess the adequacy of loan loss reserves and lending standards.**

- **The prospects of more frequent and more intense hurricanes and the increased difficulty of obtaining insurance coverage could pose risks to some commercial banks and thrifts in the Atlanta Region.**

Commercial Bank Profits Generally Remain High

For the most part, commercial banks in the Atlanta Region continue to report strong earnings even though the Region's economy is starting to slow (see ***Growth in the Atlanta Region Continues to Slow*** for an analysis of current economic conditions in the Region). In the aggregate, commercial banks had a second-quarter return on assets (ROA) of 1.25 percent, down slightly from 1.28 percent for the second quarter of 1996. The ROA for commercial banks in the Atlanta Region just edged the second-quarter national average of 1.24 percent this year and 1.27 percent a year ago. Return on equity (ROE) showed a larger decline, dropping from 15.33 percent during the second quarter of 1996 to 14.31 percent in this year's second quarter. National figures for second-quarter ROE were 14.72 percent this year and 15.41 percent last year. The reduction in both ROA and ROE is mostly due to lower fee income, primarily at banks with assets over $10 billion. Higher capital levels also contributed to the lower ROE. Currently, the leverage ratio stands at 8.89 percent for the second quarter, versus 8.40 percent a year ago.

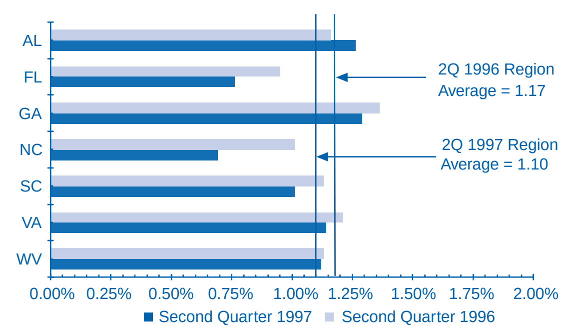
Another noteworthy item in the second-quarter figures is the large addition of commercial banking assets to the Region. During the quarter, banking assets in **North Carolina** rose nearly 64 percent from last quarter to $343 billion as several of the superregional banks headquartered in the state consolidated their out-of-state operations in June. Going forward, the large internal reorganization of assets by these companies will limit the analytical value of Call Report data for certain geographic areas in the Atlanta Region.

As seen in Chart 1, the earnings performance at small banks—those with assets of $100 million or less—compares unfavorably with last year's figure in all states except ***Alabama***. The drop in ROA is due to higher loan loss provisions and overhead and slightly lower fee income. The changes in these items were much greater at small banks in **Florida** and North Carolina; the average small-bank ROA in these two states has been well below the peer average for the Region the past two years. Regionwide, 271 small banks reported a lower ROA, with the median decline being 25 basis points. However, the news is not totally negative at all small banks, as 358 banks had a second-quarter ROA that exceeded last year's.

The aggregate ROA for **Georgia** banks showed a precipitous decline, dropping from 1.27 percent last year to

Chart 1

Second-Quarter Earnings Are Lower at Small Banks



Note: Small banks include commercial banks with assets of $100 million or less.
Source: Bank Call Reports

0.83 percent this year. As seen in Chart 2, most of the decline is due to the loss reported at medium-size banks (those with assets between $1 billion and $10 billion), which was large enough to move the state average. While the six banks in this group reported an ROA of –1.55 percent, down significantly from 1.02 percent a year earlier, only one bank in this peer group actually reported a loss. The poor-performing bank is a credit card bank that is divesting assets in order to facilitate its sale.

Trends in noncurrent loans and net charge-offs are depicted in Chart 3. Noncurrent loans (those past due 90 days or more and nonaccruals), at 0.82 percent of loans, are well below their peak level of 2.5 percent in 1992. Net charge-offs peaked at 1.25 percent of loans in 1991, bottomed in 1994 at 0.29 percent, and have since trended upward to 0.47 percent in 1996. Nevertheless, *about one-third of net charge-offs over the past two years come from credit card loans issued by monoline specialty banks. The charge-off ratio would decline 15 basis points to 0.32 percent in 1996 if the handful of credit card banks were excluded from the analysis.*

In the aggregate, commercial banks in the Atlanta Region continue to reduce the relative size of the allowance for loan losses. As seen in Chart 3, loan loss reserves have declined relative to loans after reaching a peak level during the height of the last recession in 1991. The decline in this ratio is due mostly to loan growth. Loan loss provisions have averaged 110 percent of net charge-offs the past five calendar years, not enough to maintain the loan loss reserve ratio in the face of loans growing at a 9.4 percent annual compound rate.

CHART 2

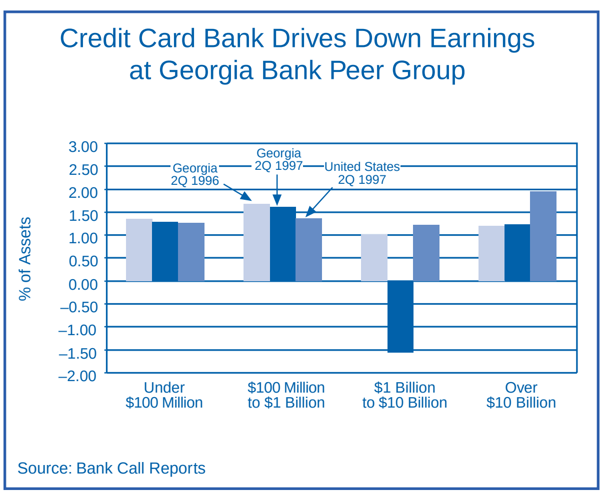
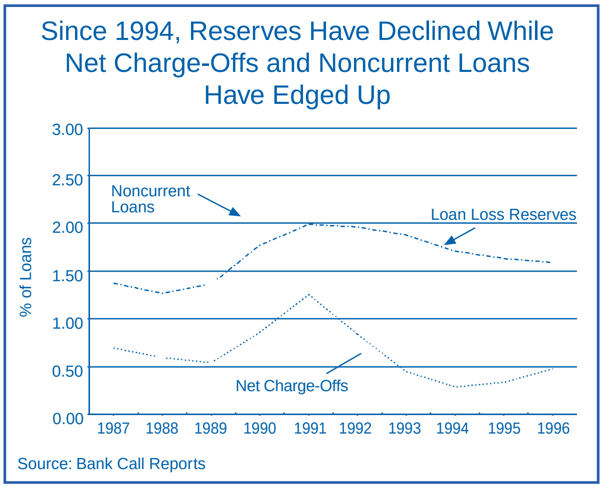


CHART 3



Although the ratio of reserves to loans is a way to assess reserve adequacy, it should not be the sole measurement in the assessment. Ultimately, the composition and quality of each institution's loan portfolio is the primary determinant of an adequate loan loss reserve. For some institutions in the Region, a less risky loan portfolio may explain a relative decline in loan loss reserves. For example, in the aggregate, residential real estate lending as a share of assets increased during the period 1987 to 1996. As discussed below, however, some institutions have increased their pool of risky loans.

Although most indicators of the health of commercial banks are favorable, there are some areas of potential concern. First, there has been an increase in the number of banks with large real estate construction loan concentrations. Last year, only 228 banks in the Region had a real estate construction loan concentration that exceeded 5 percent of assets, compared with 266 this year. Moreover, 48 banks have a concentration in excess of 15 percent of assets, up from 38 last year. Second, the rapid annual compound growth rate of loans may result in a tendency to understate past-due and charge-off ratios; many of these new loans have not seasoned, nor have they been recession-tested. Finally, some concerns about underwriting standards continue to surface. The recent Federal Reserve ***Senior Loan Officer Opinion Survey on Bank Lending Practices*** found that a large number of banks have eased interest rates and other terms on commercial and commercial real estate loans because of competitive pressures. In like fashion, the Comptroller of Currency, in ***Advisory Letter 97-8***, alerted national banks to review their reserve practices because of concerns about trends in the syndicated loan market, a general relaxation of commercial underwriting standards, and possible flawed methods for estimating losses on pools of loans.

Implications: Given the long economic expansion and signs of increased loan underwriting risks at some institutions, a number of industry observers argue that now is a good time to revise and strengthen lending and reserve practices. Such steps may be particularly important for institutions in the southeast, given some signs that the Region's economy is slowing (see ***Growth in the Atlanta Region Continues to Slow***).

Storm Warnings

Hurricanes have always posed a risk to some parts of the Atlanta Region. Before the start of this year's season, hurricane expert ***William M. Gray*** of Colorado State University forecasted a new era of more frequent and intense storms. This forecast, if accurate, could lead to levels of destruction higher than those in prior eras. Moreover, the damage potential has been heightened by the rapid economic growth along the Atlantic and Gulf coastlines the past two decades (for further analysis of growth trends, see ***Just Another Hurricane Season?***).

While all of the coastal states in the Atlanta Region have been devastated by hurricanes, **Florida** has been struck by more storms and experienced the greatest damage. As seen in Table 1, the Florida Department of Insurance reports that the state has had six storms since 1992 that have caused more than $1 million in insured losses. Collectively, these storms resulted in insured losses of approximately $19 billion. The most devastating storm, Hurricane Andrew, struck South Florida in 1992 and caused approximately $36 billion in damages (1996 dollars), with insured losses of about $16 billion.

The large losses from Hurricane Andrew caused many insurers to declare bankruptcy or leave the state. According to the ***Florida Association of Insurance Agents***, nearly 100 of its members went out of business, along with many other agencies that were not members. One insurance company even paid many of its policyholders a year's worth of premiums to move their business to another underwriter. As a result, many home owners and small-business owners are having difficulty finding affordable property and business-interruption insurance. *The premium rates for some comprehensive packages have increased as much as fourfold, and deductibles have increased by as much as tenfold over their pre–Hurricane Andrew levels.*

Florida is not alone in its insurance problems. Most **North Carolina** insurance companies are reluctant to write home owners' policies along the coastline. According to the ***North Carolina Department of Insurance***, of the 629 insurance companies licensed in the state, only 33 will underwrite policies in the beach territory. Of those 33 insurers, 10 companies write 93.6 percent of the policies and 3 companies write 67 percent. **Alabama** has had similar experiences with the reluctance of insurers to serve its coastline residents. In general, fewer insurance companies are willing to underwrite policies that cover property located in the potential path of a hurricane.

Because of the dwindling number of private insurers willing to underwrite coastal property, several state insurance commissioners have enacted joint underwriting funds, which are considered "last resort" insurance for property owners who have not been able to obtain private insurance. In 1987, the ***Alabama Insurance Underwriting Association*** established a Beach Plan to enable property owners to finance the purchase and improvement of their property. The North Carolina General Assembly also created a Beach Plan to cover

Table 1

Insured Losses from Recent Tropical Storms and Hurricanes in Florida

Storms	Dates	Losses
Hurricane Andrew	August 24–26, 1992	$16 billion
Hurricane Opal	October 4–5, 1995	$2.5 billion
Hurricane Erin	August 1–4, 1995	$350 million
Tropical Storm Josephine	October 4–8, 1996	$65 million
Tropical Storm Gordon	November 14–16, 1994	$60 million
Tropical Storm Beryl	August 15–17, 1994	$8 million

Source: Florida Department of Insurance

storm damage and the Fair Access to Insurance Requirement Plan to cover wind damage. **Georgia**, **Virginia**, **West Virginia**, and **South Carolina** depend solely on the private market to provide insurance coverage for storm damage.

Florida has the most noteworthy plan, known as the Florida Residential Property and Casualty Joint Underwriting Association (JUA). Although the JUA was set up as a last-resort insurer, it has grown rapidly to about 900,000 policyholders, or about 100,000 policies fewer than the state's largest private insurer. The JUA covers 18 percent of all Florida residents and is heavily concentrated in southern Florida, where it has an exposure of more than $4 billion. Another last-resort carrier is the Florida Windstorm Underwriting Association (FWUA). This state insurer was originally set up in 1970 to cover high-risk parts of the Florida Keys but has grown since to cover property owners in 25 of Florida's 35 coastal counties. Although the JUA and FWUA provide coverage for many that would otherwise be uninsured, their ability to withstand a major storm is in doubt, as the majority of annual premiums are merely covering routine claims. Many insurance analysts have expressed concerns about the financial health of both last-resort insurers because their ability to raise a large amount of capital on short notice is limited by their small backup lines of credit.

Private insurers are also struggling with the escalating cost of reinsurance. As a result of the cost increases, many companies have raised their deductibles or loss maximums before reinsurance is effective. Most companies have purchased some protection for losses caused by a catastrophic storm like Hurricane Andrew. However, many companies are not protected if their coverage areas are struck by a series of smaller storms that have losses below their reinsurance threshold.

The potential problems with insurance providers, state-sponsored and private, could have serious credit-risk implications for some commercial banks and thrifts. Loans secured by property in coastal areas may be underinsured or uninsured. Also, small-business loans could become impaired because of a lack of business-interruption insurance. The risk exposure for insured institutions extending credit in coastal areas may have increased substantially over the past ten years. For example, commercial banks with assets under $250 million headquartered in Florida's coastal counties have increased their residential real estate lending from $2.1 billion to $5.4 billion and business loans from $0.9 billion to $2.1 billion. Although most lenders in coastal areas are cognizant of the risks posed by hurricanes, many contend that there is little they can do because of the competitive lending environment in which they operate. Nevertheless, finding ways to manage and contain potential credit exposure arising from hurricanes will be an important challenge to insured institutions in these areas.

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