Regional Outlook

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FDIC CHICAGO REGION

DIVISION OF INSURANCE

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◆ ***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.*

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Subprime Lending: A Time for Caution

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

What Are Subprime Loans?

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

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

Table 1

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

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

How Big Is the Market?

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

Who Makes Subprime Loans?

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

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

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

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

Financial Difficulties of Some Subprime Lenders

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

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

Differences between Prime and Subprime Lending

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

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

Insured Institutions and the Subprime Market

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

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

Through these strategies, insured institutions have:

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

Risks Associated with Subprime Lending Need to Be Considered Carefully

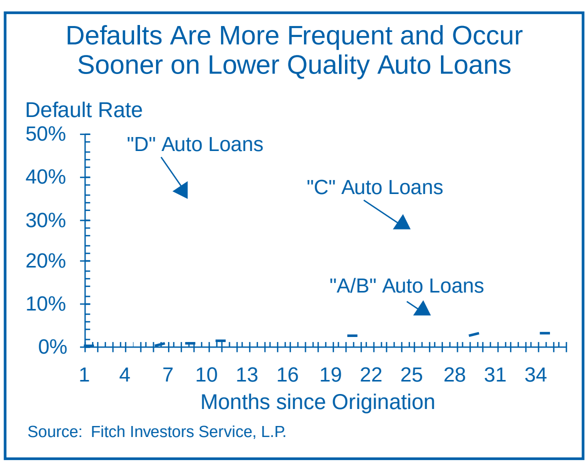
According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because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

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

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

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

CHART 1



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

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

Conclusion

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

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Retail Shakeout: Causes and Implications for Lenders

- **Changes in the marketplace, technology, and finance are transforming retailing.**

- **These trends have given rise to rapid growth in the new "big box" store format.**

- **Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.**

- **The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.**

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

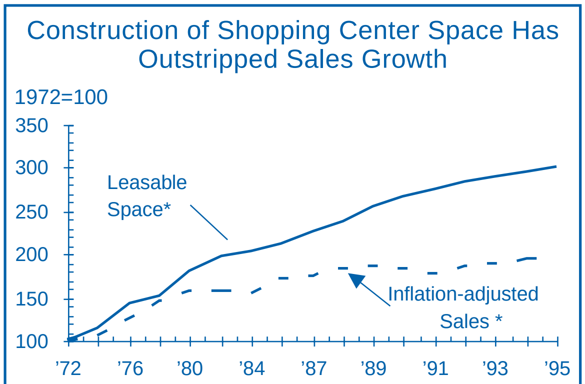
Based on signs of "overstoring," a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate,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



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

98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

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

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

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

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

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

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

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

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

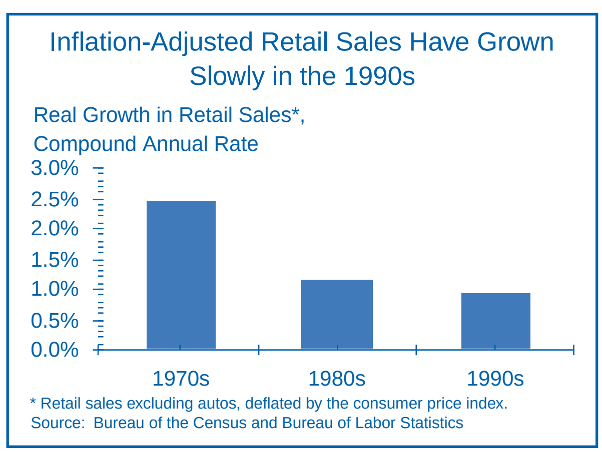
A low cost of capital has fueled investment. Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise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

Growth of the "Big Box" Format

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

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

CHART 2



Industry Consolidation to Continue

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

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

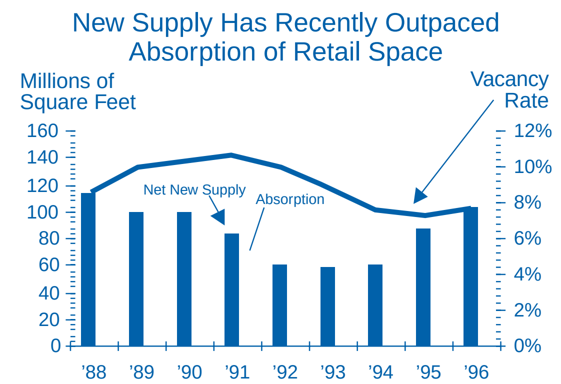
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more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

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

Overbuilding Is a Risk for Retail Real Estate

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

CHART 3



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

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

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

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

Retail Vacancy Rates Climb Slightly in the Chicago Region

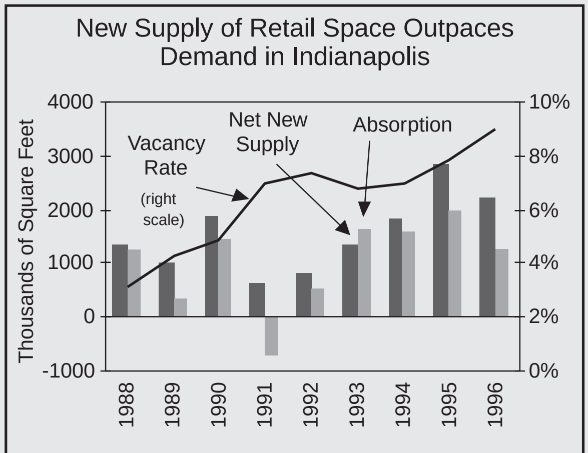
Reports from around the Chicago Region indicate that the supply of new retail space is beginning to outstrip the demand for that space in many metropolitan areas. Net new supply of retail space slightly exceeded demand in many of the Region's major metropolitan areas recently. Thus, most vacancy rates in this Region at year-end 1996 were several tenths of a percentage point higher than year-earlier levels, according to the latest edition of the FDIC's ***The Real Estate Report*** (see Table 1).

Two metropolitan areas are exhibiting signs of potential overbuilding. In **Indianapolis,** cumulative net new supply over the past three years has exceeded absorption by more than 2 million square feet (see Chart 4). Consequently, the vacancy rate rose by about 1 percentage point in each of the past two years, reaching 8.9 percent late in 1996. Planned retail projects for the Indianapolis area call for an additional 2.9 million square feet of space. However, over 90 percent of this space is in the early planning stage and therefore subject to postponement or cancellation until more of the currently available space is absorbed.

Cleveland's vacancy rate has risen more slowly than the rate in the Indianapolis market. Nevertheless, it is the highest since the late 1980s, with the exception of 1992. This increase has developed despite relatively limited new supply in recent years (see Chart 5). The opening of the SouthPark Center, the first new mall built in Northeast Ohio in the past 18 years, accounted for some of last year's spurt in new space built. The customer traffic it experienced, however, reportedly drew heavily from several existing malls. At the same time the new mall was opening, the area's first mall, constructed in 1963, was being demolished to make room for a big box store and a strip center.

Joan D. Schneider, Regional Economist

CHART 4



Source: FDIC, *The Real Estate Report*

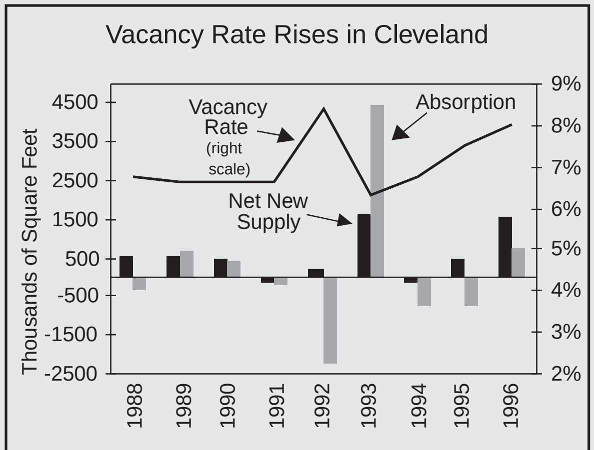
TABLE 1

VACANCY RATES IN CHICAGO REGION'S RETAIL REAL ESTATE MARKETS

	1993	1994	1995	1996
CHICAGO PMSA*	8.3	7.7	6.9	6.6
CINCINNATI PMSA (OH-KY-IN)	10.8	8.2	7.4	7.7
CLEVELAND PMSA	6.3	6.7	7.5	8.0
COLUMBUS MSA*	6.8	5.6	4.7	5.1
DETROIT PMSA	8.0	5.1	4.6	4.8
INDIANAPOLIS MSA	6.7	6.9	7.8	8.9
MILWAUKEE PMSA	8.8	8.7	8.7	9.2

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

CHART 5



Source: FDIC, *The Real Estate Report*

Chicago Region's Economy: Checking Its Pulse

- **Continuing healthy auto and truck sales and low inventory stocks suggest that the motor-vehicle and related industries will continue operating at high levels in the near term. A significant rise in interest rates is among the possible risks that would be detrimental to the Region's industrial economy.**

- **Multifamily residential construction outpaced demand recently, pushing the Midwest's rental vacancy rate to its highest level in a decade.**

- **Agricultural banks are facing increased competition at a time when volatile output prices and changes brought about by the 1996 Farm Bill may challenge traditional underwriting practices.**

- **The extended cyclical expansion has contributed to the Region's current economic vigor. Even so, the expansion's longevity and the recent, policy-induced rise in interest rates suggest that institutions should review the economic assumptions used for their product pricing and strategic planning.**

Steady Pulse: Motor-Vehicle Sector

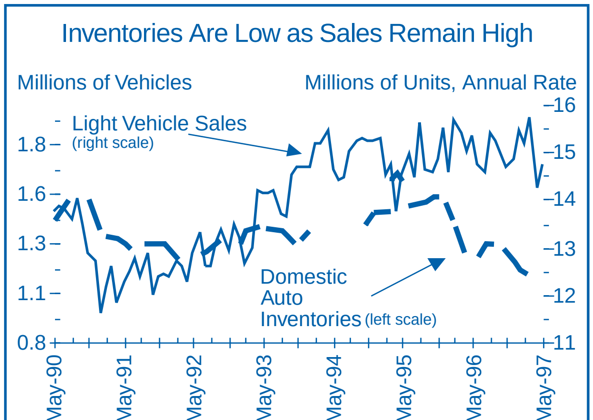
Healthy demand from households and businesses continues to support national car and truck sales at a high level (see Chart 1). Although interest rates have edged up recently (see Chart 3 in ***Financial Markets*** article), the near-term effect on demand for vehicles is expected to be marginal. An industry rule of thumb is that a 25 basis-point increase in the federal funds rate trims vehicle sales by only 100,000 to 150,000 units at an annual rate. In order to offset this projected loss, however, some automakers and dealers are sweetening incentives or subsidizing their financing terms.

Auto inventories were already lean before recent labor strikes, which trimmed inventories even further (see Chart 1). The currently wide gap between sales and inventories suggests that there will be some short-term rebound in production both to rebuild inventories and meet demand. Because over half of the nation's auto assembly plants are located in this Region, the vehicle industry's current health is exerting a pervasive influence. Another rule of thumb suggests that for every one job in auto and truck plants, there are about two and one-half jobs in ancillary industries. High levels of activity in this and many other industries helped reduce the Region's unemployment rate to 4.5 percent in the first quarter, the lowest in more than two decades.

Despite the strength of vehicle sales, competition and changes in financing options have trimmed the share of consumer auto loans held by banks. Nationwide, banks currently hold 40.4 percent of auto credits, according to the Federal Reserve's consumer credit data. This share is more than 3 percentage points lower than in 1994 (see Chart 2, next page), reflecting gains among such other lenders as credit unions and savings institutions as well as the development of the auto asset-backed securities (ABS) market.

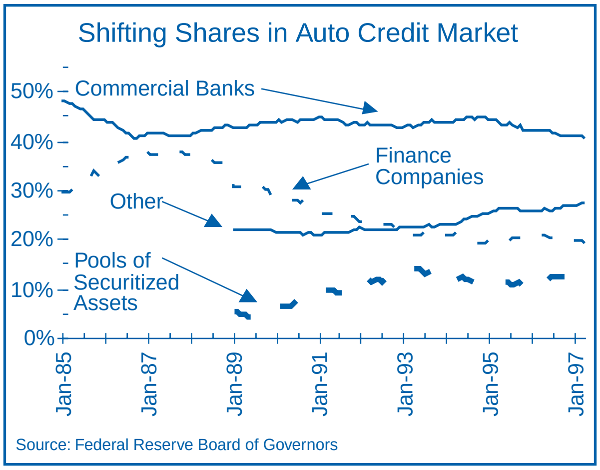
To some extent, banks are transforming how they participate in the auto financing market but not necessarily yielding earning power. For example, commercial banks' issuance jumped to 28 percent of the auto ABS market in 1995 after three years of subdued participation. It rose further in 1996, to 34 percent. The rise in banks' share reflects not only their increasing participation but also the fact that the captive auto finance companies (e.g., GMAC, Chrysler Financial, Ford Motor Credit) have shifted their funding strategies away from this market to asset-backed commercial paper and other alternatives.

CHART 1



Source: U.S. Department of Commerce

CHART 2



Implications: To date, the recent rise in interest rates appears to be having little impact on the Region's motor-vehicle and other major industries, from either the demand or supply side. If interest rates rise significantly or labor shortages intensify, however, the manufacturing sector will have difficulty sustaining recent levels of activity. In that event, income growth for both the household and business sectors will be negatively affected, which could lower loan demand and possibly cause credit quality problems. While many banks in the Chicago Region retain auto loans in their portfolios, a few are participating in the auto ABS market.

Quickening Pulse: Multifamily Construction

An upswing in residential construction has been under way since 1991. The expansion reflects both favorable economic conditions and a sharp rebound in the Midwest's homeownership rate to a 20-year high. The Midwest, which covers states in the FDIC's **Chicago** and **Kansas City** Regions, historically has the highest rate in the nation. In the first quarter of 1997, the homeownership rate was 70.6 percent in the Midwest, solidly above the national rate of 65.4 percent.

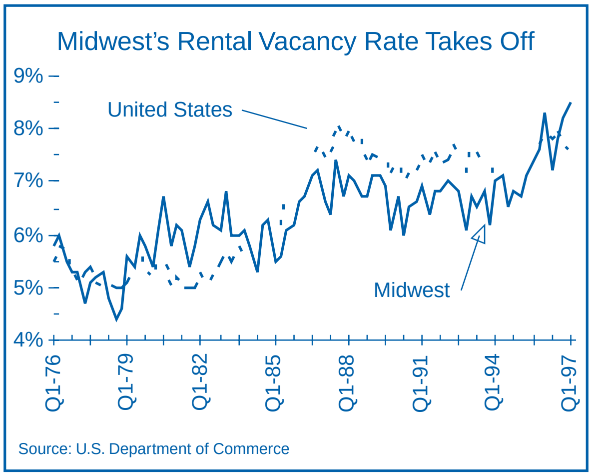
Since 1991, single-family home starts in the Midwest have risen at a 5.8 percent average annual rate. *Rising considerably faster were units started in multifamily buildings.* These starts averaged 10.2 percent annual growth but soared by as much as 35 percent in 1994. Behind this vigor, however, was considerable variation among cities in the Chicago Region, as shown in Table 1.

Signs are appearing that the supply of new apartments is outpacing demand in some markets. First, the rental vacancy rate for the Midwest climbed to 8.5 percent in the first quarter of 1997 (see Chart 3, next page). This rate is not only considerably above its range during the past decade but also now exceeds the national rate, which has not seen a similar increase.

TABLE 1

Permits for New 5+ Unit Buildings				
Market	Number of Units		% Change	
	1995	1996	1995	1996
Akron PMSA	309	815	–48%	164%
Bloomington IN	259	181	–17%	–30%
Chicago PMSA	5259	6768	7%	29%
Cincinnati OH-KY-IN PMSA	2513	1734	4%	–31%
Cleveland-Lorain-Elyria	1437	858	126%	–40%
Columbus	2587	3291	7%	27%
Dayton-Springfield	371	1319	–62%	256%
Detroit PMSA	2826	3414	–7%	21%
Grand Rapids-Muskegon-Holland	1109	1320	5%	19%
Indianapolis	2558	2439	64%	–5%
Madison	1394	568	–3%	–59%
Milwaukee-Waukesha PMSA	2143	2232	8%	4%
Toledo	531	117	59%	–78%
Source: Census Bureau				

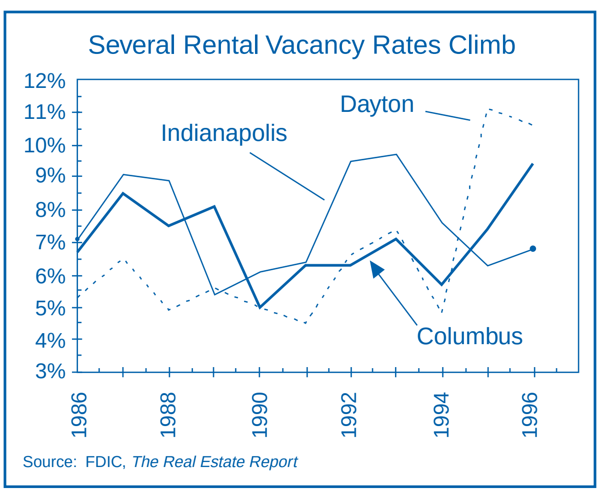
Chart 3



Second, a number of apartment projects, ranging from new construction to conversion of former industrial and office structures, are in the pipeline and will add to supply in coming quarters. Third, there are anecdotal reports of investor funds seeking projects owing to an upswing in activity by capital-rich real estate investment trusts, insurance companies, and others looking for longer term investment opportunities.

Implications: Rental vacancy rates in **Dayton** and **Columbus** have risen noticeably in the past two years, increasing by more than 3.5 percentage points (see Chart 4). It remains to be seen whether demand this year will significantly lower these rates, as happened in the **Indianapolis** market after 1993. If a substantial number of apartments are still in the construction pipelines in these cities, then the near-term outlook may involve weakness in rental rates and cash flows. Troubled profitability, in turn, could erode developers' ability to

Chart 4



maintain loan repayment schedules or obtain permanent financing.

Agriculture Banks Face Challenges Despite Robust Crop Forecasts

Soybean and corn plantings progressed at a near-record pace through mid-May. Early estimates from the U.S. Department of Agriculture (USDA) suggest that U.S. farmers may harvest a record 2.6 billion bushels of soybeans and a near-record 9.8 billion bushels of corn. Since the Chicago Region grows about one-third of the nation's corn and soybeans, good harvests should benefit the Region in various ways:

- The USDA estimates that crop revenues nationally will fall by about 4 percent this year—partly because of lower corn prices—yet remain above $100 billion after posting a record high last year.

- Rebuilding of corn and soybean stockpiles would occur after a season when reserves were the lowest in 20 years or longer.

- Profits for livestock producers should be enhanced by an easing of feed costs for cattle and hogs.

- Food companies could avoid repeating last year's shutdowns of processing and milling operations owing to raw material shortages.

Despite the favorable planting reports, soybean prices currently are quite high (see Chart 5, next page). Late-May cash prices in central **Illinois** were roughly 25 percent higher than at the start of the year, partly because strong domestic and foreign demand suggests additional shrinkage of reserves until the harvest starts at the end of this summer.

Agricultural banks face other challenges beyond the impact of gyrating product prices on their customers and localities. Increased competition from several fronts slightly trimmed banks' share of farm debt to 39.4 percent in 1996, according to the USDA. This drop was the first since the 1980s. Among the contributing factors are:

- Equipment manufacturers, seed companies, and other agricultural vendors are more active in offering credit to farmers. John Deere Credit, for example,

CHART 5

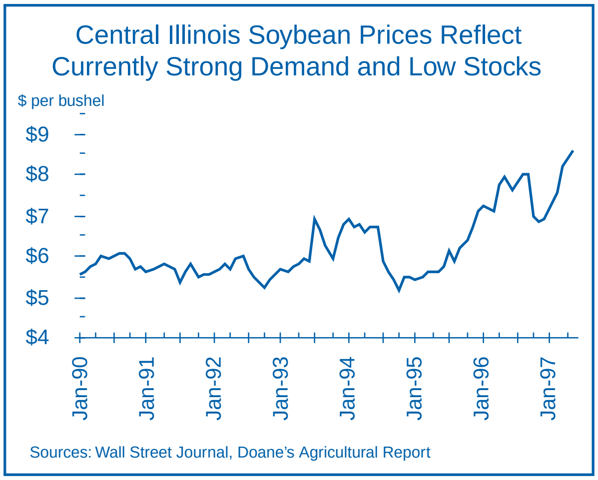
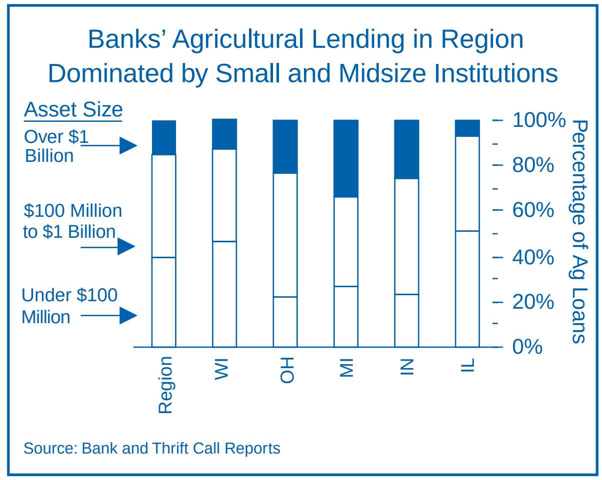


CHART 6



reportedly had $3.6 billion in its agricultural retail note program last year. PHI Financial Services, the financing arm of the nation's largest seed supplier, has started offering operating lines of credit in addition to its traditional short-term financing for seeds.

- Leasing of equipment through manufacturers, another substitute for traditional credit, is being used by about 20 percent of crop farmers.

- The Farm Credit System has recently become more active. Its share of agricultural lending rose to 25.6 percent in 1996 from 24.4 percent in 1994. The USDA estimates that it will rise by another percentage point this year.

In addition, small institutions face increasing competition from within the industry. Several large banks that operate nationwide are seeking to grow their share of farm lending. Beyond funding large, commercial-sized farms, some of these institutions are encroaching on the traditional customer base of smaller banks.

Implications: Early 1997 agricultural production projections appear bright, which should be a plus for insured institutions with credit concentrations to this sector. Even so:

- Lenders need to ensure that the potential volatility of prices, such as seen recently for soybeans, is incorporated into their underwriting decisions.

- Small and midsized banks, which currently provide 84.5 percent of agricultural loans made by insured institutions in this Region (see Chart 6), are facing increased competition from larger banks as well as nonbank lenders.

- The potential impact of the 1996 Farm Bill deserves watching. Lenders need to assess the potential impact on borrowers whose crops are affected by the planned phase-out of farm subsidies.

Joan D. Schneider, Regional Economist

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.**
- **Community bank stocks in the Chicago Region performed smoothly despite turmoil in the broad market.**

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

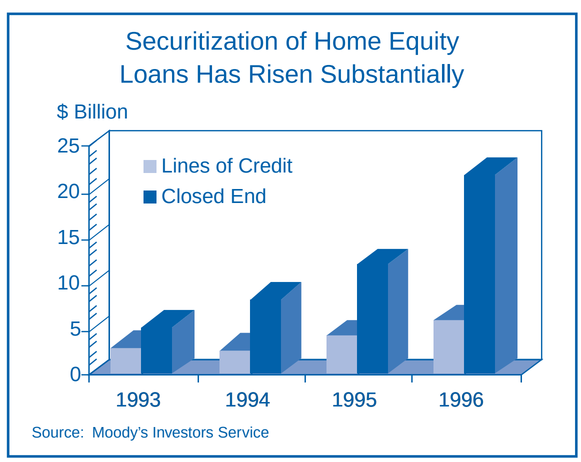
The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has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

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

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

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

CHART 1

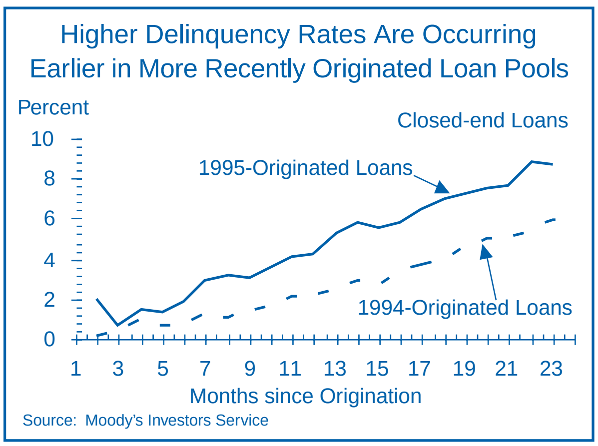


The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The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

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

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

Chart 2



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

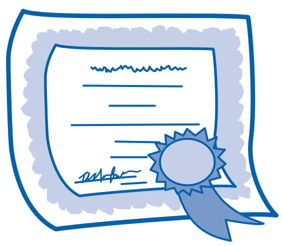
The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results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

FASITs Promise to Change the ABS Market

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

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

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



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, nonreal 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

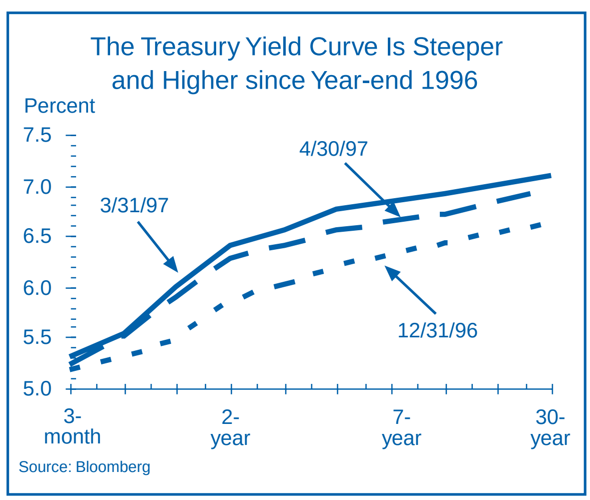


Table 1

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.

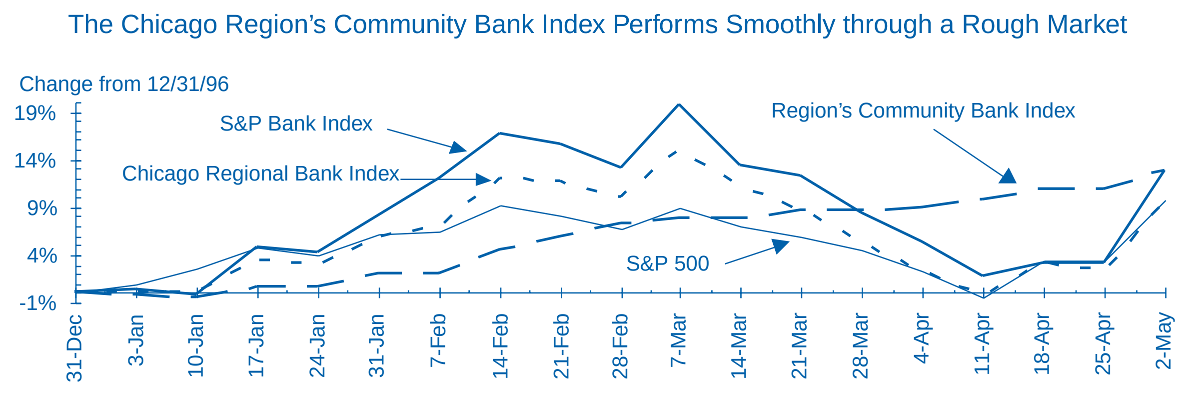
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate 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.

Community Bank Stocks in the Chicago Region Performed Smoothly Despite Turmoil in the Broad Market

Both the S&P Composite Bank Index and the Chicago Regional Bank Index have been subject to similar performance swings this year (Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The Chicago Region's Community Bank Index was spared much of the influence of a gyrating market, rising in value steadily to a 12.72 percent gain through May 2, 1997, just 5 basis points shy of the S&P Composite Bank Index's gain.

Allen Puwalski, Banking Analyst

Chart 4



Source: Bloomberg, *American Banker*

Chicago Region Banks and Thrifts Manage Interest Rate Changes and Expand Revenue Sources

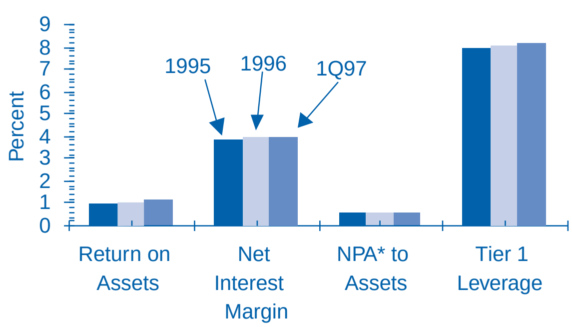
- **The overall condition of the Region's insured institutions remains sound, with strong capital and earnings providing significant financial flexibility.**
- **Recent interest rate changes and implementation of the new "Sensitivity to Market Risk" examination component rating reinforce the need for interest rate risk controls.**
- **Noninterest income has become more important to institutions large and small, creating new opportunities and risks.**
- **Interstate branching has become a reality, with states in the Chicago Region setting different conditions for branch network acquisitions and *de novo* branches.**

Overview

In the aggregate, the Region's banks and thrifts continue to be positively influenced by good economic conditions (see ***Chicago Region's Economy: Checking Its Pulse***). These conditions have helped to maintain traditional measures of profitability and capital adequacy at high levels. In addition, they have assisted in keeping the amounts of nonperforming assets low (see Chart 1). During the first quarter of 1997, the Chicago Region's institutions:

- increased aggrgate leverage capital to over 8 percent of average assets;
- improved their aggregate return on assets to 1.22 percent; and
- except for consumer loan portfolios, continued to report low nonperforming and past due asset levels.

CHART 1



Source: Bank and Thrift Call Reports *Nonperforming Assets

Banks and thrifts also continue to adapt to changes in different economic and business sectors by altering balance sheet structures and earnings strategies. Last quarter, this section of the ***Regional Outlook*** focused on some of the ongoing balance sheet changes and discussed how the Region's institutions altered:

- lending practices and strategies—decreasing growth in consumer lending and more actively participating in construction lending, home equity lending, and lease financings; and
- funding patterns—relying more heavily on alternatives to core deposits to fund their operations.

This quarter, the focus shifts to selected components of the revenue stream and a brief discussion of interstate branching as it relates to the Chicago Region.

Net Interest Income Remains the Primary Source of Revenue

Net interest income has declined slightly as a percentage of net revenues over the past several years, but it remains the primary source of income for insured institutions (see Table 1, next page). Because of its importance, prudent management and control of net interest income remains a primary goal of many managers.

While many factors affect net interest income and margin performance, the effect of rising and falling market

Table 1

Net Interest Income Is the Primary Component of Net Revenue		
	1Q97	1Q92
Net Interest Income	71%	74%
Noninterest Income	28%	24%
Securities Gains and Losses	1%	2%

Source: Bank and Thrift Call Reports

interest rates has been one of the more significant factors for this Region. Changes in interest income earned and expense paid by insured institutions have generally followed market interest rates. However, on an aggregate basis, changes in each of these components have substantially offset one another. *As a result, the Region's aggregate quarterly net interest margin has been maintained within a 47 basis point range (highest quarter to lowest quarter) over the past five years, or about 11 percent of the highest quarter's performance.* The aggregate net interest margin for banks under $100 million in total assets has been more stable, varying by only 38 basis points, or about 8 percent of the highest quarter's performance. This range of movement, though slightly more than that of the nation as a whole, appears manageable and is considerably less than the 300 basis point range within which the quarterly average federal funds rate has fluctuated during the same period (see Chart 2).

While aggregate performance has been relatively stable, margin fluctuations at individual institutions have been much more volatile. *In fact, the range of change in the quarterly net interest margin for about 27 percent of individual banks and thrifts in this Region exceeded 150 basis points over the past five years* (see Chart 3, next page). In some cases, the effects and management of rising and falling market interest rates played a significant role. In others, factors such as growth realized by new banks, timing of interest accruals, and problem asset levels are primary drivers of net interest margin changes.

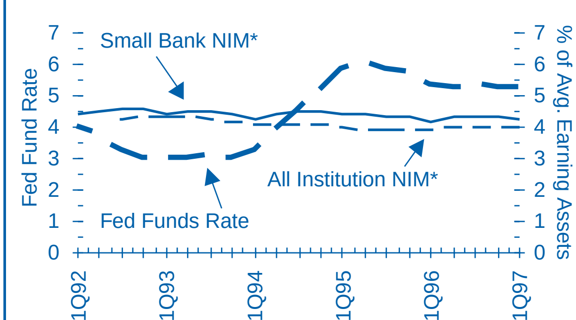
Implications: Concern over controlling rate risk is heightened when interest rates are volatile or market participants are uncertain in which direction rates are headed. While interest rates have not been extremely volatile of late, recent actions by the Federal Reserve—first to raise interest rates in March (see ***Financial Markets***), then to hold them steady in May—have left some analysts uncertain over where short- and intermediate-term rates may be headed.

In the past, banks and thrifts have implemented various strategies to manage interest rate margins as well as market values of their asset, liability, and off-balance-sheet positions. These strategies include altering balance sheet structures and actively managing loan and deposit pricing. One of their more important advantages has been significant price flexibility on nonmaturity deposits. For example, many banks and thrifts have demonstrated the ability to increase rates on money market and NOW accounts at a much slower rate than changes in short-term market rates might otherwise dictate.

In recognition of the importance of managing risk in this area, bank and thrift regulators recently added a sixth examination rating component to the former CAMEL rating called "Sensitivity to Market Risk" (or "S" rating). This rating was designed to address the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect an institution's earnings or capital. (Interest rate risk, which is the prevailing market risk for most of the banks and thrifts in this Region, had primarily been reflected in the Earnings component rating in the past.) The new component also focuses on an institution's ability to monitor and manage risk in these areas. Since its inception earlier this year, examiners have assigned a "1" or "2" rating for this component in over 90 percent of the Region's institutions where an "S" rating has been assigned.

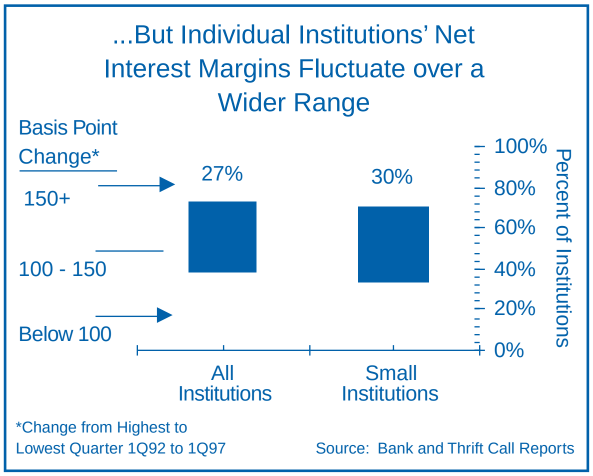
Chart 2

Aggregate Net Interest Margin Is Fairly Stable Despite Changing Market Rates…



Source: Bank and Thrift Call *Net Interest Margin

CHART 3



Noninterest Income Growing in Importance

In an attempt to mitigate the effect of interest rate risk on total revenues, as well as to diversify revenue streams, insured institutions have focused on increasing noninterest income. As a result, noninterest income has trended upward and, while somewhat volatile, represented about 28 percent of net revenues for the Chicago Region on an aggregate basis during the first quarter of 1997 (see Chart 4).

In many cases, traditional sources of noninterest income, such as service charges on deposit accounts and trust fees, are being reviewed by banks. Some institutions have initiated fees for previously free services, such as conducting business with tellers. Others have changed the fee structure on returned checks and ATM usage.

In addition, institutions are expanding their sources of revenue through the sales of items such as:

- mutual funds;
- annuities; and
- insurance.

Though large and midsize institutions in the Region generate significantly more fees for these products than do banks under $100 million in total assets, the latter also have participated in the trend toward additional revenue sources. For example, over 500 institutions in this Region, or about 23 percent of the Region's total, recorded annuity sales during the first quarter of this year, with over 100 smaller institutions participating. Additionally, over 575 institutions, 150 of them small banks and thrifts, posted mutual fund sales.

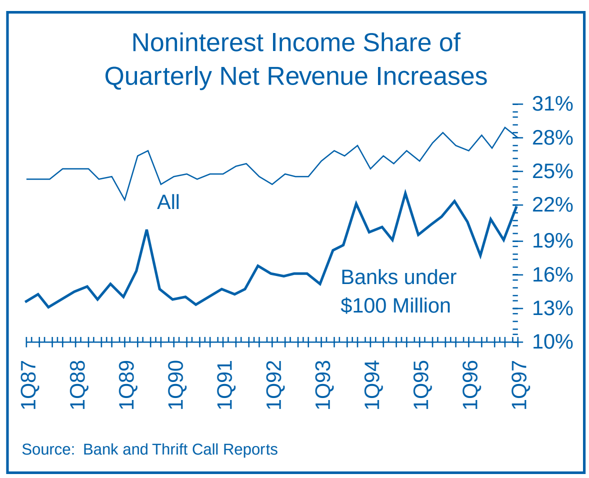
Implications: Many of the recent initiatives to raise fee revenues have some risks attached. For example, some banks with large ATM networks in the Region recently began charging noncustomers a fee for use of their ATM equipment. These banks have had to balance the added fee income against a considerable amount of negative publicity from consumer groups that claim the fees are unfair. Some of the newer fee-related business lines, such as mutual funds and annuities, also have unique risks. Increased revenues from these sources must be balanced against potential contingent liability and reputation risk arising from the sale. For example, banks may create some contingent liability if they fail to make appropriate disclosures regarding the noninsured status of annuities they sell.

Regulators have reacted to changing risk profiles, especially in the area of nondeposit investment products. During May of this year, the FDIC's Division of Supervision issued new examination guidance concerning nondeposit investment products and provided this information to insured institutions through Financial Institution Letter #48-97.

Interstate Branching Becomes a Reality

Beginning June 1, 1997, Title I of the Riegle-Neal Act provides "authority for banking organizations to acquire banks across state lines and for the acquisition or establishment of interstate branches." It significantly eases

CHART 4



restrictions on the interstate acquisition of banks by bank holding companies. Banks in different states may merge and operate the resulting institution as a bank with interstate branches.

Table 2

Rules for Interstate Branching Vary across States

State	Allow Only a Portion of a Branch Network to Be Acquired?	De Novo Interstate Branches?
Illinois	No	No
Indiana	Yes	Yes, only on a reciprocal basis
Michigan	Yes	Yes, only on a reciprocal basis
Ohio	Yes	Yes
Wisconsin	Yes, as long as home and host state regulators approve	No

Source: Conference of State Bank Supervisors, Washington, D.C.

All states within the Region now allow some form of interstate branching, though there are differences (see Table 2). For example, Illinois has limited the ability of a purchaser to branch into that state unless the purchaser acquires all the branches of the target bank in that state. Thus, an acquirer would need to purchase all ten branches of a ten-branch bank rather than only one or two. In addition, Illinois and Wisconsin require that branches and banks acquired must have been in operation for five years or more.

Implications: The national trend toward fewer insured institutions is being experienced by all states in the Region, which has seen a net reduction of over 20 percent of independently chartered banks and thrifts since the end of 1990. Much of this reduction is due to acquisitions and mergers, trends that interstate branching may accelerate. Interstate branching also may cause changes in the competitive landscape, as some existing institutions compete against larger, nonlocal banking organizations.

John D. Weier, Senior Regional Analyst
Elise A. Flynn, Examiner, Division of Supervision

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