
◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

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In Focus This Quarter

FDIC MEMPHIS REGION



◆ **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.*

By Ronald Spieker, Steve Linehan, George French

◆ **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.*

By Steven Burton, Gary Ternullo

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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

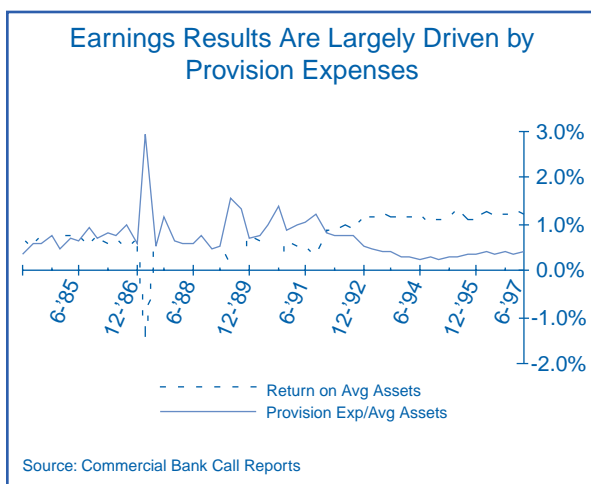


CHART 2

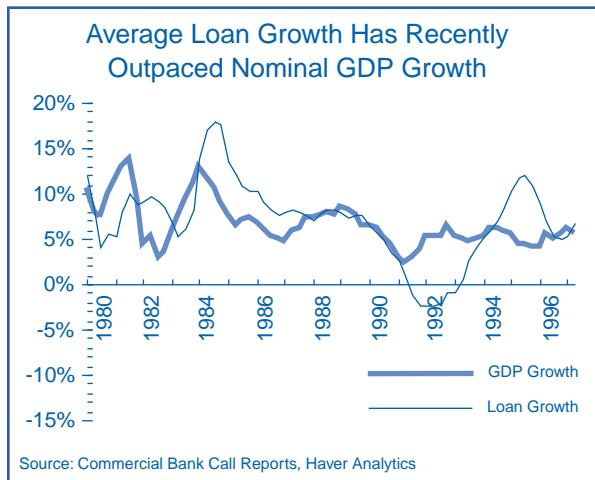
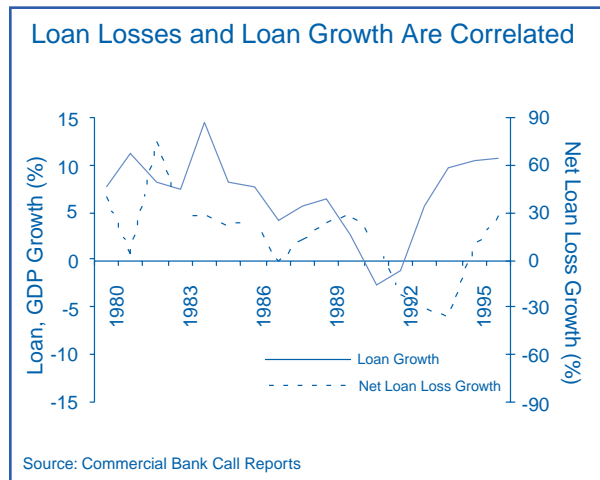


CHART 3



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 exposures¹ 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 non-residential structures, as well as construction loans.

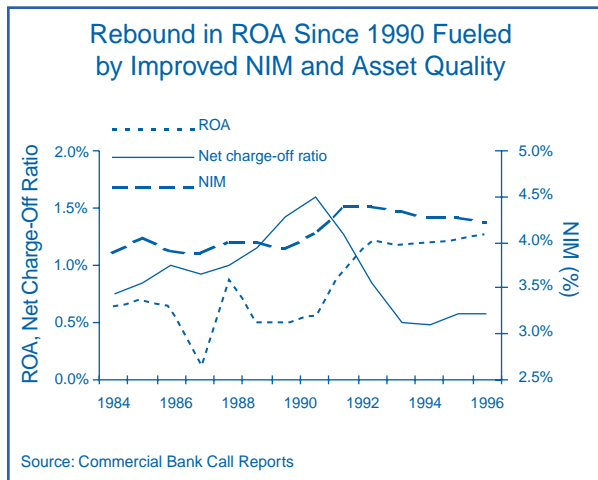
consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 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



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

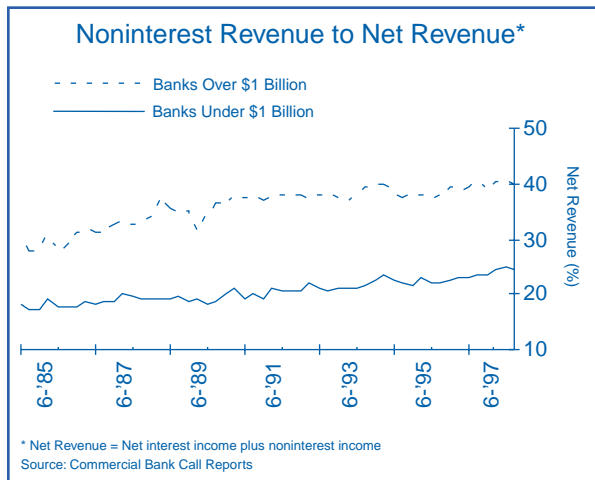
simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures 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).

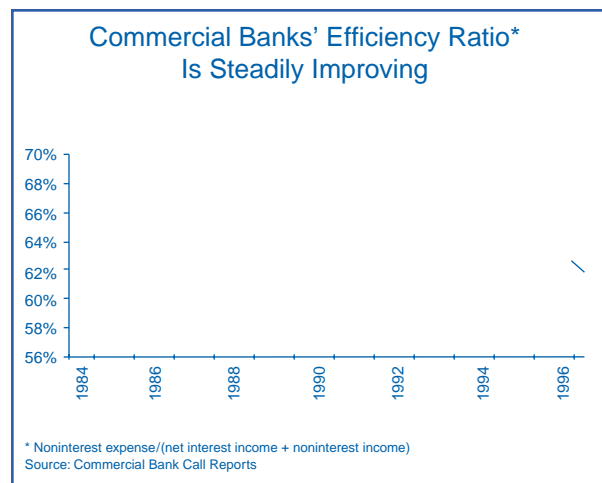
² The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

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.

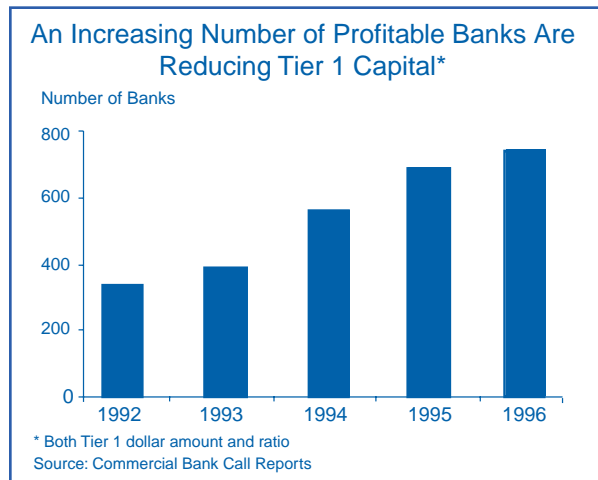
The Role of Capital in the Management of Earnings

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 man-

CHART 7



age 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.

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

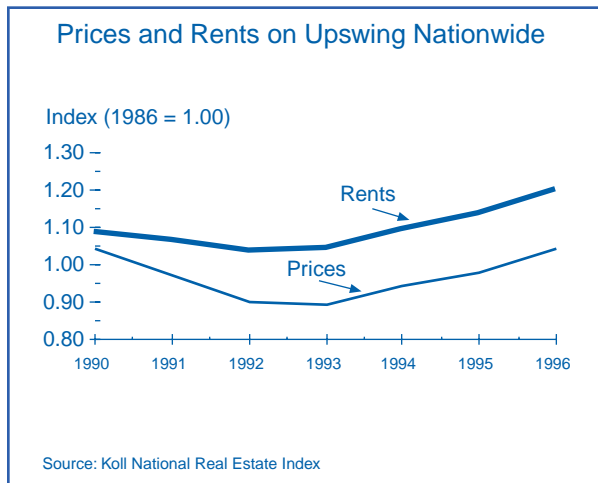


CHART 2

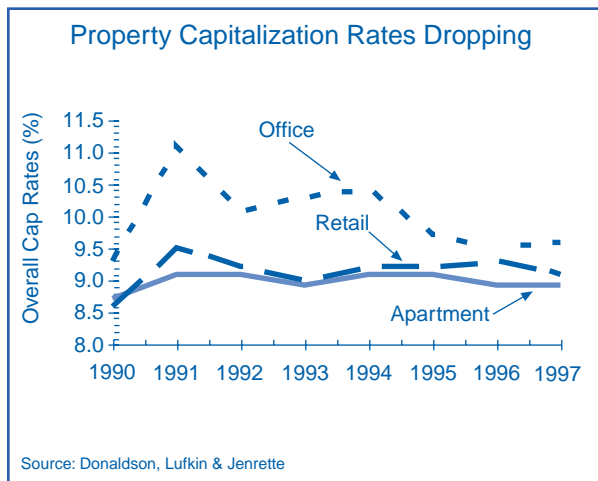
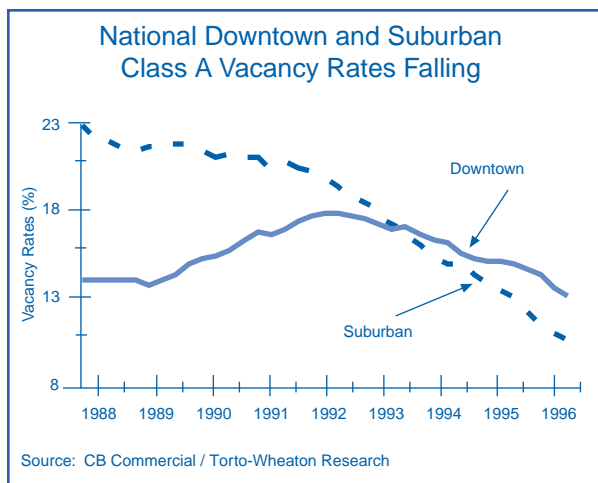


CHART 3



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 institu-

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.

tions 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.

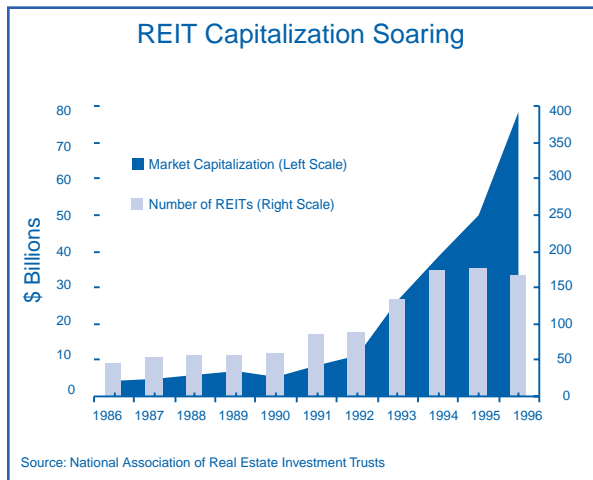
Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array 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

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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Memphis Region: There Is Widespread Participation in Commercial Real Estate Lending Growth

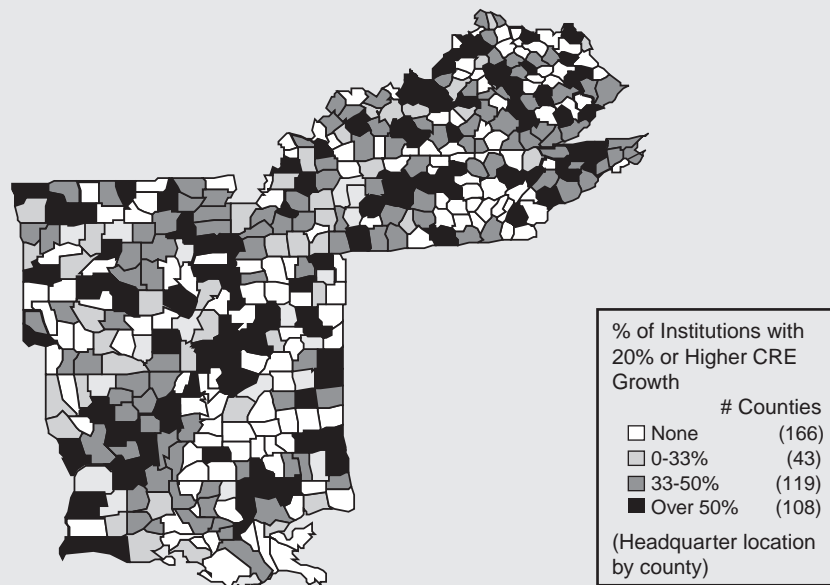
Direct commercial real estate (CRE) lending (construction and nonresidential) is important to many of the Memphis Region's insured institutions. Almost 50 percent of banks and thrifts in the Region reported aggregate exposures in this lending type exceeding Tier 1 capital at midyear 1997. In addition, some of

these institutions, and others with less exposure, registered very strong CRE loan growth over the past year. In total, just under 40 percent of Memphis Region institutions had CRE loan growth of 20 percent or higher. This group includes small and large institutions (under and over \$100 million in total assets) in percentages approximating the distribution for the Region as a whole. These banks and thrifts are geographically dispersed, in metropolitan and non-metropolitan areas alike (see Chart 5).

Gary L. Beasley, Regional Manager

CHART 5

CRE Loan Growth Is Widespread in the Memphis Region



Source: Bank & Thrift Call Reports

Growth Continues to Moderate in the Memphis Region

- Growth continues to decelerate as the Memphis Region moves further away from its cyclical peak.
- Manufacturing's strong presence may make the Memphis Region more susceptible to fluctuations in the national business cycle.
- The transportation industry remains a vital source of growth for the Memphis Region, despite transformations within the industry.
- New bank formation—a response to areas of strong growth?

Quarterly Update

The economic expansion in the Memphis Region has slowed since its peak in 1994; by 1996, job growth fell below the national average. Moreover, while gains at the national level accelerated, growth in the Region continued to decelerate in the first half of 1997 to its lowest level since 1991 (see Chart 1). Throughout 1997, all areas of the Region's economy have seen slowing levels of growth. Of particular note, however, has been a continued slowdown in job growth among many of the Region's industrial sectors. Manufacturing employment accounts for 18.6 percent of the Region's total payrolls, compared with 15.3 percent at the national level. Manufacturing can be broadly classified into two types of production: durable and nondurable. Performance in these two sectors traditionally has tracked closely in the Memphis Region, except for greater volatility in the durable goods industries. Since 1993, however, there has been a divergence in performance between these sectors. While nondurable goods manufacturing lost

more than 40,000 jobs, employment in durable goods manufacturing increased by 60,000 from 1993 to 1995, before experiencing a slight decline in 1996. The greater presence of durable goods manufacturing in the Region could make its economy more susceptible to fluctuations in the business cycle.

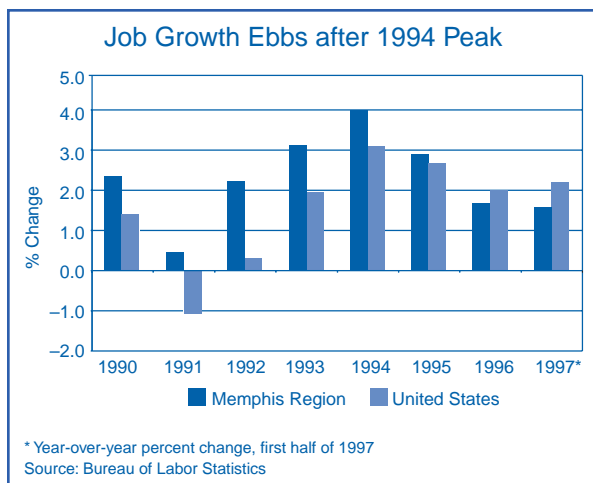
Growth in Kentucky Leads the Region

In June 1997, employment in Kentucky was up 2.1 percent from a year earlier. While this increase was the highest in the Region by a wide margin, it was still below the national average and slowed throughout the first half of the year. The fastest-growing manufacturing industries in the state are fabricated metals and paper products. The transportation equipment sector, which includes automobile-related production, continues to add jobs as well, particularly in the northern portions of the state. Despite its apparent strength, manufacturing remains highly vulnerable to trends in the national business cycle. Growth at the national level picked up during the first half of 1997, perhaps contributing to sustained demand for industrial goods nationwide. Should the nation's economy slow, however, demand may weaken, which will have an adverse effect on growth among the state's manufacturers.

Louisiana's Economy Slows

Louisiana's economic performance continues to deteriorate, although some healthy pockets in the state's economy remain. In June 1997, employment in the state was up 1.1 percent from a year earlier, or about half the national average rate of increase. As of midyear 1997, manufacturing employment in the state was flat, with payrolls about even with the previous year. Most of this

CHART 1



sector's weakness stems from losses in nondurable goods production. Although some jobs have been lost in chemicals and petroleum, most of the decline is a result of ongoing erosion in the textile and apparel industry. This trend appears likely to continue through 1997, given the August announcement that Fruit of the Loom would lay off 2,380 employees at garment factories in **St. Martin, St. Vermilion, and St. Landry Parishes** in October. The local residents are reported to be very concerned about the long-term prospects for retaining the remaining 1,870 jobs. On the durable goods production side, gains continue, driven by strong demand for oil rigging equipment. Employment in oil and gas extraction is up 5.2 percent from a year ago. The growth primarily benefits the southern half of the state, where oil-related manufacturing is concentrated.

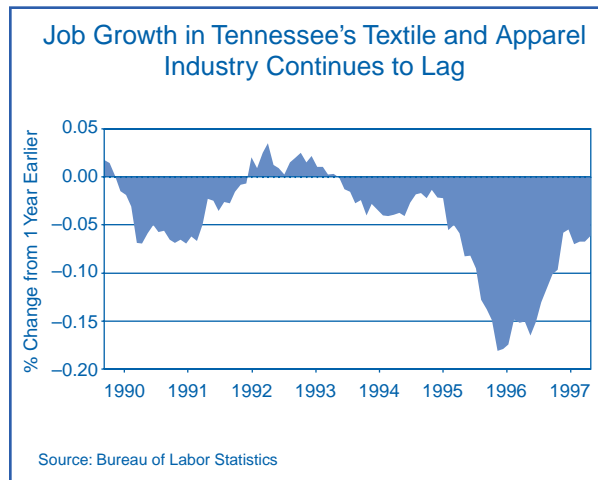
The importance of the oil and gas industry to the health of other sectors, such as manufacturing, highlights Louisiana's vulnerability to business cycles and other economic factors. Currently, the oil industry is experiencing a period of expansion. If growth slows or the price of oil declines, the impact would filter through the entire state's economy.

Tennessee Increases Dependence on Cyclical Manufacturing

After experiencing a strong rebound from the recession earlier in the decade, Tennessee's economy slowed substantially in 1996, posting job growth of 1.4 percent, compared with the national average of 2.7 percent. A major source of the deceleration in growth in 1996 was a 3.1 percent drop in total manufacturing employment, which rivaled the declines that occurred in 1991's recession. Losses were particularly severe in the textile and apparel industry, which saw several plant closures and layoffs during the year (see Chart 2). Although erosion of its job base is expected to continue as it confronts overseas competition, the rate at which the textile and apparel industry has lost jobs has abated during 1997.

While Tennessee's traditional industries, such as textiles and apparel, experienced large losses in 1996, newer industries, such as automobile manufacturing, fared better and have added jobs during 1997. In June 1997, year-over-year job growth in the manufacture of transportation equipment stood at 2.3 percent while overall manufacturing payrolls in the state were down 1.3 percent. Nonetheless, this industry remains tightly bound to the nation's business cycle; thus, a cyclical downturn

CHART 2



could adversely affect Tennessee's automotive industry. Domestically produced retail automobile sales in the United States peaked in 1994 and have since generally trended downward (see Chart 3). In the second quarter of 1997, sales were down 10.4 percent from the previous year; however, some of the decline may be attributable to the increase in imported car sales, which account for 15.9 percent of retail car sales, rather than to the nation's position in the business cycle. In the second quarter of 1997, unit retail sales of imported cars were up 1 percent from a year earlier. The slowdown in automotive sales is already affecting **Spring Hill**-based Saturn Motors, which is scheduled to reduce production by 1,000 cars per week through the end of 1997. However, Saturn's 8,500 employees will continue on the payroll for now, shifting some of their time to training.

Manufacturing Declines Persist in Arkansas

The economy of Arkansas continues to slow, and manufacturing remains a drag on growth. In June 1997, year-over-year job growth in Arkansas was 0.8 percent. Although manufacturing was the only sector that continued to see job losses, its influence on Arkansas's economy, with 23 percent of total employment, was enough to constrain faster overall growth. Manufacturing in Arkansas is dominated by food processing, particularly in poultry, which has risen in importance over the past several years. In 1970, food processing accounted for 15 percent of all manufacturing jobs; by 1996, its share had risen to 23 percent. This industry is unique in that it is relatively immune to business cycle fluctuation and it is not involved in a secular decline such as that in the textile and apparel industry. While food processing tra-

ditionally has been a source of growth for Arkansas, competitive pressures from other poultry-producing states, such as Georgia, are building in the South.

Manufacturing: Still a Potent Force in Mississippi

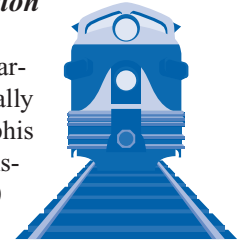
Mississippi posted just a 0.2 percent increase in total employment during the year ending June 1997, well below the national average. Most of the economy's weakness can be traced to the state's critical manufacturing sector. Like the rest of the nation, Mississippi has seen a slow erosion of manufacturing's share of total employment. In 1972, 32 percent of all employment in Mississippi was in manufacturing, and nearly a quarter of manufacturing jobs were in the textile and apparel industry. By 1996, only 23 percent of Mississippi's jobs were in manufacturing. Nonetheless, the role of manufacturing in the state remains comparatively large—only 15 percent of employment nationwide is in manufacturing. The declining fortunes of the textile and apparel industry have been a drag on the state's economy over the past 25 years, as plant closings and layoffs in the face of overseas competition have taken their toll. In 1996, losses in the nation's textile and apparel industry were particularly acute, with employment falling by 6.9 percent. *In Mississippi, the declines were more severe, with an 18 percent drop in the industry's payrolls.*

One of the fastest-growing areas in the state's economy, particularly along the coast and in northwest portions of the state, is the tourist and gaming industry, which has added thousands of jobs to the economy in recent years. According to *Southern Business and Development*, Mississippi holds the Southeast's top two job-generating development projects: **Biloxi's** \$500 million Beau Rivage casino project, which is expected to yield 4,700 jobs, and **Tunica's** \$250 million Grand Casino project, which could create as many as 3,500 new jobs.

Implications: Although the nation continues to see sustained gains in employment, the Memphis Region's economy has slowed. In part, manufacturing's strong presence in the Region and its impact on other sectors have played a role in the economy's recent slowdown. Growth in cyclically vulnerable industries could increase the Region's exposure to a national downturn, which in turn could result in greater volatility in credit quality.

Role of the Transportation Industry in the Memphis Region

The transportation industry*, particularly railroads, has traditionally played a vital role in the Memphis Region's economy. In 1996, transportation accounted for 324,000 jobs (4 percent of total employment in the Region), making the industry about 17 percent more heavily concentrated here than in the nation. The transportation industry is also a fast-growing area of the economy, with employment increasing at an annual rate of 3.4 percent since 1988, compared with the 2.5 increase in the Region's total employment. The prominence of the Memphis Region's transportation industry is a result of its geographic location and geophysical attributes. The Region is located along a north-south transportation corridor, linking the Great Lakes industrial basin to markets in the South. Since the passage of the North American Free Trade Agreement (NAFTA), this corridor has been extended to include Mexico and Canada. The Memphis Region, particularly **Louisiana**, also benefits from the presence of comparatively cheap barge traffic on the Mississippi River, which provides Midwest farm exports with a gateway to the rest of the world via ports in **New Orleans** and is also a major port of entry for the nation's imports.



The transportation industry has gone through a striking transformation over the past several decades as shipments have increasingly been carried by trucking rather than by rail. According to a *Standard & Poor's Industry Survey*, during the 1940s, 60 percent of intercity freight traffic was handled by the railroads; by the end of the 1970s, this share had fallen to 35.7 percent. During the 1980s, the nation's railroads experienced something of a renaissance by joining forces with the trucking industry—using rail transport for long hauls and off-loading to trucks for local distribution. Railroads also have capitalized on their economies of scale by shipping bulk goods such as grains, coal, chemicals, and lumber. This specialization has allowed railroads to recoup intercity traffic market share. Coal, in particular, played a major role in the reemergence of rail traffic during the 1980s.

* The transportation industry is a subset of transportation, communication, and public utilities and includes, according to the Standard Industrial Classification codes, employment in railroads, local and interurban passenger transit, trucking and warehousing, water transportation, transportation by air, pipelines (except natural gas), and transportation services.

According to the *Association of American Railroads*, coal accounts for 39.5 percent of the nation's rail tonnage. In the coal-rich Memphis Region, the importance of coal for railroads is even higher, accounting for 89 percent of all tonnage in **Kentucky**.

Another trend in the Memphis Region's transportation industry that began in the 1980s is the emerging importance of the air freight industry, especially in **Tennessee**, where the largest private employer is Memphis-based Federal Express. In 1970, air transport accounted for just 4 percent of transportation, communication, and public utilities employment in the state; by 1990, the share had risen to 20 percent.

Implications: A major vulnerability of the transportation industry in the Memphis Region, as well as at the national level, is its heavy dependence on the flow of commerce. Disruptions such as recessions, strikes within the industry or in other sectors of the economy, and even weather conditions can reduce traffic and place stress on the industry. This is one reason why transportation industry growth, although higher on average, is more volatile than growth in the overall economy, and

why credit quality and demand for lending may also exhibit volatility.

New Banking Formation in the Memphis Region

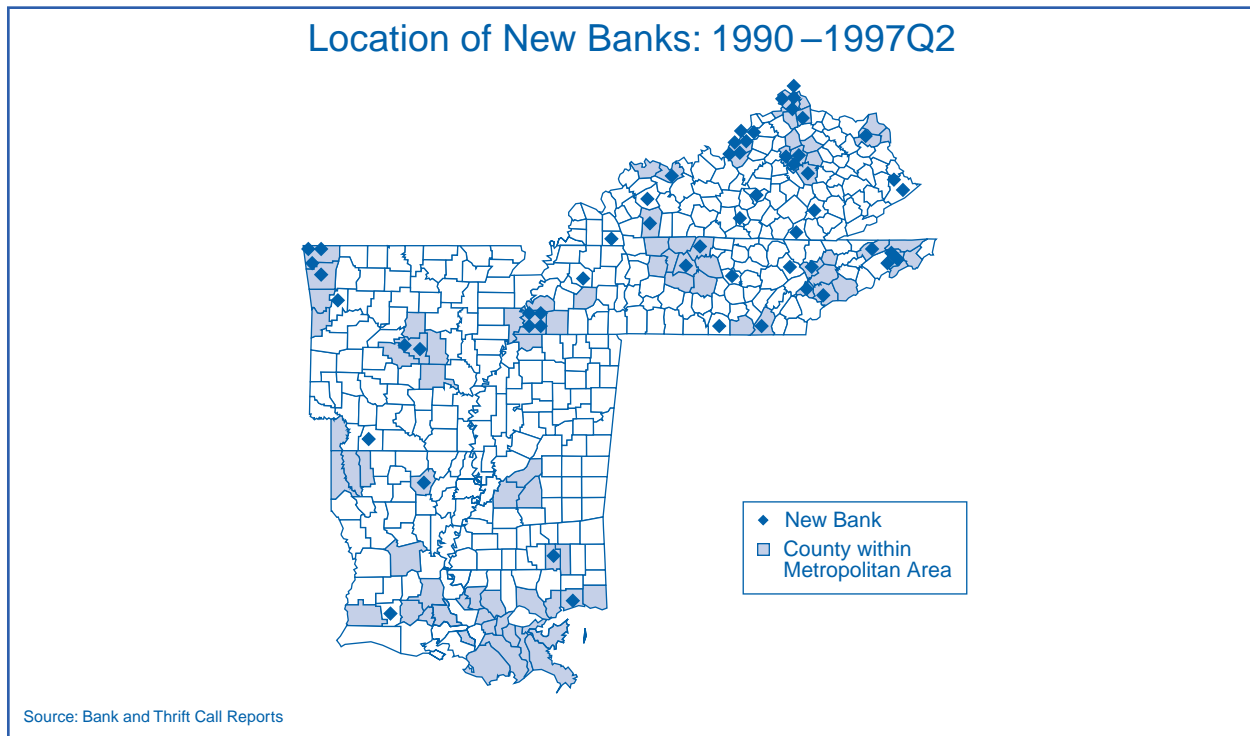
Data suggest that there may be links in the Memphis Region between the formation of new banks and economic growth. This relationship may exist on two levels. First, a recent group of new banks appears to have been formed during a surge in the Region's cyclical growth (see Table 1).

Second, the relationship between economic growth and new bank formation can be expanded to a more detailed level of analysis to include geographic variation. Between 1990 and the second quarter of 1997, 56 new commercial banks and savings institutions were formed in the Memphis Region. (Institutions formed as part of a corporate reorganization and those created to acquire the assets or liabilities of another institution were omitted from this analysis.) Chart 3 (next page) indicates that most new banks were formed within metropolitan

TABLE 1

NEW BANKING ACTIVITY FOLLOWS SURGE IN JOB GROWTH								
	1990	1991	1992	1993	1994	1995	1996	1997
NEW COMMERCIAL BANKS								
ARKANSAS	1	0	0	0	1	1	1	2
KENTUCKY	4	1	3	1	1	1	8	2
LOUISIANA	0	0	0	0	0	0	0	2
MISSISSIPPI	0	0	0	0	0	0	2	0
TENNESSEE	3	1	2	1	1	4	3	2
TOTAL MEMPHIS REGION	8	2	5	2	3	6	14	8
NEW SAVINGS INSTITUTIONS								
ARKANSAS	0	0	0	1	0	1	0	0
KENTUCKY	0	0	1	1	1	1	1	0
LOUISIANA	0	0	0	0	0	0	0	0
MISSISSIPPI	0	0	0	0	0	0	0	0
TENNESSEE	0	0	0	0	0	0	1	0
TOTAL MEMPHIS REGION	0	0	1	2	1	2	2	0
GRAND TOTAL	8	2	6	4	4	8	16	8
JOB GROWTH*	2.3	0.4	2.2	3.1	4.0	2.9	1.7	1.6
* YEAR-OVER-YEAR PERCENT CHANGE, FIRST HALF 1997 SOURCE: BANK AND THRIFT CALL REPORTS								

CHART 3



areas or in nearby counties that had above-average economic growth. (Of the 56 new banks, only 6 were outside these areas, and those 6 were located in rural counties in southeastern Kentucky).

Implications: Formation of new banks in the Memphis Region has been associated with strong job growth. Accordingly, the Region’s recent deceleration in economic growth could lead to a drop-off in new bank for-

mation. Moreover, new institutions that were formed during a period of high growth may need to consider the possibility of a slowing in growth in the Region. See the *Current Regional Banking Conditions* segment for a discussion of the performance of new institutions.

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

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 contem-

plating 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).

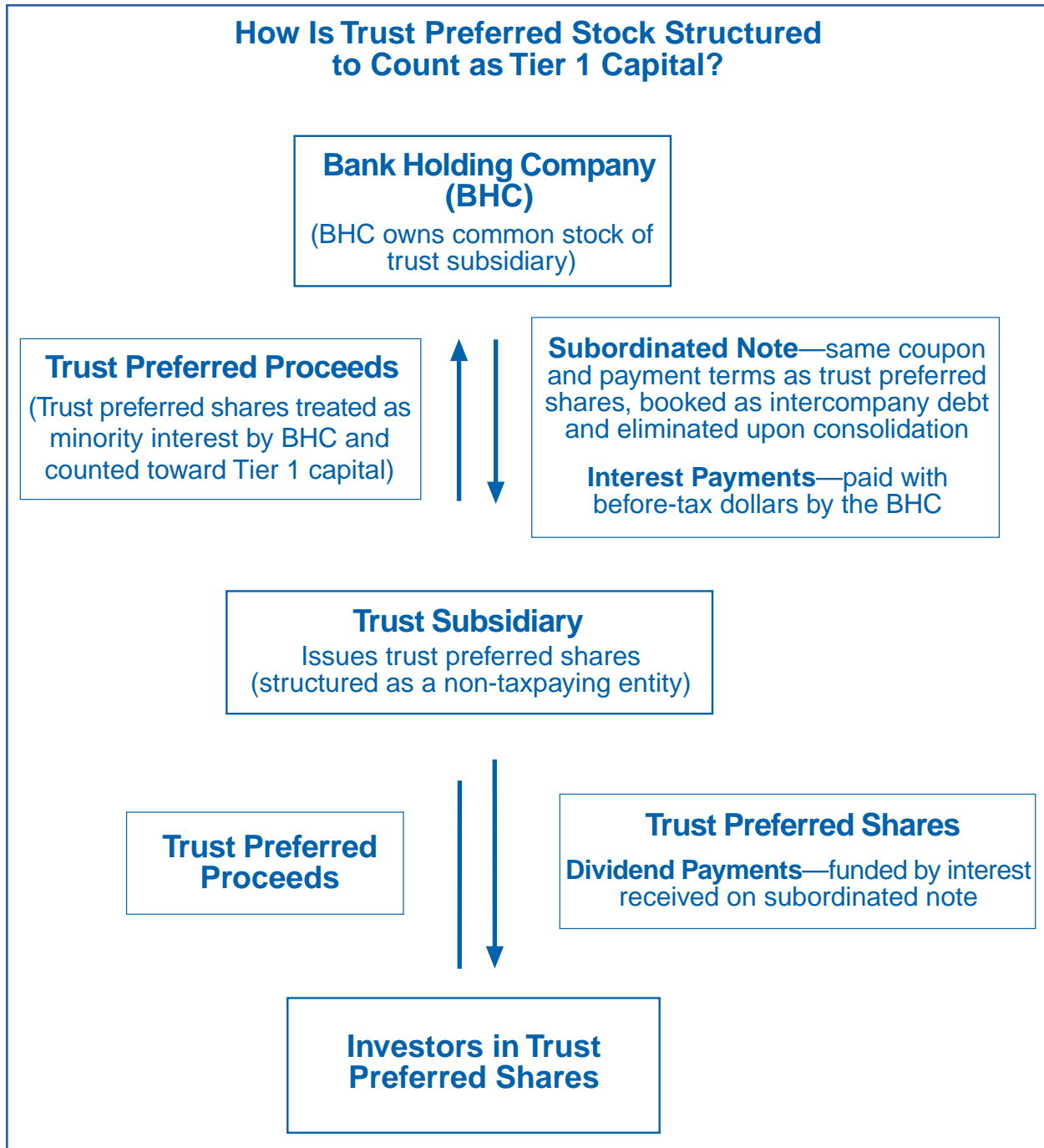
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary 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



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.

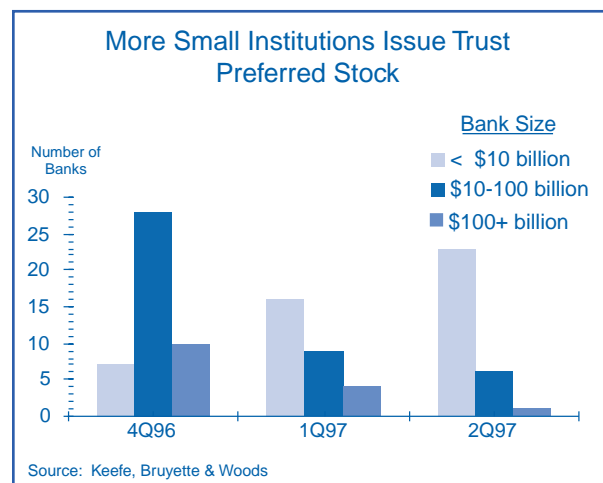
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated \$4.3 billion in the first quarter of 1997 to just under \$2.5 billion in the second quarter. Trust preferred issuance by larger banks declined 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. Kalsner, 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

- Banks and thrifts in the Memphis Region reported strong performance in the second quarter.
- Home equity loans continue to gain popularity.
- Increased fee income has boosted earnings, particularly at the Region's larger banks.
- New bank performance has benefited from the strong economy.

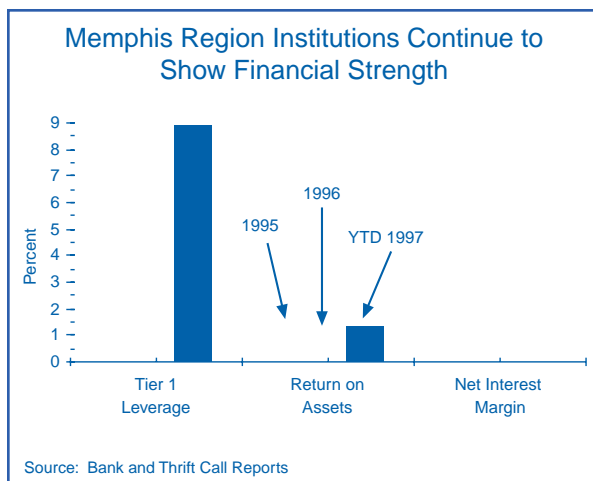
Second-Quarter Reports Show Strong Performance and Renewed Loan Growth

Commercial banks and thrifts in the Memphis Region posted continued strong results for the second quarter of 1997, as shown in Chart 1, including:

- improving aggregate return on assets by 7 basis points, to 1.35 percent of average assets;
- maintaining leverage capital just below 9 percent of average assets; and
- reducing the level of nonperforming assets and past-due loans.

After slowing to a 4 percent annualized rate in the first quarter of 1997, loan growth for banks and thrifts in the Region increased to an annualized rate of 9.6 percent for the second quarter of 1997. Slower first-quarter loan growth has been typical for the Region in recent years:

CHART 1



First- and second-quarter loan growth in 1997 mirrored that for the first and second quarters of 1996.

The market for home equity loans has been particularly active. Although the funded portion of home equity loans represented only 2.4 percent of the Region's total loans at mid-1997, this lending segment continues to exhibit rapid growth. After growing by almost 23 percent during 1996, home equity loan balances grew at a 26 percent annualized rate through the first half of 1997. While growth rates are faster for larger institutions, banks of all asset sizes are experiencing double-digit growth in the funded portions of home equity lines. Further, the growth in home equity balances does not just represent the funding of existing lines; the unfunded amount available on home equity lines continues to increase as well. As of June 30, 1997, the unfunded amount available on home equity lines of credit for commercial banks was \$3.7 billion, compared with \$3.6 billion in funded balances.

Delinquencies and loss rates on home equity lines rose in 1996 compared with 1995; however, by June 30, 1997, delinquencies were down to a two-year low of 1.4 percent. Delinquency ratios for the Region's home equity loans tend to decline in the second quarter of each year. The current decline is due in part to the large increases in balances in the second quarter, but the overall level of delinquencies has also declined in 1997. Loss rates on home equity loans through the first six months of 1997 are in line with 1996 charge-off results, at approximately 0.1 percent of loan balances.

The growth in home equity lending may be driven by a number of factors. Consumers may be increasingly using home equity lines instead of credit cards. Home equity lines are usually offered at lower rates than those available on credit cards and carry the added advantage of potential tax deductibility. For these reasons, home equity lines often are used for debt consolidation. Also,

banks are making it easier for borrowers to use such lines by reducing closing costs and raising loan-to-value limits.

Implications: Home equity loans have experienced lower loss rates than other types of consumer lending, which suggests that growth in home equity lending would tend to reduce aggregate credit risk for the Region's institutions. However, historical measures may not be good indicators of future results, as the current growth in home equity lending has been accompanied by changes in underwriting standards, such as higher loan-to-value ratios. Also, to the extent that the growth in home equity lending represents a further increase in consumer debt levels rather than a restructuring of debt, overall concern with consumer borrowing patterns remains.

Focus on Fee Income

Earnings in the banking industry continue to climb, with fee income constituting an increasing share of the revenue. Nationwide, noninterest income now represents more than one-third of net operating revenue (the sum of net interest income and noninterest income). As shown in Chart 2, the relative importance of fee income to the Region's aggregate earnings performance has increased. In dollar terms, aggregate noninterest income for the Region's commercial banks has climbed from \$1,894 million at year end 1990 to \$3,350 million at year end 1996. As of June 30, 1997, noninterest income constituted 27.7 percent of net operating revenue for banks and thrifts in the Memphis Region. While this growth in fee income follows the nationwide trend, non-

interest income for the Region's banks remains well below the national level.

Large institutions have been driving this trend, with smaller institutions continuing to focus on core banking activities. As shown in Chart 3, the relative importance of noninterest income for commercial banks with assets under \$100 million has changed very little from 1990. (Chart 3 has been adjusted to exclude three special-purpose commercial banks from the group of banks with less than \$100 million in total assets.)

Just as recent growth trends for noninterest income vary by size of institution, so does the composition of noninterest income. Chart 4 shows that smaller banks rely on service charges and other fees on deposit accounts as their primary source of noninterest income. Larger banks are more heavily involved in other sources of noninterest income. Expansion of these other sources of income has been a major contributing factor in the overall growth of noninterest income for larger institutions. "Other Fee" income shown in the chart includes all commissions and fees other than those for deposit accounts. "Other" noninterest income includes items such as fiduciary income, gains from sales of assets, rental income on other real estate, and trading revenue.*

The growth in noninterest income has included some increases in traditional items such as service charges on deposit accounts and trust fees. Institutions also are

* Results depicted in Chart 4 omit one institution with total assets between \$100 million and \$1 billion that specializes in credit card operations.

CHART 2

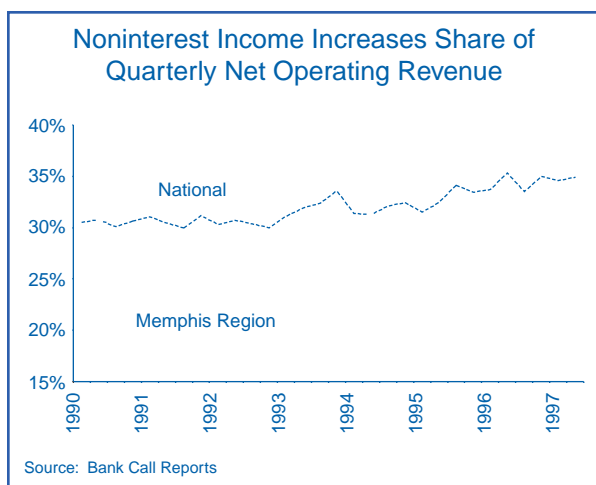


CHART 3

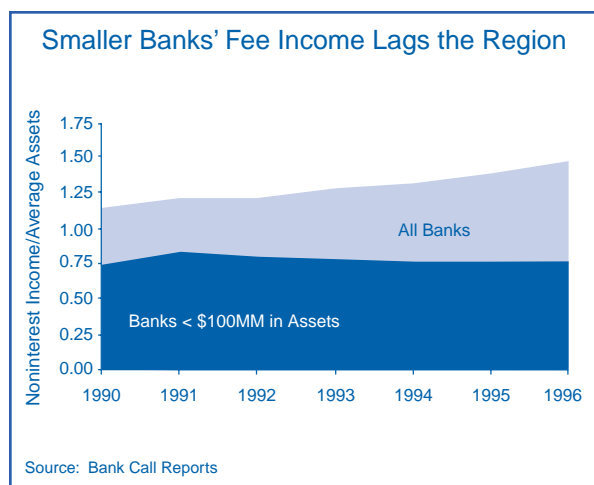
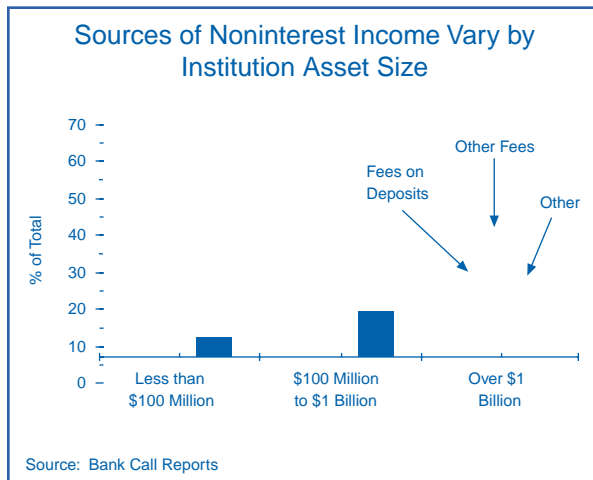


CHART 4



expanding their sources of revenue through the sale of nondeposit products such as insurance, mutual funds, and annuities. Revenue from these sales activities is growing as more institutions offer these products, but it does not yet represent a significant source of earnings. During 1996, income from mutual fund and annuity sales fees for the Region's banks contributed just 2.4 percent of noninterest income.

Participation in these nondeposit sales activities is not limited to larger banks, although sales volume and revenue are concentrated in these institutions. Increasing numbers of smaller banks offer the products, often more as a service and convenience for traditional customers than as a profit center. For example, 32 of 104 institutions in the Region reporting annuity sales during the second quarter were institutions with less than \$100 million in assets. Additionally, the 158 institutions reporting mutual funds sales included 33 smaller banks. This level of reported involvement still represents a modest segment of the 701 smaller banks in the Region.

Implications: Expanded fee income can provide an opportunity for both improved earnings performance and diversification of revenue. While this diversification of income sources should theoretically reduce aggregate risk, individual banks may be taking on new risks or elevating historically low-risk areas. For example, reputation risk for a community bank may be substantially increased through the offering of mutual funds and annuities. Customers may associate the performance of the investment products they purchase from their bank with the bank itself. This could lead to customer dissatisfaction, a loss of traditional banking business with the customer, or litigation. Changing risks

have led to increased regulatory attention being directed to some of these activities. For example, in May of this year, the FDIC's Division of Supervision issued expanded guidance on nondeposit investment product sales.

New Bank Formation Is Strong, Particularly in Kentucky and Tennessee

The opening of 22 new commercial banks in the span of 18 months (the period ending June 30, 1997) and 14 approved but unopened institutions provides the setting to assess new bank formation in the Region. Chartering of new banks has been geographically concentrated during the decade. **Kentucky and Tennessee**, the largest and most robust state economies in the Region this decade, are home to 80 percent of the newly formed banks reviewed in this article. On the other extreme, **Louisiana and Mississippi** together account for only 8 percent of the new banks. The ***Growth Continues to Moderate in the Memphis Region*** section contains a discussion on the relationship between economic conditions and the formation of new banks. A map detailing the locations of new banks and a table listing activity by state also are contained in that section.

Financial data in Table 1 (next page) show that banks chartered during the period 1992 to 1995, henceforth the "boom" group of banks, benefited from the expansive economic conditions that have existed since their inception. However, somewhat surprisingly, their early earnings performance was only modestly better than that of banks chartered during the economic downturn of 1990 to 1991. The modest difference in the performance of the groups is demonstrated by the similarity in the time it took to reach profitability. Conversely, banks formed during the boom period grew their deposits faster and held a greater proportion of their assets in loans than those formed during the downturn.

Average loan-to-asset levels for both the boom and downturn groups reached almost 70 percent at mid-1997, compared with just under 64 percent for the Region. This variance may be attributable in part to the fact that all but two of the institutions in those groups are located in Tennessee or Kentucky, the two states that have experienced the most robust economic condition in the Region this decade.

Formations of new banks in the Region often appear to be a response to banking consolidation. Thirteen of the

TABLE 1

NEW BANK PERFORMANCE HAS VARIED RELATIVE TO ECONOMIC CONDITIONS						
GROUP	QUARTERS TO PROFITABILITY	FIRST YEAR			TIER 1 LEVERAGE 6/30/97	TRAILING ROA 6/30/97
		DEPOSIT MULTIPLE	LOANS TO ASSETS	EQUITY RATIO		
DOWNTURN	5.22	5.40	57.56	16.23	8.44	1.02
BOOM	4.93	6.35	64.72	14.13	10.61	0.72
NEW	NA	7.21	56.08	12.23	12.39	NA

NOTE: DEPOSIT MULTIPLE IS DEPOSIT TOTAL AFTER ONE YEAR TO INITIAL CAPITALIZATION.
SOURCE: BANK CALL REPORTS

22 banks in the “new” group are located in counties where institutions were purchased after January 1995, often by large banks in the Region or their holding companies. The apparent relationship is even stronger when the scope is limited to the most active two states for new banks, Tennessee and Kentucky. In those states, 80 percent of the counties hosting new institutions experienced one or more purchase transactions. Further evidence of the correlation has come in the form of

announcements on the formation of several new banks, which noted that the organizing groups include officers, directors, and shareholders of banks recently involved in a takeover.

New bank formation is also driven by economic activity: Almost all new banks this decade were chartered in or near metropolitan areas. Metropolitan areas have been attractive to bank acquirers and those contemplating forming a new bank, because they have been the primary beneficiaries of the strong job growth experienced in the Region since 1991. Refer to the *Growth Continues to Moderate in the Memphis Region* section for further discussion of the influence of the economy on new bank formation.

New Bank Analysis Background

The institutions reviewed here consist of 46 commercial banks that opened between January 1990 and June 1997. Institutions created pursuant to a reorganization or to assume the assets or liabilities of other institutions were excluded to prevent skewing of performance measures. Likewise, two niche banks were excluded—one a bankers’ bank, the other a credit card processor. Data were analyzed by segregating the institutions into three subgroups. The “downturn” group includes nine institutions opened during 1990 and 1991, when recessionary conditions existed. The “boom” group includes 15 institutions that opened between January 1, 1992, and December 31, 1995, a period of economic expansion. The “new” group includes the remaining 22 institutions, all of which have opened since January 1, 1996.

Implications: The potential for an adverse turn in economic conditions is always present. The significant number of newly insured institutions raises concerns over the potential consequences of such an event for those banks, especially when one considers that new banks tend to experience higher failure rates than more established institutions. Nevertheless, performance of an admittedly small group of newly insured institutions suggests that well-conceived, adequately capitalized, and closely supervised new banks can weather limited periods of economic downturn.

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