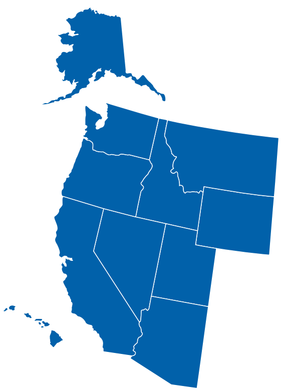
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION | THIRD QUARTER 1997

FDIC
SAN FRANCISCO
REGION



In Focus This Quarter

◆ ***Subprime Lending: A Time for Caution*—The extent of subprime lending is increasing as strong competition for high-quality borrowers has some lenders moving down the credit quality spectrum. Subprime lending requires a commitment of resources and expertise beyond that required in more conservative lending, and the consequences of deficiencies in underwriting, servicing, and collection can be severe.** *See page 3.*

By Kathy R. Kalser, Debra L. Novak

◆ ***Retail Shakeout: Causes and Implications for Lenders*—Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions.** *See page 6.*

By Richard A. Brown, Diane Ellis

Regular Features

◆ ***Regional Economy*—Personal income and employment growth in the San Francisco Region remain strong and continue to outpace the nation. Analysts are predicting continued expansion in 1997, although enthusiasm is somewhat tempered because the Region's strength is currently fueled by industries with a history of boom and bust cycles.** *See page 10.*

By Gary C. Zimmerman

◆ ***Financial Markets*—Securitization of home equity loans is growing rapidly . . . consumer debt consolidation loans may be driving this growth . . . signs of relaxed underwriting have appeared . . . the arrival of FASITs could increase the appetite of community banks to enter the ABS market.** *See page 14.*

By Allen Puwalski

◆ ***Regional Banking*—Healthy net interest margins, rising levels of noninterest income, and the implementation of several regulatory reporting changes boosted reported first-quarter profits at the Region's depository institutions. As the pace of merger activity increases, a recent SEC ruling tightening criteria pooling of interest method for mergers may increase popularity of the purchase method.** *See page 18.*

By Catherine I. Phillips-Olsen, Roger Stephens, DiAnn Bielaczyc

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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.

A recent survey of examiners identified 39 institutions in the San Francisco Region involved in subprime lending. Some of the subprime lending activities include the following:

- C, D, and E grade automobile paper;
- secured credit card loans;
- debt consolidation loans;
- accounts receivable factoring;
- B and C grade mortgages;
- Federal Housing Administration Title I mortgages; and
- no-documentation mortgages.

Approximately half of the identified institutions are located in California.

Risks Associated with Subprime Lending Need to Be Considered Carefully

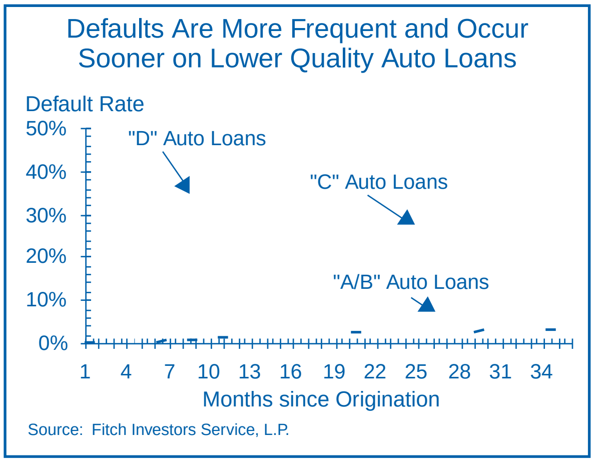
According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because 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.

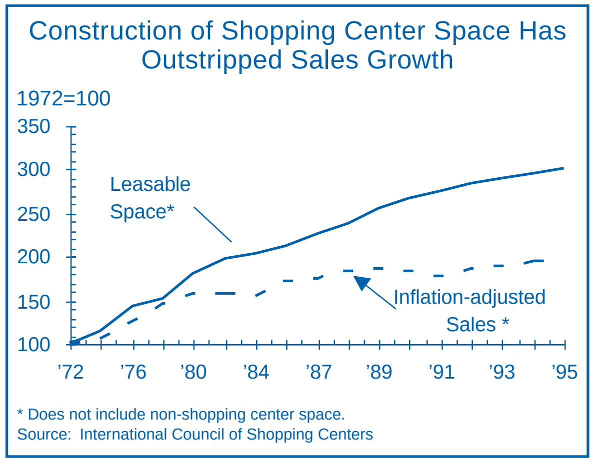
Based on signs of "overstoring," a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate,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



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.

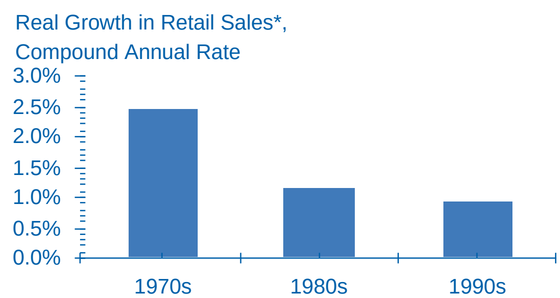
Growth of the "Big Box" Format

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

Inflation-Adjusted Retail Sales Have Grown Slowly in the 1990s



* Retail sales excluding autos, deflated by the consumer price index.
Source: Bureau of the Census and Bureau of Labor Statistics

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.

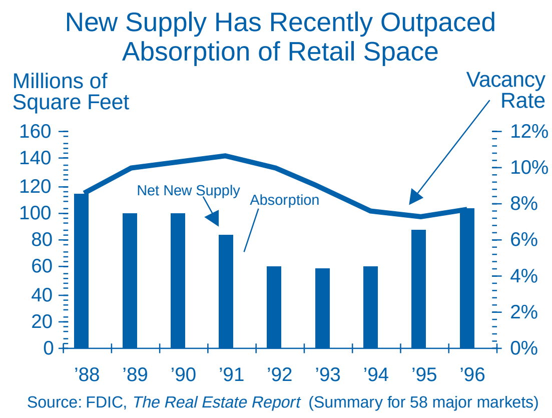
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more 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, ***Strength of the San Francisco Region's Retail Real Estate Markets Is Mixed***).

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

Strength of the San Francisco Region's Retail Real Estate Markets Is Mixed

Overall, most of the San Francisco Region's major metropolitan areas are reporting favorable trends in vacancies, relatively low vacancy rates, or both. However, conditions around the Region vary, as illustrated in Table 1. Several markets are reporting vacancy rates that are well below the 1996 national average of 7.7 percent for retail real estate, while other markets report relatively high rates.

A combination of expanding residential markets, positive job creation, limited development space, and higher median incomes help alleviate some concerns for high vacancies in markets such as **Phoenix, Riverside,** and **Oakland.** However, several markets in the Region warrant closer scrutiny because of developing negative trends in vacancy rates, such as the increasing supply of new retail space and the lagging absorption of retail space. Indeed, 9 of the 14 markets listed below have been identified as "oversupplied" with a low probability of achieving equilibrium before the year 2000, according to a quality ranking developed by ***Landauer Associates, Inc.*** (This ranking, shown in Table 1, incorporates existing inventory, planned construction, and growth.)

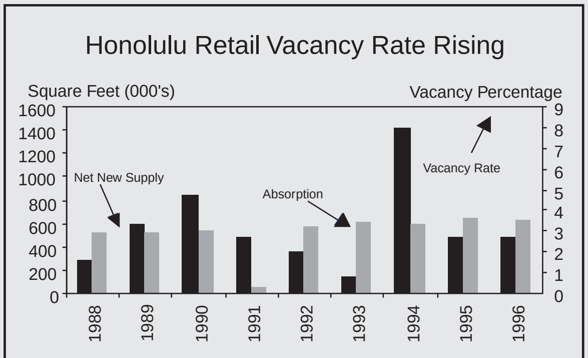
TABLE 1

SAN FRANCISCO REGION RETAIL REAL ESTATE MARKET QUALITY RANKING (MQR) AND VACANCY RATES VARY

	1993	1994	1995	1996	MQR*
LOS ANGELES	6.2%	3.8%	4.9%	4.8%	5
OAKLAND	10.9%	8.3%	7.6%	9.4%	6
ORANGE	8.5%	6.9%	6.5%	6.2%	6
RIVERSIDE	12.6%	9.3%	10.5%	9.5%	5
SACRAMENTO	10.2%	8.,7%	10.1%	9.9%	7
SAN DIEGO	6.7%	7.3%	7.3%	7.4%	6
SAN FRANCISCO	3.7%	4.1%	3.9%	3.3%	6
SAN JOSE	7.0%	6.4%	5.9%	6.9%	6
HONOLULU	5.4%	8.4%	7.9%	8.8%	7
LAS VEGAS	7.3%	5.6%	4.5%	4.2%	N/A
PHOENIX	11.4%	10.3%	9.9%	10.3%	4
PORTLAND	4.3%	3.6%	4.4%	4.4%	4
SALT LAKE CITY	6.6%	5.6%	4.6%	5.6%	6
SEATTLE	3.0%	3.1%	3.4%	4.3%	6
UNITED STATES	9.0%	7.6%	7.4%	7.7%	N/A

*LANDAUER ASSOCIATES, INC. (1=VERY STRONG, 7=VERY WEAK)
SOURCES: FDIC THE REAL ESTATE REPORT, APRIL 1997

CHART 4



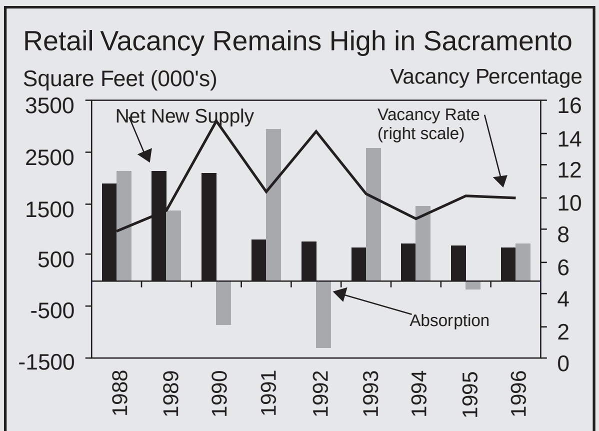
Source: FDIC, *The Real Estate Report*, April 1997

Two of the Region's markets are of particular interest. Real estate in general has long been an issue in **Hawaii,** which has endured a major real estate slump and a long recession. The retail real estate market in **Honolulu** is no exception, as indicated by rising retail vacancy rates over the past three years. Retail vacancy rates are now at their highest level of the decade, as shown in Chart 4. This high level is in part a reflection of the state's weak economy and the lower level of spending on retail goods by tourists in Hawaii.

Sacramento is also an interesting market because of the relatively high vacancy rates that have existed for the past two years, up noticeably from 1994. In conjunction with high vacancies, Chart 5 shows that Sacramento has a history of only modest absorption of retail real estate in recent years. Some analysts are expressing concerns regarding the direction of this market because of the anticipated surge in new supply that could reduce sales per square foot.

Gary Zimmerman, Regional Economist

CHART 5



Source: FDIC, *The Real Estate Report*, April 1997

Strong Growth in Services, Aerospace, and High-Tech Boosts the San Francisco Region's Performance

- **The San Francisco Region as a whole continues to outperform the nation in generating income and creating jobs.**

- **High-technology, aerospace, and construction, three industries with a history of boom and bust cycles, are presently key sources of strength in the Region.**

- **Business services and tourism boosted the performance of the service sector and are contributing to the Region's prosperity.**

Strong Growth Continues in the San Francisco Region

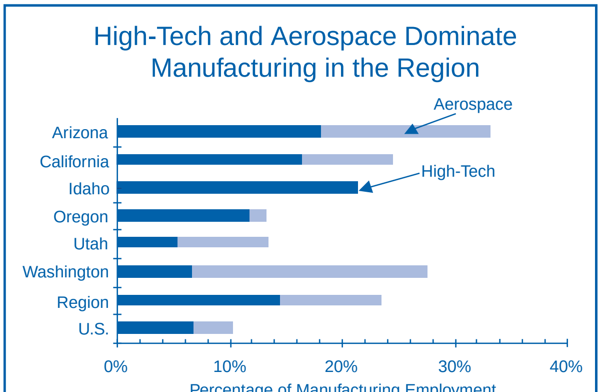
Over the past year the San Francisco Region has grown at a much faster pace than the nation as a whole, both in terms of personal income and employment. In addition, high-tech and commercial aerospace manufacturing, construction, and business and tourist services all have exhibited noteworthy strength over the past year. Most analysts continue to give the Region favorable marks and anticipate continued expansion in 1997, although perhaps at more moderate rates. The robust performance of the Region is clearly a factor in the strong earnings and generally improving asset quality of the Region's banking industry.

The Region continues to lead the nation in generating employment, as it has over the past two years. Over 724,000 jobs were added in the Region in the 12-month period ending April 1997. The 3.3 percent increase in nonfarm payroll employment was the fastest over a comparable one-year period since the national recovery began in 1991. Job growth in 6 of the Region's 11 states (**Arizona, California, Nevada, Oregon, Utah,** and **Washington**) was 3 percent or better, well above the 2 percent increase in employment elsewhere in the nation. **Idaho,** which had been showing signs of slowing over the past year, slipped to a 2.5 percent growth rate over the past 12 months, down from 3.3 percent a year ago. Over the past year, employment growth rates for the Region's slowest growing states—**Alaska, Hawaii, Montana,** and **Wyoming**—ranged from 1.1 percent in Montana to zero in Hawaii.

The manufacturing sector is presently a key source of strength for the Region. Over the 12 months ending April 1997, the Region's manufacturing employment grew 3 percent. In contrast, elsewhere in the nation manufacturing employment actually contracted. The bulk of the nearly 88,000 new manufacturing jobs created in the Region over the past year were in the production of durable goods.

The strength in two manufacturing industries, high-tech and aerospace, was especially noteworthy. Chart 1 shows that several states, and the Region as a whole, are much more dependent on the health of these two industries than is the nation as a whole. Nationally, high-tech and aerospace employment combined made up only a little more than 10 percent of total manufacturing employment, according to the 1995 ***Census Bureau*** survey on manufacturing employment. In contrast, over one-quarter of all manufacturing jobs in both Washington and California were in either aerospace or high-tech. Arizona and Idaho also have a relatively high concentration of their manufacturing jobs in these two industries.

CHART 1



Source: Department of Commerce, Census Bureau, Annual Survey of Manufacturers, 1995

High-Tech Should Improve with the Chip Market

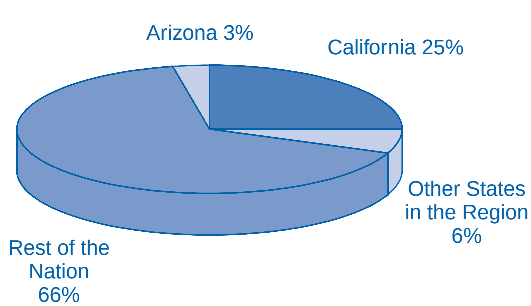
High-tech employment is defined here to include jobs in manufacturing computers, electronic components, communications, and measurement and control equipment. The Region accounted for over 34 percent of the nation's employment in high-tech electronics in 1995, according to the ***Census Bureau*** survey on manufacturing employment. The importance of California to the nation's high-tech industry is illustrated in Chart 2. California accounts for less than 11 percent of the nation's employment, yet 25 percent of the nation's high-tech manufacturing jobs are located in the state.

The soft demand for chips and computer products that surprised the industry in 1996 is expected to give way to a moderate increase in production in 1997. Recent forecasts by industry analysts suggest that the chip market should grow between 5 and 12 percent in 1997. That rate of expansion would benefit both California and the growing number of states, including Arizona, Idaho, Oregon, Utah, and Washington, that have developed sizeable high-tech manufacturing industries.

Within California, high-tech is most dominant in the booming Silicon Valley. A low unemployment rate, a scarcity of skilled workers, housing shortages, and extremely low commercial real estate vacancy rates all attest to the impact of the industry on business conditions in the Silicon Valley. Moreover, the boom is extending to other parts of the Bay Area and the Sacramento region, as well as to out-of-state manufacturing centers.

CHART 2

The San Francisco Region Has a Large Share of High-Tech Employment



Source: Department of Commerce, Census Bureau, Annual Survey of Manufacturers,1995

Expansion, however, continues to present challenges for the Silicon Valley. Technological changes, competition, and the lure of lower-cost production facilities continue to lead firms to relocate their manufacturing facilities outside the Silicon Valley. Several manufacturers have recently announced that it is more cost-effective to build new facilities in other locations than to refurbish an obsolete plant in the Valley. According to ***Strategic Marketing Associates***, an industry market-research firm, of the 14 large semiconductor fabrication facilities planned to open around the world by the year 2000, only three will be built in the United States, and none will be located in California.

Movement from the Silicon Valley has benefited many emerging manufacturing centers located in other areas. While other states in the Region have much smaller high-tech industries than California does, their growth rates have outpaced California's. Computer-manufacturing employment grew at rates in excess of 20 percent in Oregon and Washington last year, compared with a 7.7 percent increase for California.

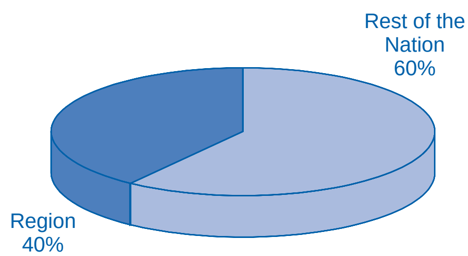
Aerospace Is Booming in Washington State

The Region's share of the nation's aerospace jobs is even greater than its share of high-tech employment. Aerospace employment is defined here to include jobs in manufacturing aircraft, missiles and spacecraft, and search and navigation equipment. As shown in Chart 3, next page, the Region accounts for 40 percent of aerospace employment nationally. For comparison purposes, the Region accounts for under 19 percent of the nation's employment. The bulk of the aerospace employment in the Region is in Washington and California.

Commercial aerospace manufacturing, especially in Washington, is reaping the benefits of a favorable economy, growth in airline passenger traffic, and the need to replace aging or noisy jet fleets. The surge in demand has built a huge backlog of orders, more than half of which are from foreign air carriers whose fortunes are less closely tied to U.S. economic conditions. Boeing, headquartered in Seattle, and its many subcontractors have responded to the aerospace boom by increasing production to meet the demand. Boeing alone is slated to add another 10,000 employees over the course of 1997 following the addition of more than 20,000 employees in 1996.

CHART 3

The San Francisco Region Has a Large Share of Aerospace Employment



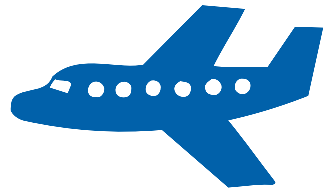
Source: Department of Commerce, Census Bureau, Annual Survey of Manufacturers,1995

In 1996 Washington's aerospace employment surpassed that of California, and by April 1997 it again exceeded the 100,000 level. Despite the current boom, Washington aerospace employment still is well below the peak of 118,000 it hit in 1989 before the full impact of defense cutbacks hit the industry. However, Washington's turnaround still compares favorably with California, which because of its dependence on defense contracts has yet to experience an upturn in aerospace.

Technology and Aerospace Stand Out Because of Their History of Wide Business Cycle Swings

Both the high-tech and aerospace manufacturing industries have a history of experiencing more severe business cycle swings than do most other sectors of the economy. High-tech and aerospace investments are sensitive to interest rates movements. Weak industry or economic conditions also may warrant postponing high-tech investments or costly aircraft purchases until conditions improve. In addition, demand for aircraft tends to move in cycles that depend on air traffic volume and the performance of the world's airlines, factors that are strongly influenced by economic conditions.

These highly cyclical industries usually are procyclical; they tend to boost the Region's growth during good times and weaken it during recessions. Chart 4 shows the exaggerated business cycle swings since the mid-1970s for California's high-tech industry compared with total employment (excluding high-tech). Chart 5 (see next page) shows the similar patterns for Washington's aerospace industry. Aerospace also has been subject to wide swings related to increases, and more recently decreases, in defense spending. At the state and local levels, where these industries may account for a large portion of local economic activity, their boom and bust cycles can be especially important.



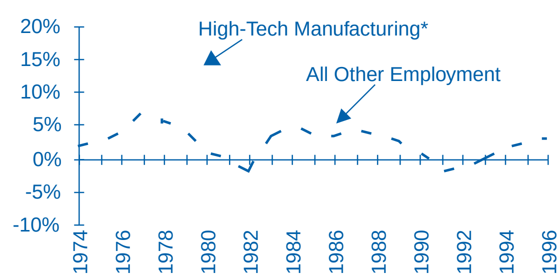
Implications: *High-tech and aerospace tend to exhibit wide swings in growth over the course of the business cycle that can affect business conditions at the local, state, and regional levels.* The San Francisco Region's exposure to these swings is even greater than the nation's because the Region is much more dependent on these industries. Thus, while the growth phase of the business cycle for these industries may stimulate expansion in other industries and increase the demand for loans, the contraction phase traditionally has weakened economies that are dependent on these industries and caused deterioration in asset quality. Because of the highly cyclical nature of these industries, it is important to understand both their current contribution to the Region's economic health and their future prospects.

Construction Employment Climbs as Real Estate Markets Heat Up

A third highly cyclical industry is construction. The San Francisco Region is slightly more dependent on construction employment than is the nation. Current conditions in the Region's construction sector are generally robust, with the key exceptions of Hawaii and some areas of Southern California. Over the 12 months ending in April 1997, the sector added more than 80,000

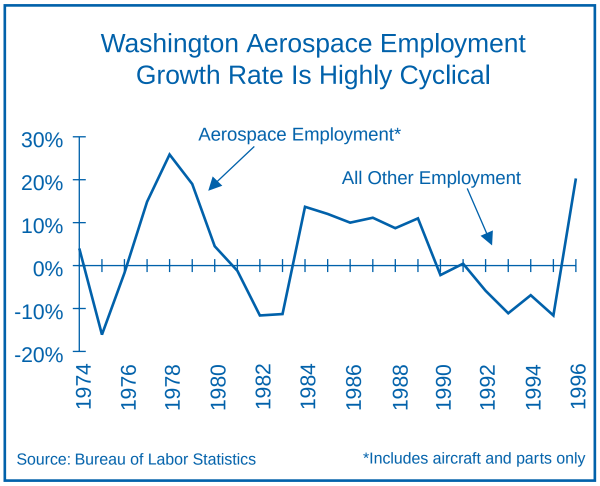
CHART 4

California High-Tech Employment Growth Rates Vary More Than Other Employment



*Excludes communications.
Source: Bureau of Labor Statistics.

CHART 5



jobs. This increase of 7.7 percent is nearly twice the rate of growth nationally. Despite a sharp decline in housing permits, residential construction activity remained strong in Nevada during the first quarter. Building activity also has picked up in California in the aftermath of the devastating flooding earlier in the year and the mild winter that followed.

Relatively low commercial vacancy rates in most office and industrial markets in the Region, along with increased activity in the commercial real estate industry, also are contributing to the pickup in construction employment. As noted in ***Retail Shakeout: Causes and Implications for Lenders***, most analysts believe that vacancy rates and market fundamentals for retail-based real estate in most metropolitan areas of the Region remain positive.

Strength in Services and Tourism

The service sector tends to experience relatively small variations in annual growth rates over the business cycle, a sharp contrast with the behavior of high-tech, aerospace, and construction. Not only has the service sector been more stable in recent decades, it also has been the fastest growing sector. Its current performance is consistent with that trend.

The Region's service sector added 309,000 jobs over the past year, a robust 4.7 percent growth rate. Business services, which encompasses an array of rapidly growing activities including programming and software services, equipment leasing, and temporary employment agencies, added more than 129,000 jobs over the past 12 months, an increase of 9.3 percent.

Tourism and travel services also scored gains in much of the Region and helped boost service sector activity. The healthy economy has stimulated both business and tourist travel. Five states reported noteworthy strength in tourism: Arizona, California, Nevada, Oregon, and Utah. The San Francisco and Los Angeles areas recorded increased tourism in 1996, and analysts expect similar favorable conditions for 1997. Arizona reported nearly a 4 percent increase in domestic visitors last year, and Utah reported rapid growth in lodging employment. High occupancy rates have improved conditions for hotels in Las Vegas, Portland, and San Diego. Finally, both the travel and amusement industries are reporting rising employment levels.

Implications: The simultaneous robust performance of three cyclical industries over the past year is a key factor in the current health of the Region's economy. *Still, the boom in all three highly cyclical industries bears monitoring.* While all three are presently doing well, and most analysts anticipate continued favorable conditions, this Region is much more dependent on the health of these industries than is the nation as a whole. Furthermore, the strong economy is an important reason for the robust performance of the Region's banking institutions. However, in the past, downturns in these sectors, like aerospace in Washington in the early 1980s or California in the 1990s, high-tech in the Silicon Valley in the mid-1980s, or real estate in California in the first half of the 1990s, all have adversely affected both the Region and some of its banks.

Gary C. Zimmerman, 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.**
- **During the first quarter of 1997, the San Francisco Region's Community Bank Index gained steadily despite disturbance in the broad market and other bank indices.**

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

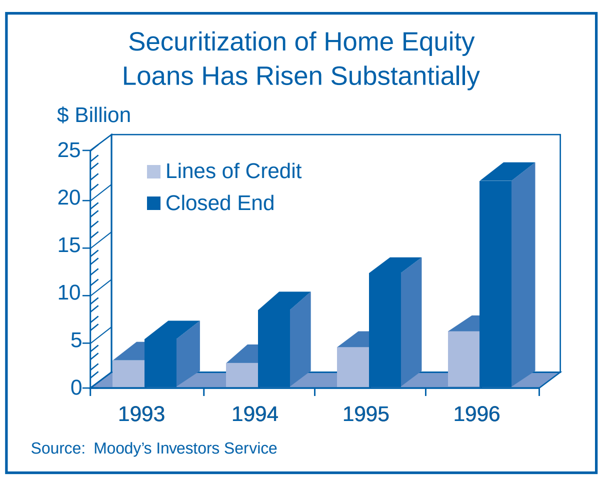
The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has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

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

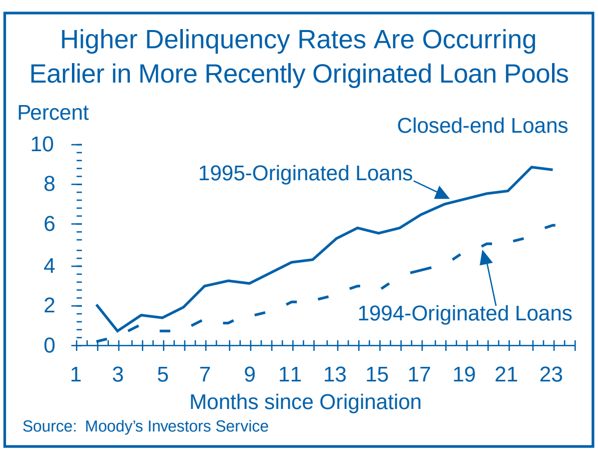


The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The 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.

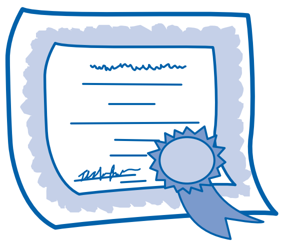
The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results 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

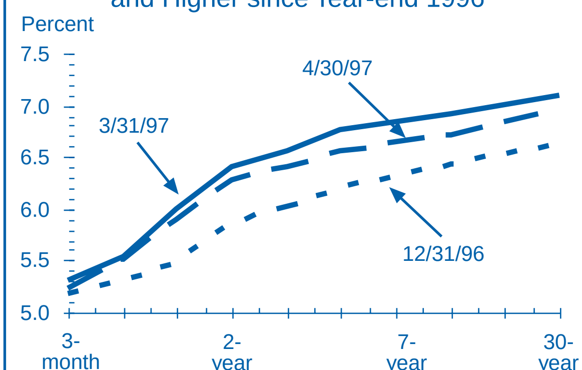
The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained 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

The Treasury Yield Curve Is Steeper and Higher since Year-end 1996



Source: Bloomberg

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.

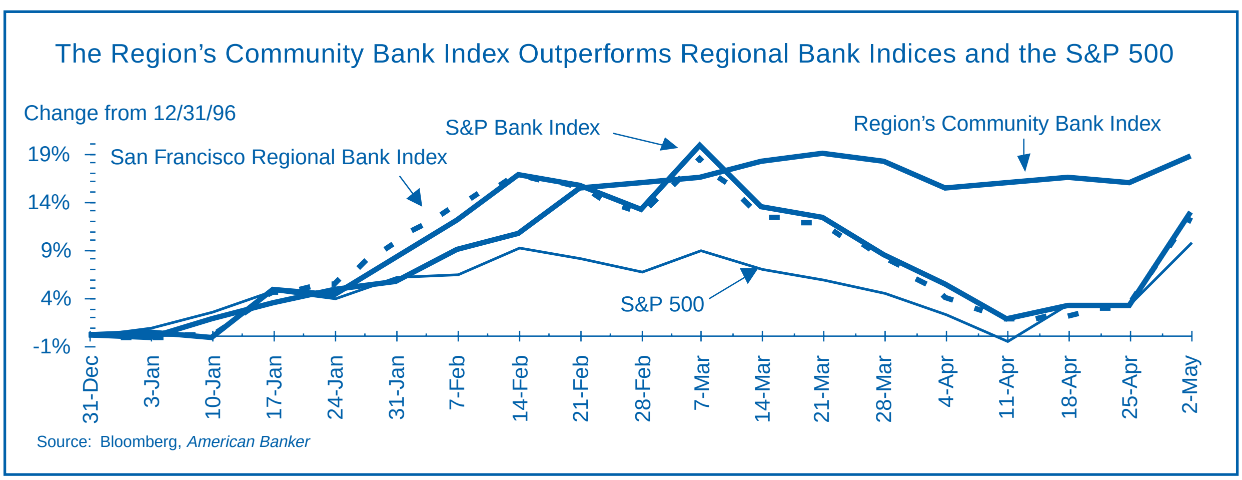
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate 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 San Francisco Region Performed Smoothly Despite Turmoil in the Broad Market during the First Quarter of 1997

Both the Standard & Poor (S&P) Composite Bank Index and the San Francisco 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 San Francisco Region's Community Bank Index was spared much of the influence of a gyrating market, rising in value steadily to an 18.59 percent gain through May 2, 1997, exceeding the S&P Composite Bank Index's gain by almost 6 percentage points.

Allen Puwalski, Banking Analyst

CHART 4



Current Regional Banking Conditions

- **Reported earnings, asset quality, and capital continue to improve during the first quarter, boosted not only by positive economic conditions in the Region but also by the adoption of Generally Accepted Accounting Principles (GAAP) for regulatory reporting purposes.**

- **Regulatory reports in the San Francisco Region were most affected by the adoption of the GAAP accounting standards related to mortgage servicing rights, assets sold with recourse, and the extended amortization period for intangible assets.**

- **In the first quarter of 1997, unrelated merger candidates in the Region favored the purchase method of accounting. The purchase method may have gained popularity among merger candidates as a result of a recent Securities and Exchange Commission (SEC) ruling that tightens rules on stock buyback programs and a Call Report change that lengthens the goodwill amortization period from 15 to 25 years.**

Region's Profit Levels Highest since the Recession

The San Francisco Region's depository institutions continue to report strong performance as positive economic conditions, coupled with the long period of relatively low interest rates, boosted first-quarter earnings to the highest level since the recession (see ***Strong Growth in Services, Aerospace, and High-Tech Boosts the San Francisco Region's Performance***). A return on assets ratio of 1.17 percent was attained in the first quarter, with commercial banks earning 1.32 percent and thrifts 0.83 percent. First-quarter profits were buoyed not only by healthy net interest margins and increasing levels of noninterest income, but also by the implementation of several regulatory reporting changes.

The Region's banks reported record profits despite an increase in loan loss reserves at large credit card banks. These banks increased their allowance for loan and lease losses to cover another uptick in delinquent credit card loans. Credit card loans past due 30 days and over climbed from 4.17 percent of average total credit card loans at year-end 1996 to 4.47 percent as of March 31, 1997, although delinquency rates for total loans in the Region fell below the national level for the second quarter in a row.

Regulators Adopt Generally Accepted Accounting Principles

First-quarter 1997 financial results were affected by the Federal Financial Institutions Examination Council's 1995 decision to adopt Generally Accepted Accounting Principles (GAAP) for regulatory reporting purposes. The regulators' objective in adopting GAAP, which became effective January 1, 1997, was to provide greater consistency between an institution's regulatory reports and its general-purpose financial statements. The regulators did not, however, change their capital regulations. Consequently, differences continue to exist between GAAP equity capital calculations and regulatory capital calculations.

Institutions in the San Francisco Region were most affected by the adoption of GAAP in the following areas:

- *Extension of goodwill amortization from a maximum of 15 years to a maximum of 25 years.*

Banking regulators extended the amortization period for intangible assets to achieve consistency with the Securities and Exchange Commission Staff Accounting Bulletins. This change affected both the balance sheet and income statement at several institutions in the Region.

As shown in Table 1 (see next page), goodwill increased by $1.6 billion during the quarter. This increase stems from two sources: (1) premiums paid for acquired institutions and (2) write-up of previously amortized goodwill. Several institutions retroactively adjusted the life

TABLE 1

KEY COMPONENTS OF ACCOUNTING CHANGES IN THE REGION	(IN MILLIONS OF DOLLARS)		
	12/31/96	3/31/97	CHANGE
INTANGIBLE ASSETS	$16,428	$19,211	17%
GOODWILL	$10,678	$12,315	15%
MORTGAGE SERVICING	$1,309	$2,121	62%
OTHER INTANGIBLES	$4,442	$4,765	7%
ASSETS SOLD WITH RECOURSE	N/A	$28,401	N/M
CUMULATIVE EFFECT OF RETROACTIVE ACCOUNTING CHANGES	$0	$1,124	N/M

N/A = NOT AVAILABLE, N/M = NOT MEANINGFUL.
SOURCE: CALL AND THRIFT CALL REPORTS.

of their recorded goodwill to the new 25-year maximum by writing up their goodwill asset. Evidence suggests that some 40 percent of the increase in goodwill may be attributable to this write-up. *Insured institutions reported the cumulative effect of the goodwill write-up as a direct adjustment to their capital accounts.*

It also appears that the extended amortization period is responsible for the 23 percent decline in intangible amortization expense that occurred despite a 17 percent quarter-over-quarter increase in total intangible assets. Based on historical intangible amortization expense ratios, the extended amortization period boosted the Region's aggregate return on assets during the quarter by approximately six basis points.

- *Elimination of the distinction between normal and excess servicing fees receivable (ESFR) and other charges related to servicing of financial assets.*

Servicing fees receivable, or servicing rights, as defined in Financial Institution Letter 106-96 dated December 27, 1996, are the contractual obligations undertaken by an institution to provide servicing for loans and other financial assets owned by others, typically for a fee. For regulatory reporting purposes prior to January 1, 1997, servicing rights were divided into the following two categories:

1. Purchased servicing rights, which were servicing rights purchased from others.

2. Originated servicing rights, which generally arose when an institution originated and subsequently sold the financial assets but retained the rights to service those assets. *When an institution sold these financial assets with servicing retained and the servicing fees exceeded the normal servicing fee rate, it booked ESFRs.*

In the past two years, however, GAAP accounting treatment for servicing rights changed significantly. Effective in 1996, the Financial Accounting Standard Board's Statement No. 122, "Accounting for Mortgage Servicing Rights" (FAS 122), eliminated the distinction between purchased mortgage servicing rights and originated mortgage servicing rights. It required that these assets, together known as mortgage servicing rights, be treated as a single asset for financial statement purposes, regardless of how the servicing right was acquired.

Effective January 1, 1997, FAS 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," reclassified the interest cash flows associated with normal and excess servicing contracts into the following two categories:

1. Servicing assets, which are measured based on contractually specified servicing fees.

2. Interest-only strips receivable, which represent interest cash flows received on the serviced assets in excess of the contractually specified servicing fees. *To qualify as an interest-only strip, the servicer must have the right to retain the excess cash flows if the related servicing asset is sold or the related servicing contract is shifted to a new servicer.*

During the first quarter, the adoption of these GAAP guidelines for regulatory reports affected both the balance sheet and the income statements at several of the Region's banks because, prior to 1997, there were significant regulatory accounting differences related to the servicing of financial assets. First, banks were allowed to recognize only gains and book assets on ESFRs for *first lien 1 to 4 residential real estate mortgage loans*. With the adoption of GAAP and FAS 125 on January 1, 1997, banks can now recognize income and book originated servicing assets on all types of financial assets, not just mortgage loans.

Second, servicing assets were classified differently and, because of their respective classifications, they were treated differently in regulatory capital calculations. Prior to 1997, mortgage servicing rights were classified as intangible assets and limited to 50 percent of Tier 1 capital. Conversely, ESFRs were considered tangible "other assets," and 100 percent of these assets were included for capital adequacy purposes. In addition, any purchased servicing rights on assets other than mortgages were classified as intangible assets for regulatory reporting purposes but were deducted from capital in their entirety.

Although the adoption of GAAP eliminated the balance sheet and income statement differences related to the servicing of financial assets, these assets continue to be treated differently in regulatory capital calculations. As of January 1, 1997, 100 percent of interest-only strips generally are included in capital, while mortgage servicing assets are limited to 50 percent of Tier 1 capital. Servicing assets on financial assets other than mortgages are limited to 25 percent of capital at savings associations but are totally excluded in bank capital calculations. The total of all servicing assets that may be recognized at any savings association is limited to no more than 50 percent of Tier 1 capital.

In the San Francisco Region, most ESFRs were reclassified from tangible "other assets" to intangible "mortgage servicing assets" during the first quarter primarily because the servicers were unable to retain the excess cash flows if the related servicing assets were sold. This reclassification of ESFRs accounted for approximately one-half of the $812 million increase in the mortgage servicing assets outstanding (see Table 1). Although the reclassification did not change asset totals, it did affect capital ratios of individual institutions with large mortgage servicing portfolios, because intangible mortgage servicing assets are limited for regulatory capital purposes.

- *Removal of certain loans and other assets sold with recourse from the balance sheet.*

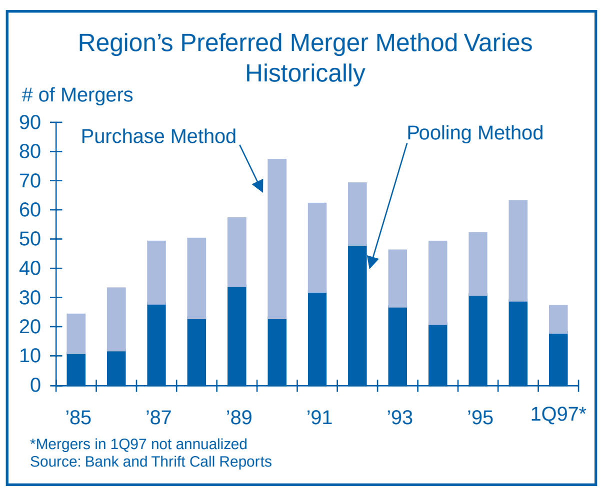
With the adoption of GAAP in the first quarter, institutions in the Region reported a cumulative total of over $28 billion in assets sold with recourse. About $4 billion of this total relates to loans sold during the first quarter of 1997. These assets, which were primarily credit card loans, account for the majority of a $4.3 billion decline in loans at the Region's banks during the quarter.

For regulatory accounting purposes prior to January 1, 1997, banks could record a transfer of assets other than residential mortgage loans as a sale only when the transferring institution (1) retained no risk of loss from the assets transferred and (2) had no obligation to pay principal or interest on the assets transferred. With the adoption of GAAP, however, assets sold with recourse prior to 1997 can now be recognized as sales if the amount of recourse can be reasonably estimated and the transferring institution establishes an appropriate reserve for the recourse liability in a separate liability account.

- *Retroactive application of GAAP in regulatory reports.*

In the San Francisco Region, over 40 institutions elected to amend their financial statements for prior years and adopt the GAAP accounting changes retroactively. *These institutions reported the cumulative effect of the nonrecurring accounting adjustment, which totaled $1.1 billion, as a direct adjustment to equity capital, net of applicable income taxes.* Although this adjustment is the net effect of several different accounting entries, a

CHART 1



large portion relates to the write-up of goodwill discussed above.

Implications: Both financial institutions and industry analysts should benefit from the adoption of GAAP for regulatory financial statements. Financial institutions no longer will have to maintain a separate set of records for regulatory purposes, and analysts will find greater consistency between regulatory reports and the institution's general-purpose financial statements. However, these changes will create challenges for the analysts and regulators who use the 1997 regulatory financial statements and make comparisons to prior periods. Analysts and regulators will need to carefully scrutinize shifts in balance sheet structure and earnings levels to ascertain what effects, if any, are attributed to the 1997 regulatory reporting changes.

In addition, regulators will be analyzing interest-only strips and servicing rights on all types of financial assets, not just residential real estate mortgage loans. The capitalized value of the servicing rights on each of these financial assets is influenced by servicing costs, prepayment speeds, discount rates, and other factors. Assumptions about these factors have an important effect on the related values of these assets and are worthy of attention by regulators and bank analysts.

Merger Activity and Regulatory Changes Renew Debate over Accounting Methods

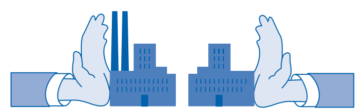
Increased merger activity in the nation, as well as in the Region, has resulted in increased discussion about merger accounting methods in both the regulatory and corporate arenas. Currently, corporations merging with or acquiring other companies can account for the transaction either through the pooling of interests (pooling) or the purchase method of accounting.

Unlike national trends, which show a definite preference for pooling, Chart 1 shows that historically the Region's merging banks have shown no clear preference for either of the two accounting methods. In 6 of the past 12 years, merging banks in the Region preferred the purchase method of accounting for mergers. Although 18 of the Region's 27 mergers in the first quarter of 1997 used pooling, the majority of the pooling mergers involved related companies. However, in 70 percent of the mergers involving unrelated entities, the purchase method was favored.

Merger Methods Offer Different Advantages

With pooling, the companies exchange stock, and the assets, liabilities, and capital of each institution are added together on a line-by-line basis without adjustments for fair market value. However, for an applicant to be eligible for pooling, it must meet 12 separate criteria outlined in Accounting Principles Board (APB) No. 16. Merger applicants who meet the pooling eligibility requirements can benefit from the following factors:

- Future earnings are not reduced by amortization of goodwill; therefore, reported income, return on assets, and return on equity can be higher.
- Valuation of acquired assets and liabilities, which can be a complicated process, is avoided.
- Assets with significant appreciation are booked at historical cost, so taxes are avoided.
- Regulatory capital ratios are not affected by the need to deduct goodwill.



In comparison, the purchase method accounts for a business combination as the acquisition of one company by another. Assets and liabilities are recorded on the acquiring institution's books at their fair market values. Any amount paid in excess of the net fair market value of the assets and liabilities acquired is recorded as goodwill and amortized against future earnings. The purchase method can be attractive for the following reasons:

- Purchase transactions are not limited to the exchange of stock; for example, a buyer could offer a combination of both cash and stock.
- The method allows more flexibility in disposing of assets for cost-cutting purposes.

Securities and Exchange Commission Closes Stock Buyback Loophole

Recent bank mergers combined with stock buyback programs prompted the Securities and Exchange Commission (SEC) to review and tighten stock buyback rules for merger candidates using the pooling method of accounting. As a result of these revised rules, some analysts believe purchase accounting will gain popularity among merger candidates.

With earnings reaching historical highs and the industry's focus on earnings per share, many banks involved in mergers have been returning excess capital to shareholders through stock buyback programs. Stock buyback programs also are quite popular when additional stock is issued as part of the merger transaction and the new stock dilutes earnings per share. Although merger candidates using the purchase method can use stock buyback programs, one of the 12 conditions for pooling of interests described in APB Opinion No. 16 prohibits the combined company from repurchasing any of the common stock exchanged in the transaction.

To overcome this restriction, a number of banks merging under the pooling method took advantage of ambiguous language in APB Opinion No. 16 and instituted stock buyback programs. However, in March 1996, the SEC closed this loophole by issuing Staff Accounting Bulletin No. 96. This bulletin clarifies that in most circumstances there can be no planned stock repurchases for a maximum of two years after a pooling of interests merger is consummated.

Purchase Method of Accounting May Gain Popularity

Industry analysts suggest that purchase accounting will become even more popular if investors alter their method of analyzing earnings per share: Some merger partners are encouraging investors to focus on "cash earnings per share," which uses earnings before amortization of intangible assets, to evaluate merger transactions. They argue that goodwill amortization is merely a byproduct of an accounting method and should not affect the economic value of a merger.

Additionally, some industry analysts believe the Financial Accounting Standards Board (FASB) and the SEC may further limit the use of the pooling method. One reason for this view is that international accounting practices generally allow pooling only when it is impossible to tell which company is the acquiring company, as in a merger of equals. In addition to promoting consistency with international practices, proponents of the purchase method argue that pooling does not reflect the economic substance of a transaction because the fair market value of assets and liabilities is not recognized. Alternatively, the FASB may maintain pooling but make purchase accounting less onerous by eliminating the amortization of goodwill.

Implications: Further restrictions on pooling would likely result in both a greater use of the purchase method of accounting for mergers and an increase in recorded goodwill. Consequently, assessing the potential effects of goodwill may become increasingly important when analyzing a bank's earnings performance.

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