
◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

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In Focus This Quarter

FDIC BOSTON REGION



■ ***Will Credit Scoring Transform the Market for Small-Business Lending?*** - In an effort to reduce the cost of small-business lending, some institutions are using credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios, in some cases venturing into markets well beyond their local economies. The ramifications could be significant. An overreliance on credit scoring models could expose lenders to increased credit risks. Over time, the traditional niche enjoyed by small banks in small-business lending could come under considerable pressure. *See page 3.*

■ ***Banking on the Internet: New Technologies, New Opportunities, New Risks*** - Internet banking promises a wide range of new benefits. It also offers a host of new problems and some new twists on old ones. The tradeoff is one that depository institutions and regulators alike must grapple with as they stake out their positions in cyberspace. *See page 7.*

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Regular Features

◆ *Regional Economy* ◆ *Financial Markets* ◆ *Regional Banking*

- Economic Recovery
- Massachusetts
Construction
Home Sales
- Connecticut
Aerospace & Defense
Insurance & Banking

See page 11

- Asset-Backed Securities
- Bond Values
- Price/Earnings Ratios

See page 15

- Overall Conditions
- Examination Results
- Credit Card Lending
- Core Asset Growth
- Earnings Strategies
- Net Interest Margins

See page 20

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Will Credit Scoring Transform the Market for Small-Business Lending?

- **Small-business lending, traditionally a segment in which small banks have enjoyed comparative advantages, is receiving greater focus from larger banks and nonbank financial companies.**
- **Some insured institutions are beginning to re-think traditional approaches to small-business loan underwriting to include the use of credit scoring models.**
- **The use of small-business lending credit scoring models, while providing banks opportunities for underwriting and servicing efficiencies, carries with it a number of potential risks.**

Background

As of 1994, there were more than 22 million small businesses in the U.S., making this a very attractive potential market for lenders. Small-business lending has been a line of business in which small banks have been very successful given their traditional strong niche in relationship banking. Small-business lending traditionally has been a relatively cost-intensive lending segment, since origination costs are spread over smaller loan balances. Some institutions are now beginning to use credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios. A number of larger banks, especially, appear to be looking to the efficiencies of credit scoring to help provide quick loan approvals and more competitive loan rates. With the aid of this technology, some institutions are rapidly expanding their loan portfolios, in some cases venturing into markets well beyond their local economies.



Small-business loans (defined as commercial and industrial loans with original amounts of \$1 million or less and reported annually in June Bank and Thrift Call Reports) represent a significant exposure and source of revenue for insured institutions. The Boston Region's insured institutions disclosed \$8 billion of small-business loans as of June 1996, 18 percent of total commercial and industrial loans reported. For institutions under \$1 billion in total assets, small-business

loans were 79 percent of total C&I loans, which underscores the relative importance these loans have to smaller institutions (see Chart 1 next page).

A distinctive feature of this Region is the importance of savings banks in small-business lending. Savings banks in the Boston Region traditionally have made more commercial loans than savings banks nationally, and they hold a greater percentage of small-business loans to assets. At June 30, 1996, savings banks accounted for 31 percent of all small-business loans by dollar volume in the Region. Comparatively, the proportion of small-business loans held by savings banks nationally is only 3 percent.

In the twelve month period ending June 1996, small-business lending exposure declined by 4 percent in the Region in contrast to a 7 percent increase nationwide. New England's slow recovery may be contributing to the disparity in growth rates between the Region and the nation. Additionally, New England's small-business recovery primarily has been driven by services and technology firms companies that do not typically rely on bank funding for capital needs. Many start-up companies in the Region also have benefited from heavy investment by venture capital firms. Both Connecticut and Massachusetts rank among the top 10 states in the country in venture capital investment.

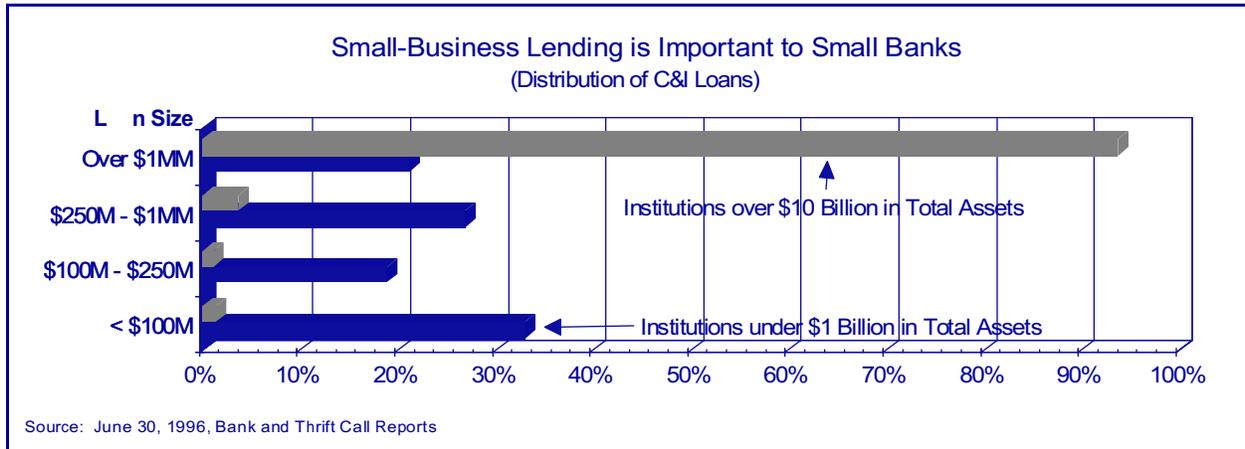
Thus far, the use of credit scoring for small-business lending has not been widespread in the Boston Region. However, the increasing level of competition for this segment of the business should continue to put pressure on pricing. As banks in the Region seek less expensive means for generating small-business loans, they may place increased reliance on credit scoring technologies.

The Growing Importance of Credit Scoring

While credit scoring technology is not new, until recently it typically has been associated with consumer lending, particularly with credit card lending. Primarily using credit bureau information, credit scoring provides lenders with a tool to rank risks or probabilities of default, assigning statistically derived numerical ratings or scores based upon a borrower's past experience with paying debt.

Small-business credit scoring models are similar to

CHART 1



consumer credit scoring models in one significant aspect -- the most important indicator of credit performance is the credit profile of the principals of the business. These profiles are derived from consumer credit bureau information.

A primary vendor of these scoring models has cited analysis purporting to show that business financial statement information did not prove a useful indicator of credit performance for small-business loans. The reasons for this result may be due to inconsistency in financial statement quality and the difficulty in separating business entity cashflow information from the business owners' activities. Also, the relative importance of principals' credit history and financial statement information in predicting credit performance was found to change somewhat with the size of the business -- the larger the business the more important financial statements become in assessing performance.

Many institutions cite the potential cost savings involved in the underwriting process as one of the most significant characteristics of credit scoring. In many cases, with scoring technology, loan application processes have been streamlined to one page forms for loans up to \$50,000, not dissimilar to that of consumer loan applications. In some cases, financial statements are not required at all. Reducing paperwork helps to reduce both processing time and costs. Table 1 illustrates how scoring has changed underwriting practices, as reported by one large bank at a recent conference on credit scoring. While it is impossible to know whether the information presented in Table 1 is representative of the way most institutions are using credit scoring models, it is clear that credit scoring may represent a major departure from traditional underwriting methods.

Part of the reduction in underwriting costs may come from improvements in the allocation of underwriting resources. It has been argued that credit scoring allows banks to more easily identify those applicants which are clearly either approvals or denials. This process would enable banks to reallocate their underwriting resources more efficiently to those loans which pose intermediate risks and require closer attention. Other advantages of credit scoring systems that often are cited are greater consistency in underwriting, better measures for pricing strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

TABLE 1

SMALL-BUSINESS LENDING: CREDIT SCORING VERSUS TRADITIONAL LOAN UNDERWRITING			
	1993	1996	1997
PERCENT OF LOANS REQUIRING ANNUAL FINANCIAL STATEMENTS	100%	20%	--
PERCENT OF LINES REVIEWED ANNUALLY	100%	0-5%	--
PROCESSING TIME FOR LOANS OF \$50,000 - \$250,000	3 DAYS	1 DAY	1 HOUR

SOURCE: REPORTED BY A LARGE BANK AT A RECENT CONFERENCE ON CREDIT SCORING.

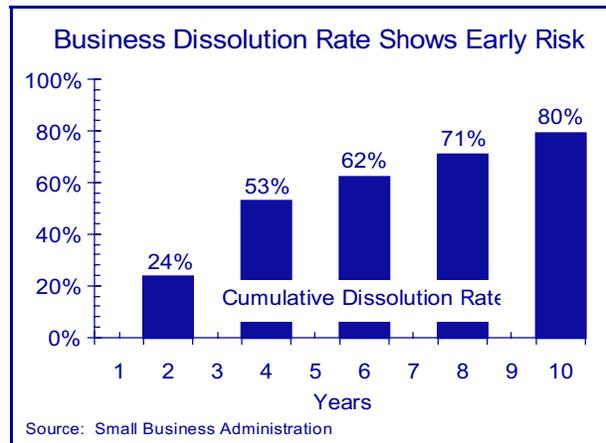
Small-business lending has historically been a profitable area of bank lending. This situation is most likely attributable to lenders thoroughly analyzing potential customers, persistently monitoring their performance, and building solid lending relationships. Credit scoring for small-business lending raises the possibility that some banks will forgo the traditional underwriting concepts of relationship lending in favor of a more mass-marketing approach, in a manner similar to credit card lending. To the extent that credit scoring is used to rapidly gain new customers by either targeting out-of-territory customers, or customers with less business experience, the risk profile of an institution's small-business lending portfolio may change. Any such change in profile may be significant due to the risks associated with newer borrowers. For example, new firms tend to fail at an extremely high rate, with 53 percent of new businesses failing within the first four years of inception (see Chart 2). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

There are potential dangers associated with placing undue reliance on credit scoring models. *The predictive value of any credit scoring system may be substantially diminished if the model is used for unintended purposes or customer types.* Therefore, misuse of a scoring system could expose an institution to considerable losses. Since only the largest banks have small-business loan portfolios large enough to create statistically valid scoring models customized for their own customer base, smaller companies should be especially aware of potential misuse. This risk takes on added meaning when one considers that a \$1 million small-business loan represents substantially more capital to a \$100 million bank than to a \$10 billion bank. Adding further uncertainty, small-business credit scoring has been implemented during a period of relatively strong performance by businesses, with commercial and industrial loan delinquency ratios near historical lows. How well these models perform during an economic downturn remains to be seen.



Depending on the manner in which it is implemented, credit scoring for small-business lending may represent a fundamental shift in underwriting philosophy -- *viewing a small-business loan as more of a high-end consumer loan and, thus, granting credit more on the strength of the principals' personal credit history and less on the financial strength of the business itself.* While this may be appropriate in some cases, it is important to remember that the income from small busi-

CHART 2



nesses remains the primary source of repayment of most loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

Competitive pressures in small-business lending are increasing not only because of large banks' efforts to expand their lending but also because of greater participation in the market by nonbank financial companies. Several large firms, such as American Express, AT&T, the Money Store, and GE Capital Services, are expanding their business lines to service the needs of small businesses. These companies are offering small-business credit cards, innovative new types of credit, and adding other services such as consulting, accounting and investment services. Some observers have suggested that the cost advantages of credit scoring may cause small-business lending in the future to be dominated by 12 to 15 large banks or financial firms. Faced with stiff competition, there may be strong motivation for some institutions to increase the dollar threshold on low documentation loans, streamline the process for larger loans, or lower credit scoring thresholds for loan approvals.

The most recent *FDIC Survey of Underwriting Practices* and the *Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices* both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth goals were seen as the main reasons for easing in these cases. With regard to small-business credit scoring techniques, the Federal Reserve survey pointed out that banks were most commonly using credit scores for automatic acceptance or rejection of loans up to \$50,000.

Summary

Credit scoring has the potential to transform the market for small-business lending. The traditional niche enjoyed by small banks in this area may come under tremendous pressure from larger banks and nonbank companies employing this new technology. Credit scoring at a number of institutions is driving dramatic changes in underwriting methods for small-business lending. These changes may facilitate short-term revenue generation as business can be expanded rapidly and underwriting costs can be slashed. It is extremely important, however, that banks understand and control the potential risks inherent in such a strategy. The application of credit scoring to small-business lending merits the close attention of both bankers and their supervisors.

Andrea W. Bazemore, Banking Analyst

Banking on the Internet

New Technologies, New Opportunities, New Risks

- Despite the potential for lower transaction costs, increased efficiency, and greater asset diversification, few banks do business through the Internet.
- Although competitive risks are pushing banks to create an Internet presence, operational risks remain an obstacle to actually using those sites for moving information or money.
- The FDIC's Division of Supervision recently released examiner guidance on Internet banking and is developing training programs for its examiners.

The Allure of Cyberbanking

On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking*, is of particular interest to banks because it exploits an existing and geographically extensive public network infrastructure and promises a range of new operating and marketing benefits. One such benefit is the ability for an institution to expand its trade area to include other cities, states, regions -- or even countries -- without a commensurate expansion of its branch structure. This greater geographic reach can

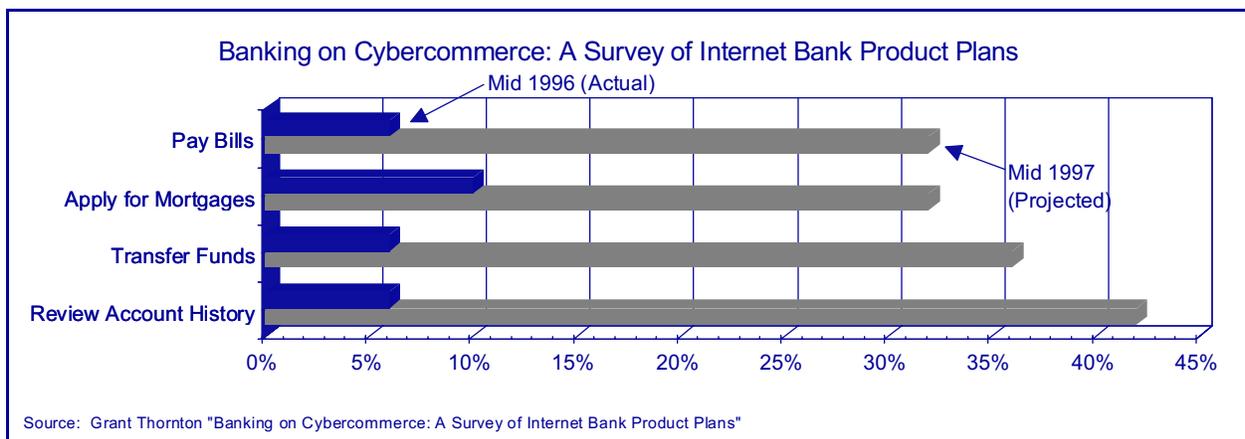


do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. A March 1996, study by *Booz, Allen & Hamilton Inc.* estimated an average Internet transaction cost of \$0.01 compared to \$0.27 for an ATM, \$0.54 for a telephone, and \$1.07 for a full-service branch.

Slow Migration to the Future

Another 1996 study, this one by *Grant Thornton* in July (see Chart 1), found that despite these potential benefits, most banks established an Internet presence for appearance's sake -- being perceived as a leader, advertising bank services or staying abreast of competitors -- rather than with an intent to grow deposits or capture the transaction economies that cyberbanking could provide. Of the 44 Internet institutions surveyed, only one in three expressed intentions to begin offering bill payment or funds transfer over the Internet by the end of the second quarter of this year. Even this subdued enthusiasm now appears optimistic. Despite the perceived benefits and the scarcity of competition, few banks have to date ventured into this area in a meaningful way. According to the *Bankweb* world-wide web site, only 800 or so banks -- less than 1 percent of the industry -- have an Internet site and only 18 of those permit transactions. In the Boston Region, 78 institutions have an Internet presence but none of these institutions allow customers to

CHART 1



pay bills or transfer funds. A major question, then, is why so few institutions have chosen to exploit this medium?

Risk

The reason is risk. Banks are familiar with the control of exposures found in proprietary or private payment channels, but they are less comfortable with the new risks attendant to a public network. On one hand, there are *operational* exposures that convincingly argue against rushing headlong into cyberspace. On the other hand, there are *competitive* risks. Nonbank competitors with strong foundations in cybertechnology pose a budding threat to the banks' historical payment-services monopoly and argue with equal authority for an immediate Internet presence to gain or preserve market share. These opposing forces help explain the large numbers of banks establishing web sites that stop short of actually moving information or money.

Of these two types, operational risks are the most immediate and command the most attention. They derive from the formative state of both the technology supporting on-line commerce, and the legal and regulatory structure governing its use. These risks include theft or misappropriation of internal data or external transmissions, transaction fraud, errors in underwriting virtual transactions, liquidity shortfalls, changing technical standards, inadequate or geographically inconsistent regulatory and legal infrastructure, noncompliance with existing laws or regulations that were not designed for an on-line world, and damage to an institution's reputation from the realization of any or all of these risks (see *Some Concerns for the CyberBanker*, right).

Systemic Threats and a New Payments Model

In addition to bank-specific risks there are the systemic threats that a public domain payments model could bring. One of the key features of the Internet is redundancy. Any one of a large number of possible paths can be used for a given transaction and therefore the failure of any one path or node will not affect the functionality of the network as a whole. This feature presents a multitude of new and -- from a banker's perspective -- previously unconsidered points of vulnerability to technologically-sophisticated miscreants. In a cyberworld of small value transactions, the effects of an attack may not be much more severe than those which accompany credit card crime. However, there is good reason to expect that Internet transaction sizes will

Some Concerns for the CyberBanker

Internal Data Security. The Internet cannot distinguish between customers and criminals. Invasive attacks can range from simple vandalism to theft or destruction of proprietary operating or customer data. Firewall software, data encryption, specialized hardware configurations and commercial insurance can limit such exposures.

External Transmission Security. Because the Internet is an open network, transaction messages are completely exposed, rendering them vulnerable to theft or tampering. Message encryption is a common response, but hardware implementation flaws can circumvent it. This threat will increase greatly if large value or interbank transactions migrate to the Internet.

Transaction Fraud. Fraud takes two forms: misrepresentation during a transaction or repudiation following it. This problem takes new dimensions in cyberspace because no physical relationship with a customer exists. Encryption protocols which include digital signatures are one response. Biometric authentication schemes, the most commonly proposed being fingerprint or retinal verification, are another.

Difficulties with Virtual Underwriting. Even if your cyber-borrowers are who they claim to be, there remain difficulties in establishing their creditworthiness. The lack of a personal relationship is one factor. The limited knowledge of local employers and credit grantors that appear on applications is another. Such difficulties could hasten and heighten dependency upon credit scoring models.

Liquidity Risks. Internet transaction volume and velocity are expected to increase rapidly, potentially creating transactions which occur so rapidly as to exceed immediate bank liquidity. Denial of service attacks, where a site is intentionally deluged with transactions in order to shut it down, also can affect liquidity if affected customers decide to close their accounts.

Lack of Technical Standards. An institution building an early presence on the Internet is making a financial bet as to which standards will endure.

Lack of Regulatory and Legal Infrastructure. Regulators are waiting and observing. Future promulgated "best practices" may not be those which an institution has already adopted. Similarly, a lack of legal precedent hinders criminal and civil prosecution of cybercriminals. Even where precedent exists, it is frequently inconsistent across jurisdictions.

Reputation Risk. An image of solidity is a cornerstone of banking. Internet banking confronts banks with more exposure and potentially greater publicity about losses.

Competitive Risks. Unlike the operational risks discussed above, competitive risks accrue to institutions not securing an Internet foothold. They involve the threat of lost market share or payment system position to more aggressive peers and nonbank competitors.

continue to grow. According to one software vendor, *interbranch* payments on the Internet are likely to begin in 1997 with *interbank* activity to follow a year or so later. This development would be a significant evolution because wholesale transactions are generally large relative to bank liquidity. An attack or disruption of the Internet payments mechanism for a single large transaction could conceivably pass liquidity shocks to other banks in the same way that bad weather at a major airport can disrupt air traffic throughout the country.

New Technologies, Old Reporting

The advent of fully transactional web sites also could heat up bank competition for low cost deposits and frustrate regulatory oversight in the process. One possibility is a “deposit arbitrageur,” a hybrid of brokered deposits and program trading in which a computer program could search the Internet for the highest deposit rates and immediately reallocate deposits accordingly. In the long run, such activities could harmonize local interest rates. In the short run, however, this rapid turnover could mean substantial liquidity drains on institutions accustomed to local deposit monopolies. From the regulatory perspective, this transaction velocity -- and its potential to rapidly alter bank balance sheets -- could present new challenges in a world of quarterly Call Reports and examination intervals that can exceed one year.

FDIC -- the CyberRegulator

New risks demand new supervision techniques and the FDIC’s Division of Supervision (DOS) has responded with their recently-released electronic banking safety and soundness examination guidance. Under that guid-

ance, institutions having Internet sites are placed into one of three tiers based upon the “maturity” of their site. Safety and soundness examination procedures focus on bank policies, procedures and planning. The examination procedures are cumulative -- meaning that each successive tier adds an additional level of scrutiny to the tiers below -- and do not require a technical knowledge of Internet systems. “Information Specialist” involvement also varies by tier (see Table 1). A DOS training program for all safety and soundness examiners already has begun, and technical training for information systems specialists is being developed. A new specialty, the electronic banking Subject Matter Expert, also is being established.

Measured Steps in a New Environment

Banks increasingly are becoming distributors of commodity-like products. As such, profitability may become dependent upon both cost efficiencies and high volume -- a combination sometimes argued as inconsistent with high-cost branch structures. Internet banking offers institutions a means to compete in this new environment. It also offers new risks. Recognizing this tradeoff, many banks have entered this realm with measured steps. Those who have not face risk of a different sort. They face instead the risk that their competitive position will pass to more innovative competitors -- competitors with new technologies and the drive to accomplish old business in thoroughly new ways.

*Gary Ternullo, Senior Financial Analyst
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TABLE 1

THE DIVISION OF SUPERVISION CLASSIFICATIONS FOR INTERNET BANKS			
	<i>LEVEL 1</i>	<i>LEVEL 2</i>	<i>LEVEL 3</i>
DESCRIPTION	AN INFORMATION-ONLY SITE	A SITE PERMITTING ELECTRONIC SUBMISSION OF LOAN OR DEPOSIT APPLICATIONS	TRANSACTIONAL SITE OFFERING ELECTRONIC BILL PAYMENT OR FUNDS TRANSFER SERVICES
SPECIALIST EXAMINATION REQUIREMENT (IN ADDITION TO SAFETY AND SOUNDNESS EXAM)	INFORMATION SPECIALIST REVIEW REQUIRED ONLY IF SITE IS TIED INTO INTERNAL BANK SYSTEMS.	CONSULTATION WITH INFORMATION SPECIALIST REQUIRED TO DETERMINE IF FURTHER REVIEW IS WARRANTED.	CONCURRENT INFORMATION SPECIALIST EXAMINATION REQUIRED.

For More Information:

Division of Supervision

DOS currently is implementing examination guidance for safety and soundness examiners and developing training for technical specialists.

*Cynthia Bonnette, Examiner
Chairman, New Banking Technologies Task Force
(202) 898-6583*

*Stephen White, Information Systems Review Examiner
Chairman, Information Systems Subcommittee
Federal Financial Institutions Examination Council Task Force on Supervision
(202) 898-6923*

Division of Compliance and Consumer Affairs

DCA is reviewing new banking technologies from a consumer protection, fair lending and CRA perspective to provide guidance on compliance matters. DCA also is coordinating outreach efforts with consumer community groups.

*John Jackwood, Special Assistant to the Director
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Regional Office Contacts

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Office of Policy Development

OPD provides leadership in developing FDIC policies, including those addressing new banking technologies. The office coordinates several interdivisional electronic banking efforts and represents the FDIC on the interagency U. S. Treasury Consumer Electronic Payments Task Force.

*Sharon Powers Sivertsen, Director
(202) 898-8710*

Related Web Sites

FDIC	http://www.fdic.gov
FFIEC	http://www.ffiec.gov
NETBanker	http://www.netbanker.com
Bankweb	http://www.bankweb.com
National Computer Security Assoc.	http://www.ncsa.com
RSA Data Security Inc.	http://www.rsa.com
Smart Card Resource Center	http://www.smart-card.com
American Bankers Association	http://www.aba.com

Boston Region: Will Past Problems Aggravate Any Future Downturn?

- While New England's economy continues to expand at a steady pace, the Region's banks have experienced only modest commercial loan growth.
- The modest recovery in construction activity during the last few years apparently has not been accompanied by large-scale speculative building or significantly higher lending by area institutions.
- Residential real estate markets in Massachusetts are fueling loan growth for the state's banks.
- In Connecticut, growth in technology, services, and tribal gaming employment are helping to offset continued declines in aerospace and defense, insurance, and banking.

New England Recovery Continues

Last year saw the Boston Region's nonfarm employment increase 1.7 percent over 1995. This increase was modestly below the national rate of 2 percent. Massachusetts accounts for almost one-half the Region's employment base, with Connecticut holding another 25 percent. Both states have witnessed positive job growth for the last four years.

As businesses have expanded their employment and revenues, tax receipts across the Region also have risen. Chart 1 shows the relationship between overall business activity (as measured by gross receipt and general sales taxes) and commercial and industrial (C&I) lending at all FDIC-insured institutions in the Boston Region.

Between 1992 and 1996, taxable receipts for the entire Region increased at an average rate of 4.6 percent per

year, while C&I loans grew by an average of 5.7 percent per year. Relative to 1990, however, tax receipts were 23.5 percent higher in 1996, while C&I loan volume ended the year up only 6.4 percent.

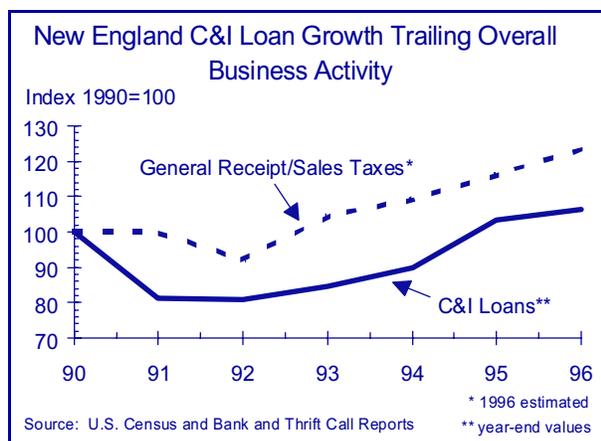
Implications: Should New England experience a slowdown, the Region's modest commercial credit exposure could result in fewer dollars at risk to declining credit quality and rising default rates.

Will Past Problems Aggravate Any Future Downturn?

As the Region's insured institutions see their loan portfolios grow (however modestly), concerns may arise over the potential for an economic downturn. At this time it does not seem likely that the Region will fall into a recession on its own. New England generally is in step with the nation in terms of turning points in employment and economic growth (both the U.S. and the Region's last troughs in nonfarm employment occurred within two months of each other). As a result, a national downturn would have a near-simultaneous dampening effect on the Region's economy.

To determine what factors could pose risks to the New England economy, it is useful to examine some of the key sectors that amplified the severity of the last recession. Particular attention will be given in this article to construction in Massachusetts and aerospace and defense manufacturing, insurance, and banking in Connecticut. Although these sectors still pose some downside risks to the Region's largest economies, their effect on insured institutions today should be less severe than what was seen in the early 1990s.

CHART 1



Could Massachusetts' Real Estate Market Overheat (Again) Anytime Soon?

Although commercial construction activity has picked up modestly during the current expansion, there has been little in the way of new speculative building. The greater Boston area dominates the state's commercial real estate market, and most new construction there has been in significantly pre-leased or built-to-suit sites.

In addition, the state's insured institutions have been on the sidelines with respect to development loans. Although total construction employment in the Bay State increased by almost 28 percent between 1992 and 1996, annual average construction and land development loan balances at all insured institutions actually fell 25 percent.

Some might argue that the pick-up in construction employment in recent years has arisen mostly from the nation's largest infrastructure project -- the multiyear Central Artery/Tunnel project in downtown Boston (the "Big Dig"). This project is an area of construction activity in which there typically would be little demand for funds from insured institutions -- and thus would explain the lack of loan growth. However, this project is not the driving force behind the state's increase in construction-related employment.

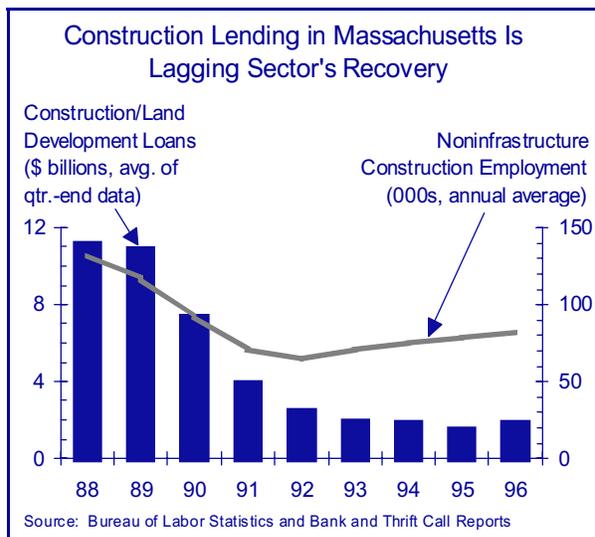
While employment in heavy construction did rise almost 34 percent between 1992 and 1996, this rise accounted for only 14 percent of the net gain in construction jobs during this time. Most of the growth occurred in nonpublic construction (specialty trades and general contractors), which rose by about 27 percent over the last four years. This growth represented job generation mostly



tied to construction of new residential and nonresidential structures -- areas where banks and savings institutions traditionally have provided significant funding. Chart 2 highlights the restrained growth in construction lending in Massachusetts.

Implications: Market fundamentals at the present time do not appear to point toward an overbuilt market -- office and industrial vacancy rates around Boston are among the lowest in the nation, while overall construction employment and commercial building activity remain well below their late-1980s peak. These fundamentals generally should cushion insured institutions'

CHART 2



existing real estate portfolios if the commercial market experiences a downturn.

Massachusetts' Home Sales Supporting Loan Growth

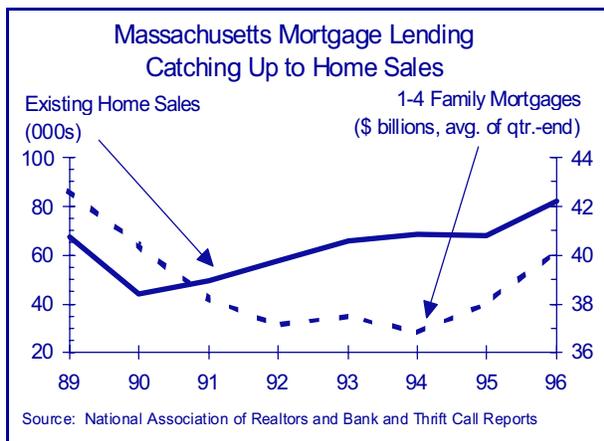
Existing home sales have risen dramatically across Massachusetts since 1990. The elimination of rent controls around the greater-Boston area, the lack of quality rental housing, steady job growth, low mortgage rates, and high consumer confidence all have led to greater sales and median home prices.



In 1996, existing home sales jumped 21 percent across the state. The number of sales tracked through the *Massachusetts Association of Realtors* set a new record, beating the prior all-time high achieved in 1987. Even the state's previously overbuilt condominium market has seen a resurgence in both sales and prices.

Chart 3 (next page) illustrates the state's escalating appetite for owned homes and the effect it has had on mortgage origination volume at insured institutions. Although mortgages on 1-to-4 family homes grew little during the first few years of the recent home-sales boom, they began to increase within the last two years. Volume rose 4 percent in 1995 and 5.3 percent in 1996, after remaining essentially unchanged between 1991 and 1994.

CHART 3



Implications: Industry sources expect home-sales activity to level off or decline modestly in 1997. Building activity has been modest, with the level of permits statewide up only 5 percent between the end of 1992 and 1996. Because housing construction and unsold inventory have not accelerated dramatically during the current cycle, it is not likely that there will be a repeat of the 1980s glut of condominiums or other overbuilding of residential real estate in Massachusetts in the near future. In most cases, this situation should mitigate risks to residential lenders in the event of an economic slowdown.

Defense and Insurance Still Downsizing in Connecticut

The last recession was particularly hard in Connecticut because of secular effects that amplified the cyclical decline. Prime examples include the mass layoffs in aerospace and defense manufacturing, insurance, and banking associated with consolidation in these industries. Although the statewide share of labor income and jobs related to aerospace and defense, insurance, and banking may seem modest (see discussion below), local effects from defense and financial industry downsizing have been significant (e.g., the high office vacancy rates in Hartford due to shrinking insurance and banking employment).

Aerospace and Defense Manufacturing: With the end of the Cold War, procurement spending on aerospace and defense hardware began declining in the late 1980s -- with adverse effects on private-sector suppliers and local economies. (The closing of military installations also has hurt many local communities across the country

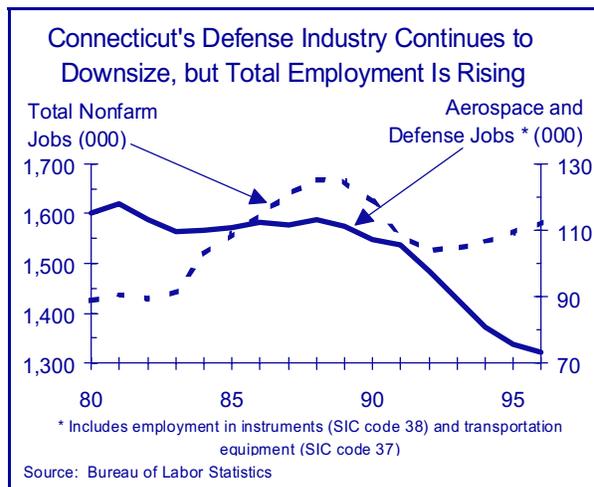
and the Region, but is not examined here). Aerospace and defense manufacturing employment began to drop-off in Connecticut by 1989 and has continued that trend ever since. (For the purposes of this article and due to constraints on the availability of detailed data, aerospace and defense employment is defined to include all jobs in transportation equipment and instrument manufacturing). Chart 4 highlights this sector's decline -- which has continued even as the state's overall employment levels have begun growing again.



By 1996, jobs in Connecticut's defense industry were about 35 percent below their 1988 peak. During the 1980s defense build-up, employment in that industry accounted for 7 to 8 percent of Connecticut's total job count and about 10 percent of the state's labor income. By 1996, defense jobs accounted for only about 4.5 percent of total employment and 6 percent of income. In the mid-1980s, Connecticut's share of labor income from defense was about four times that of the broader U.S. economy; in 1996, the state was three times more reliant on defense income than the nation as a whole.

The downsizing trend of the last eight years is likely to continue. Despite a pick-up in nondefense-related aircraft and parts demand, one of the state's largest suppliers has indicated plans for further layoffs in 1997. Current federal budget plans also may negatively affect local defense jobs over the next few years. In particular, the current budget cuts prior helicopter procurement plans, while spending on development of the next generation of fighter aircraft and additional nuclear sub-

CHART 4



marines is under scrutiny by the Pentagon and Congress. Any cuts in these areas would hit Connecticut's defense suppliers particularly hard given their focus on aircraft engine and parts, submarine, and helicopter production.

Insurance and Banking: In addition to defense, the state's insurance and banking industries also have been consolidating. The consolidation among banks is a common story nationwide, and Connecticut's industry has been no different. In the insurance business, consolidation and job losses in the state largely have been confined to life insurance carriers.

Travails in the insurance industry, such as losses due to bad real estate investments and increased nonindustry competition, have led to a shakeout of weaker firms. Chart 5 shows the recent trend in insurance employment. Like defense, insurance payrolls continue to decline. Employment in the industry fell 14 percent between the 1991 peak and 1996, mainly due to a drop among life insurance underwriters. Despite the large job losses, the state's reliance on the insurance industry as a source of income continues to be about three times that of the U.S. (where it has held for the last decade).

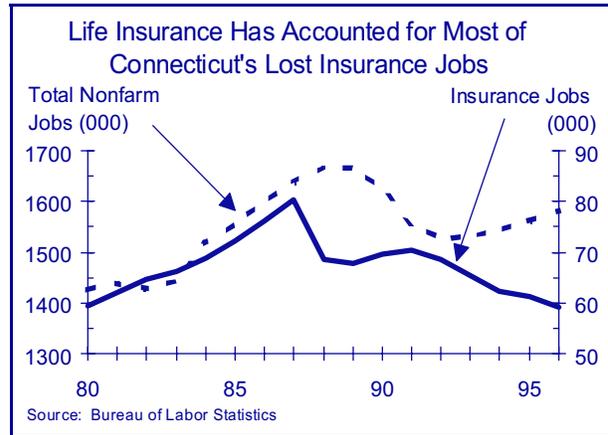


While not shown on Chart 5, banking jobs dropped by 38 percent between 1989 and 1996 -- falling 6.5 percent in the last year alone. The potential exists for further job cuts. In the absence of strong economic growth, Connecticut's institutions generally will increase market share and revenues at the expense of other players in the industry. Connecticut's reliance on labor income from banking is no more than that seen in the broader U.S. economy.

Despite Consolidating Sectors, Connecticut Economy Faces Lower Risks Today

Although consolidation and job losses seem likely to continue in defense, insurance, and possibly banking over the near term, this sectoral decline should represent less of a drag on the state's economy than in prior years. As noted in Charts 4 (previous page) and 5, total nonfarm employment has been rising across the state.

CHART 5



Job growth in tribal gaming, technology (such as fiber-optics, lasers, and software), and services have more than offset the declines in consolidating industries.

Implications: As evidenced by the state's positive overall job and income growth, Connecticut's downsizing industries should remain a modest drag on growth. The effect on loan portfolios from the state's recession lingers today. Although C&I lending increased steadily between 1991 and 1996, balances in 1996 (adjusted for out-of-state mergers) were still about 12 percent below pre-recession levels. Consumer loan balances (merger-adjusted) also are about 13 percent below their 1989 volume. Given their smaller portfolios and modest loan growth, the state's institutions should not be as heavily exposed to a potential downturn as they were prior to the last recession.

Norman Williams, Regional Economist

Financial Markets

- While demand for asset-backed securities continues to be strong, further deterioration in consumer credit quality could have adverse effects on both investors and issuers.
- Although there has been little net change in the Treasury yield curve between September 30, 1996, and early March 1997, rates in the 5-year to 30-year segment of the yield curve did fluctuate modestly during this time period.
- During the fourth quarter 1996, the S&P Composite Bank Index and the Boston Region's Bank Index (BRBI) both outperformed the S&P 500, each gaining about 12 percent, respectively, compared to an almost 8 percent gain for the S&P 500. So far in 1997, the BRBI has outperformed both the S&P Composite Bank Index and the S&P 500.
- Banks' price/earnings ratios relative to the broader market have been trending upward since 1994, perhaps signaling an improved perception of the quality of bank earnings.

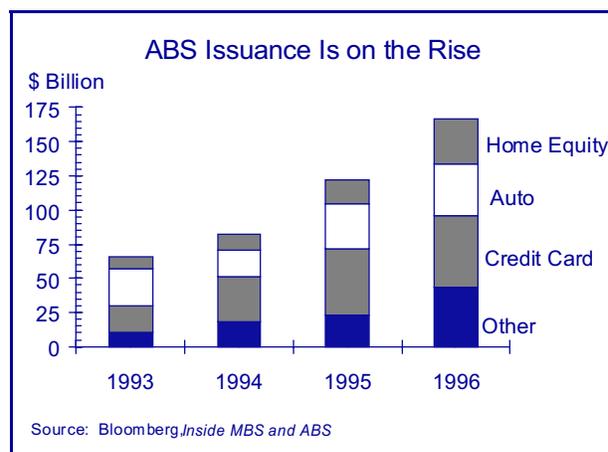
The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

Asset-backed securities (ABS) are debt securities that are backed by loans such as credit cards, car loans, and home equity loans. Over the past ten years, the ABS market has grown dramatically. In 1996, the issuance of ABS was \$167 billion, up from \$65 billion issued in 1993 as illustrated in Chart 1. Commercial banks and credit card companies accounted for approximately 35 percent of total ABS issuance last year. Major buyers of ABS were mutual funds, insurance companies, corporations, and foreign and domestic banks. Although it is difficult to quantify the amount of bank investment in the ABS market, market participants have observed that small and mid-sized banks have recently increased their holdings of ABS.

Monoline credit card banks and large banks with significant credit card operations have been particularly active ABS issuers. Issuing banks generally structure ABS transactions as nonrecourse sales (loans that cannot be "put back" to issuers upon default), which results in the removal of the assets from the bank's balance sheet and lowers capital requirements. In order to receive investment grade ratings on their ABS, issuers must provide credit support either in the form of over-collateralization, reserve accounts, or third party credit enhancement from bond insurers.

Bank issuers benefit from the sales treatment of assets into the security without completely severing their economic interest in the income generated by the assets. The economic interest results when the revenue generated by the sold assets after charge-offs, servicing fees,

CHART 1



and interest coupon payment is recognized as income by the issuer. This surplus is referred to as excess spread. Banks that issue ABS usually continue to service the underlying assets, which not only generates servicing income but also permits customer relationships to continue.

Delinquency and charge-off rates rose in 1996 on consumer loans, particularly in credit cards and auto loans. Despite this rise, the difference between ABS and Treasury yields of similar maturity did not increase. As Chart 2 (next page) shows, the average spread to the two-year Treasury note on selected ABS products continued to tighten during 1996. The lack of widening spreads despite the overall weakening in consumer credit quality reflects strong demand from an expanding investor base, which increasingly includes overseas

buyers. Spreads on selected credit card and auto ABS products began to increase during the first quarter of 1997, however, as investors reacted to higher than expected charge-offs reported by some of the larger issuers.

The increasing frequency of rating agencies' reviews for possible downgrades of credit card transactions, as well as problems in the auto finance sector, have raised some concerns in the ABS market. How would a further deterioration in consumer credit affect the ABS market? For the issuer, higher charge-offs, absent a corresponding increase in fees or rates, reduces the excess spread from the ABS. If deterioration worsens, the ABS face potential rating downgrades. This situation may compel the issuer to improve the overall loan quality in the ABS or face what is termed an "early amortization" event. An early amortization event may result in the termination of the ABS issue prior to the maturity date. Once an early amortization occurs, new receivables associated with the accounts in the asset-backed security no longer move into the security but must be funded by the bank on their balance sheet and accounted for in determining capital requirements. In addition, an issuer's access to the ABS market may become more costly after an early amortization if investors demand higher yields on subsequent issues.

For the investor, the threat of a ratings downgrade usually impairs the market value of the security. Investors also may forfeit some interest income in an early amortization because principal may be paid prior to the scheduled maturity date. ABS investors would lose principal, however, only if the deterioration in the quality of the underlying loans is severe enough to deplete the entire credit support. The high level of credit support demanded by rating agencies on existing

ABS deals minimizes the risk of principal loss by investors.

During 1996, some bankcard issuers took steps to prevent a ratings downgrade or a possible early amortization. Methods used by bank issuers to support deteriorating ABS have included the sale of new receivables at a discount, the repurchase of low quality receivables from the issue, and the infusion of additional cash into a reserve account of the ABS. However these strategies were specifically cited by the Office of the Comptroller of the Currency (OCC) as actions that could be considered recourse and require full risk-based capital treatment for the assets in the particular ABS issue. The FDIC is working with other regulatory agencies through the Federal Financial Institutions Examination Council (FFIEC) on new Risk-Based Capital Guidelines that are expected to address limitations on post-sale actions and capital requirements for direct credit substitutes or credit enhancements for ABS.

Given the continuing trend of higher charge-offs and delinquencies for credit card loans, investors consider the ABS market less homogeneous in terms of issuer quality and therefore are scrutinizing the securitizations of issuers more closely. Although the risks vary by ABS issuer, banks that issue or invest in the ABS market should be cognizant of the changing market conditions and potential risks associated with ABS.

Changes in Interest Rates and Bond Values

Chart 3 (next page) shows little change in the Treasury yield curve between September 30, 1996, and early March 1997. What this chart does not show, however, is how rates in the 5-year to 30-year segment of the yield

CHART 2

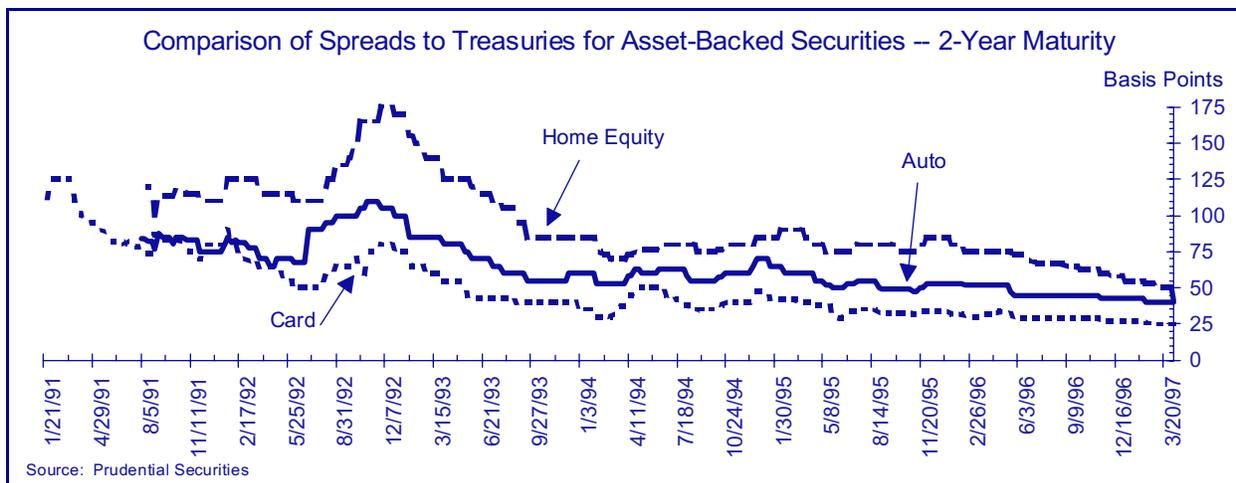
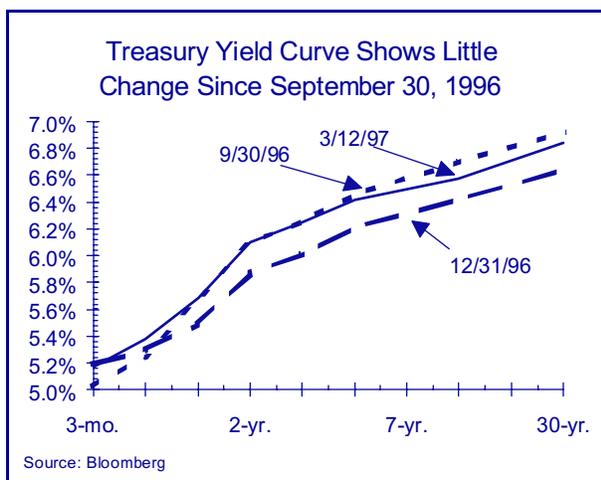


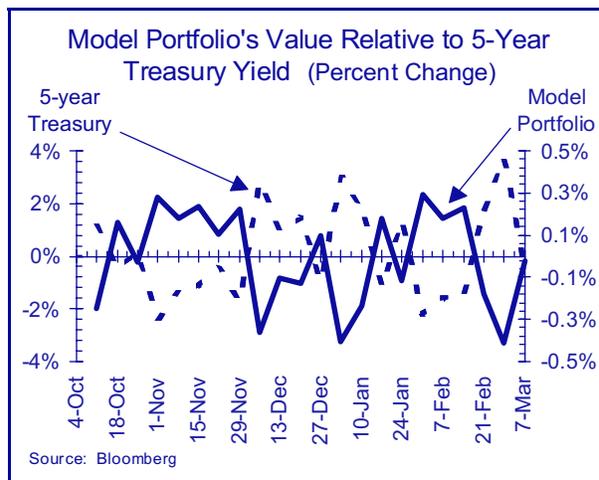
CHART 3



curve fluctuated during this time period. The path of yields on Treasury bonds with 5-year through 30-year maturities changed directions four times, rising or falling by more than 30 basis points. Movements in the shorter segment of the yield curve have been less pronounced.

In order to consider the effect that these rate swings may have had on banks' fixed income portfolios, Chart 4 shows the percent change in the yield on the 5-year Treasury and the percent change in the market value of a model bank portfolio created by the Division of Insurance. The presentation of this model portfolio extends an analysis that was introduced in the first quarter 1997 edition of the *Regional Outlook*, which looked at the market values of several common fixed income instruments relative to interest rate movements.

CHART 4



In order to enhance the model portfolio's applicability to bank portfolios, the type and amount of the securities chosen for the portfolio are based on an aggregation of securities-related Call Report data. The limitations of Call Report data concerning the maturity distribution of securities required that assumptions be made when choosing the maturity of the securities for the model portfolio. An effort was made, however, to construct a model portfolio that approximates, in the aggregate, the maturity distribution of the aggregate commercial bank portfolio. The model portfolio is shown in Table 1.

As shown in Table 1, the total market value of the portfolio changed less than one-half of 1 percent since September 30, 1996. The portfolio's period-high value, representing a 1.51 percent increase from September 30, 1996, occurred on November 29, 1996, when the 5-year

TABLE 1

TYPE OF SECURITY	PAR VALUE	PERCENT OF PORTFOLIO	MATURITY OR WAL	PERCENT CHANGE FROM 9/30/96 TO 12/31/96	PERCENT CHANGE FROM 12/31/96 TO 3/12/97	PERCENT CHANGE FROM 9/30/96 TO 3/12/97
U.S. TREASURY 5.6%	2,000	20%	1YR	0.35%	-0.05%	0.30%
FNMA AGENCY 5.8% CALLABLE	1,200	12%	2YR	0.59%	-0.25%	0.34%
STATE COUNTY MUNICIPAL GO 4.8%	800	8%	11YR	1.95%	-0.64%	1.95%
FNMA MORTGAGE PASSTHROUGH 7.5%	3,000	30%	8YR	1.08%	-0.30%	0.78%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5YR	0.58%	-0.68%	-0.10%
CREDIT CARD ASSET-BACKED SECURITY	1,000	10%	5YR	0.10%	0.00%	0.10%
TOTAL	10,000	100%	4.85YR	0.77%	-0.29%	0.48%

Treasury rate fell to its period-low of 5.83 percent. Observe that, while longer term rates fluctuated modestly over the reporting period, the reasonably short weighted average life (WAL) of the portfolio further moderated the value changes sustained by the portfolio. Changes in the value of the model portfolio demonstrate a higher correlation to changes in the 5-year Treasury yield than to other maturities along the yield curve because the 5-year bond's maturity better matches the WAL of the model portfolio. Even though the 30-year Treasury rate is often cited as a benchmark for daily rate changes, it may not be the most significant rate in assessing exposures of bank securities portfolios to changes in interest rates.



On March 25, 1997, the Federal Reserve Open Market Committee met and raised the target federal funds rate 25 basis points to 5.50 percent. By the following day, the 5-year Treasury yield had risen to 6.66 percent, 23 basis points higher than the 5-year Treasury yield dated March 12, 1997, displayed in Chart 3 (previous page). The rise in rates from March 12 to March 26 caused the model portfolio's market value to fall 0.56 percent to \$9,965.

This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect a portfolio's relative volatility.

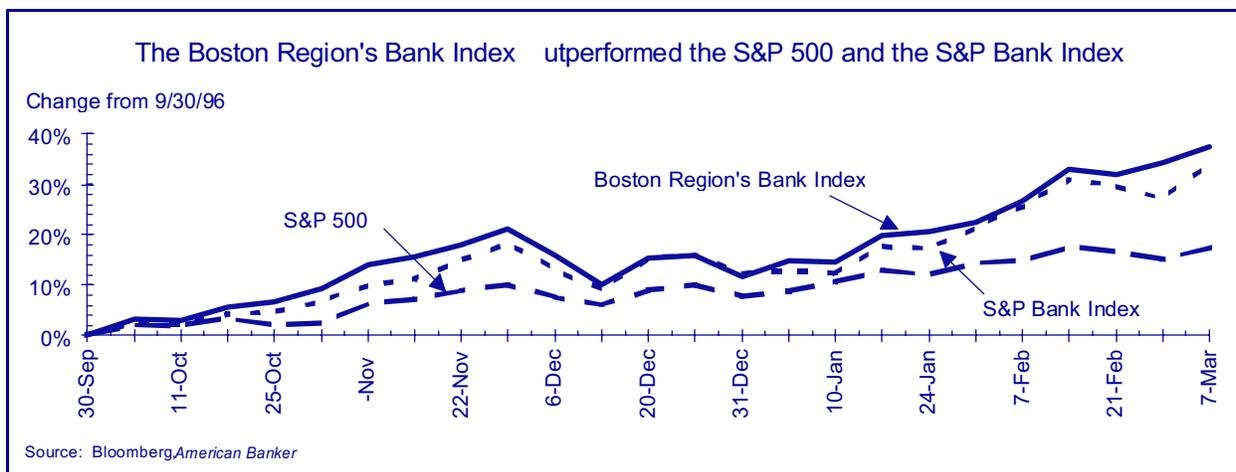
Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market Im-

proving its Perception of the Quality of Bank Earnings?

During the fourth quarter of 1996, the S&P Composite Bank Index outperformed the S&P 500, gaining over 12 percent compared to an almost 8 percent gain for the S&P 500. The fourth quarter results topped off a year during which the S&P Composite Bank Index gained 37 percent compared to a 20 percent gain for the S&P 500. As shown in Chart 5, the Boston Region's Bank Index (BRBI) gained almost 12 percent in the fourth quarter 1996. The BRBI gained almost 31 percent for the full year 1996: enough to outperform the S&P 500, but not the S&P Composite Bank Index. The year's moderate economic growth, contained inflation, and favorable interest rates are credited for providing a friendly environment for bank stocks. As 1997 began with much the same economic conditions, bank equities have continued to do well. The BRBI is up 23 percent compared to an almost 20 percent gain for the S&P Bank Index and a 9 percent gain for the S&P 500, through March 7, 1997. The BRBI has been driven particularly by the strong stock performance of Fleet Financial Group Inc, which is up 25 percent, through March 7, 1997. Fleet's stock has rallied on speculation that Chase Manhattan Corp. is planning a takeover bid. Chase's Chief Executive Officer, Walter Shipley, has denied that any such bid is planned.

While appreciating stock prices provide an obvious positive signal about the health of the industry, the market provides other information about the prospects for the industry through the price/earnings (P/E) ratio. The P/E ratio presents the price of a company's stock as a multiple of its earnings per share and is derived by dividing the stock's market value by the company's earnings per share. Typically investors are willing to

CHART 5

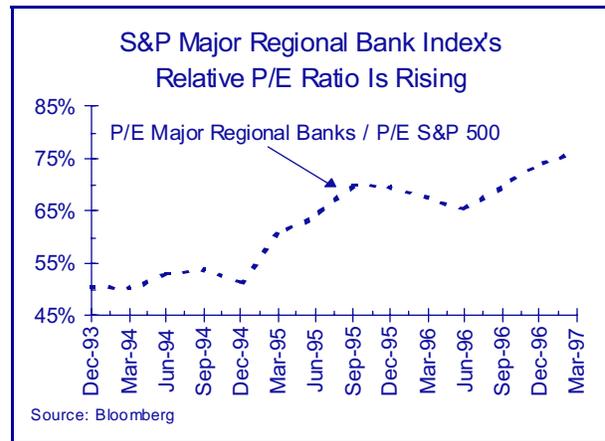


pay a higher price for a company with earnings that are expected to be consistent and growing. However, firms with more volatile earnings are generally penalized by investors in terms of stock price and lower P/E ratios. Generally, a higher P/E ratio can be interpreted to mean that investors have more confidence in the outlook for future earnings performance.

The relationship between bank P/E ratios and the P/E ratios for the broader market provides further insight into the market's perception of the quality of bank earnings compared to other firms. Historically, bank P/E ratios have been lower in the aggregate as compared to the rest of the market. The rationale posed for this discounted bank P/E ratio relative to the broader market has been that the primary sources of bank revenue, deposit taking and lending activities, traditionally have been viewed as being more volatile because they are prone to rising and falling with changes in the business cycle. For example, despite recording some of the highest quarterly return on equity averages ever at the end of 1993, the P/E ratio of the major regional bank index was at a level that was still only about 50 percent of the broader market P/E.

Over the past two years the magnitude of the banking sector's P/E discount has declined. As seen in Chart 6, the P/E discount has gone from 50 percent to only 24 percent (a relative P/E ratio of 76 percent). The higher P/E ratio may represent a view by market participants that bank earnings are becoming less sensitive to the business cycle, perhaps as a result of geographic or product-related diversification and more efficient man-

CHART 6



agement of overhead expenses. Another factor contributing to higher bank P/E ratios could include speculation on bank stocks as investors anticipate potential acquisitions.

*Allen Puwalski, Banking Analyst
Kathy R. Kalsner, Chief,
Financial Sector Analysis Section*

Regional Banking Conditions

- The Boston Region's insured institutions have come full circle from the problems of the last recession.
- Credit card debt continues to cloud an otherwise bright asset quality picture.
- Lackluster growth in core loans and deposits points to increased competition for market share.
- Structural changes in funding mix may have negative long-term implications.

Region's Banking Health Comes Full Circle

The overall condition of the New England banking industry continues to improve as positive economic factors coupled with the long period of relatively low interest rates have resulted in earnings and capital levels that now exceed pre-recession levels. In 1996, insured institutions in the Boston Region had return on assets (ROA) exceeding the national average for the first time since 1988. An aggregate ROA of 1.16 percent was attained, with commercial banks earning 1.29 percent and savings banks 0.95 percent. Only 4 percent (18 companies) of the Region's insured institutions reported losses for the full year, the lowest level since 1986. At the height of the recession, nearly one-half of all insured institutions in the Region were operating at a loss.

As of year-end 1996, the Tier 1 leverage ratio was 7.91 percent and has risen 95 basis points since year-end 1992. The increase in capital ratios was more pronounced at small and midsized institutions; larger institutions tend to maintain higher degrees of leverage to enhance returns on equity. As demonstrated in Chart 1,

the median Tier 1 leverage ratio for both commercial and savings banks has risen at a faster pace than the average for the Region as a whole.

Best Examination Results Since Implementation of the Uniform Financial Institutions Rating System

As conditions have improved, on-site examinations have noted steady and significant improvement in the overall financial condition of supervised institutions in the Region. The average composite CAMEL (now CAMELS) rating assigned for all examinations conducted in 1996 was 1.78, the lowest that measure has been since the Uniform Financial Institutions Rating System was implemented in 1979. In fact, 1996 was the first time that the average of the CAMEL rating's five individual components were each below "2." As Chart 2 indicates, the number of FDIC-insured bank failures is returning to pre-recession levels. In the period between the FDIC's inception in 1933 and the onset of the last recession in 1989, the Region averaged only one failure every three years.

CHART 1

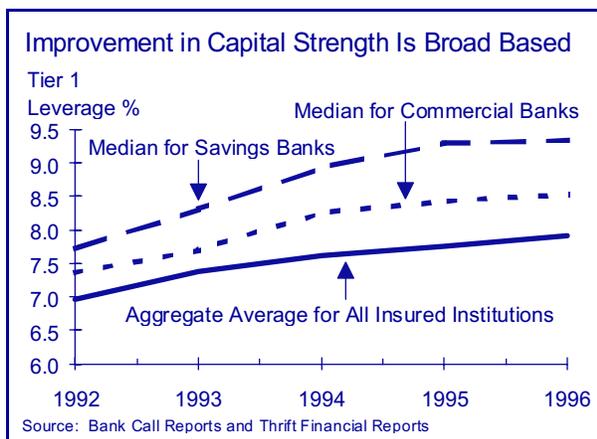
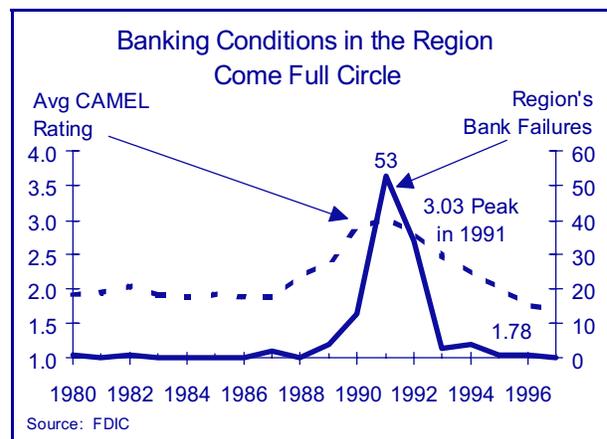


CHART 2



Credit Cards Continue to Evidence Weakness

Asset quality continues to improve, with credit card lending the only asset sector reflecting any significant deterioration. As noted in the first quarter 1997 edition of the *Regional Outlook*, personal bankruptcies continue to rise to record levels, and credit card delinquencies and losses have risen in lock step with that trend.

Delinquencies rose to 4.1 percent from 3.2 percent one year ago and net charge-offs were 3.3 percent compared to 2.5 percent in the prior period. Both delinquencies and charge-offs are below the national average. However, in this Region, credit card loans grew nearly 50 percent in 1996, which masks the true performance of the underlying seasoned portfolio of loans. If net losses are related to outstandings at the beginning of the year, the Region's loss rates fall in line with the national average.

Credit cards are dominated by a few players in the Region who thus far have demonstrated an ability to maintain profitable operations through difficult periods. However, losses and delinquencies have risen to near record levels in a period of moderate economic growth and will likely go higher if the economy softens. Additional interest rate increases following the recent tightening by the Federal Reserve also may put pressure on consumer debt payment capacity. The consumer sector remains an area deserving close scrutiny.

Core Asset Growth Continues to Lag the Nation

After adjusting for a major restructuring of Fleet Financial Group's New England banking franchise in anticipation of its acquisition of New Jersey-based NatWest Bank, asset growth in this Region was approximately 6 percent in 1996. Nearly one-half of the growth appears

to be attributable to factors not directly related to the Region's economic growth; specifically, national credit card programs, loans to other financial institutions, foreign loans, and goodwill. The remaining growth was centered in securities, which suggests that loan demand remains subdued within the Region.

While total loan growth in the Region did not keep pace with the nation, significant growth was noted in construction loans (up 17 percent) and leases (up 17 percent). As certain real estate markets have tightened, particularly around greater Boston and in Fairfield County, CT, construction activity has shown some signs of life. While the rate of growth in construction loans is significant, exposure to this sector by the Region's



banks remains well below pre-recession levels. As Chart 3 indicates, the number of institutions with exposure exceeding 100 percent of equity capital is small relative to the boom period leading up to the last recession. At year-end, construction loans of \$3.5 billion approximated 1 percent of assets and 13 percent of equity for all insured institutions in the Region. In contrast, at the peak of

the building boom in 1988, construction loans totaled nearly \$22 billion, 94 percent of total equity, and were a primary causative factor in many of the bank failures that followed.

Institutions Take Different Roads to Restore Profits

From an aggregate perspective, the Region's earnings performance has improved consistently over the past five years, from a reported ROA of 0.53 percent in 1992 to 1.16 percent for the current year. As seen in Table 1,

CHART 3

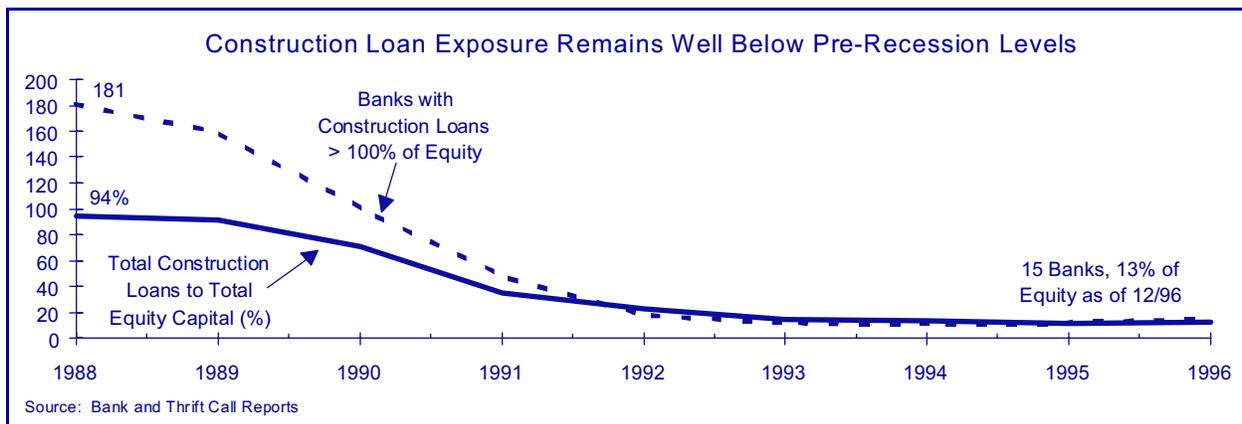


TABLE 1

KEY COMPONENTS OF THE REGION'S EARNINGS PERFORMANCE					
% OF AVERAGE ASSETS	1996	1995	1994	1993	1992
NET INTEREST INCOME	3.60	3.69	3.70	3.74	3.56
NONINTEREST INCOME	2.21	1.86	1.77	1.61	1.66
NONINTEREST EXPENSE	3.81	3.76	3.78	3.90	3.95
LOAN LOSS PROVISIONS	0.19	0.23	0.21	0.38	0.70
NET INCOME	1.16	1.01	0.96	0.82	0.53

SOURCE: BANK AND THRIFT CALL REPORTS

the improvement is largely attributable to considerable growth in noninterest income and a steady decline in the provision for loan losses. Improved earnings are evident for institutions of all sizes; however, large and small banks have taken different paths to achieve this earnings growth.

Large and specialized banking firms have actively sought out means to expand and diversify fee-based revenue sources. For example, trust fees account for approximately two-thirds of the increase in the Region's noninterest income as measured against average assets and have been particularly strong in the past two years. A buoyant stock market has contributed to solid growth in assets under management and has resulted in strong trust-fee growth. The bulk of this growth is centered in only ten companies that account for 94 percent of all trust fees. Other fees, such as those derived from mortgage servicing, investment advisory services, and credit card operations, have generated most of the remaining growth in noninterest income. This growth also is mostly centered in the larger banks and specialized institutions.

In contrast, most insured institutions have had little success expanding revenue sources significantly beyond the traditional balance sheet based mechanisms. As Chart 4 depicts, the median level of noninterest income to assets for both commercial and savings institutions in the Region has been flat over the past five years.

Most institutions have improved profitability through the more traditional mechanisms of margin management, cost containment, and lower loan loss provisions. For these institutions, strong net interest margins have been the primary contributing factor to the earnings rebound. Several factors have contributed to this strength, including a steady decline in nonperforming assets and a growing tangible equity base. However, two other

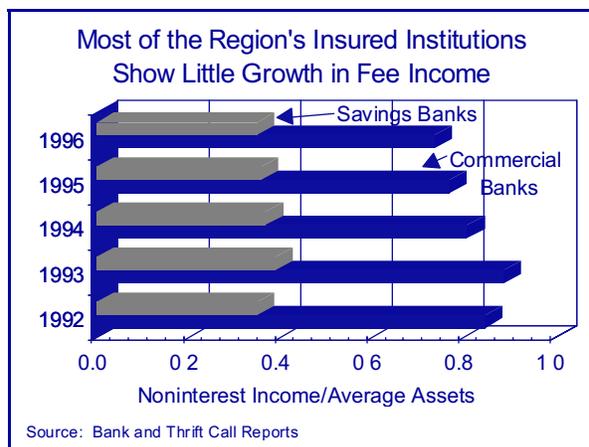
factors stand out as being critical to the maintenance of strong margins.

Margins Boosted by Favorable Interest Rates and Management of Nonmaturity Deposit Costs

First, insured institutions have benefited from a historically wide spread between the prime rate and short-term market rates, such as the federal funds rate, which has approximated 300 basis points since 1990. Prior to this time, the spread averaged well under 200 basis points. The widening of the basis between these measures has had a positive impact on portfolio yields, particularly in institutions that have a higher percentage of loans tied to this index.

Second, managing the cost of nonmaturity deposits (savings, NOW, and money-market deposit accounts) has been a major contributor to maintaining strong net interest margins over the past three years. In 1996,

CHART 4



average short-term market interest rates were approximately 225 basis points higher than in 1993. The cost of nonmaturity deposits for the Region's insured institutions rose only 30 basis points over that timeframe.

In short, a favorable interest-rate environment and bank funding mix combined to produce high net interest margins for institutions in this Region following the last recession. These conditions are not likely to last indefinitely, however.

Core deposits at the Region's banks and thrifts have been flat for several years. Core deposits now fund approximately 60 percent of the Region's assets, down from 64 percent one year ago and 68 percent in 1993. Additionally, there has been an ongoing shift from lower cost NOW and savings accounts into retail certificates of deposit and money-market deposit accounts. This shift, coupled with increased reliance on noncore funding actually has offset the benefit that has been derived from holding down costs on nonmaturity deposits. Institutions that historically have relied heavily on nonmaturity deposits are actually experiencing declining net interest margins as a result of the shifting funding mix. This trend is likely to continue and may accelerate if interest rates continue to rise.

Daniel E. Frye, Senior Regional Analyst



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