
◆ Regional Outlook ◆

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■ ***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 6.*

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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.



The Chicago Region may be especially sensitive to changes in small-business lending patterns and practices given its large number of community banks and thrifts. In fact, small-business lending has been such a large focus that, at midyear 1996, commercial banks in this Region reported \$37 billion of small-business loans, or about 30 percent of all commercial and industrial loans. (For purposes of this article, small-business lending refers to loans categorized as commercial and industrial

loans with original amounts of \$1 million or less reported on the June Call Reports.) There were 547 banks in the Region with small-business loan exposures exceeding 100 percent of equity, and 121 banks with exposures exceeding 200 percent of equity.

Though varying significantly from state-to-state, small and midsize institutions hold over 50 percent of the Region's small-business loan exposures (see Chart 1 next page). However, *some* large banking companies have announced nationwide programs to increase their market share of small-business lending. These nationwide programs may have been prompted by new credit scoring technologies that have reportedly allowed some companies to offer pre-approved lines of credit.

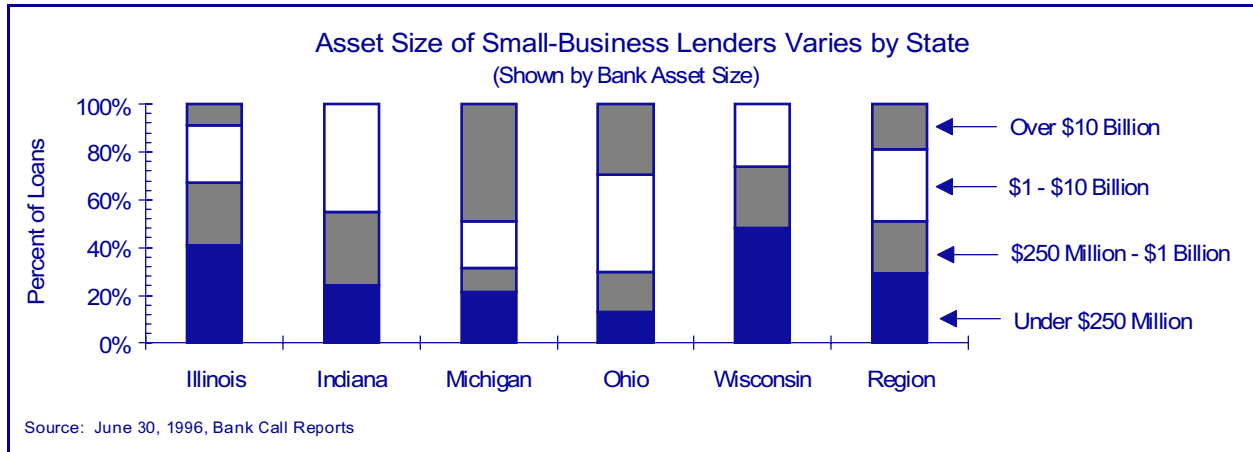
The Growing Importance of Credit Scoring

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 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 in-

CHART 1



volved 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?

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 next page). 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*

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.

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 businesses 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 partici-

pation 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.

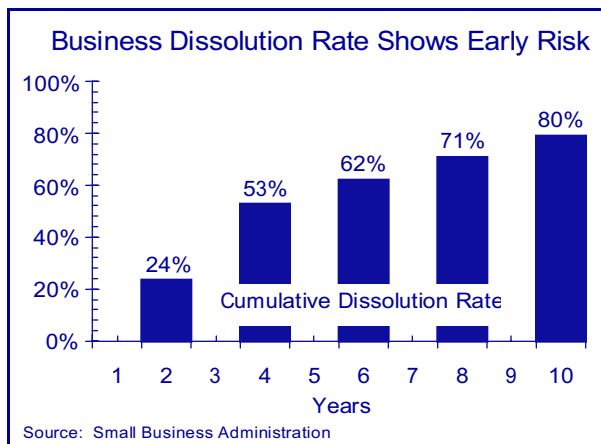
The most recent *FDIC Survey of Underwriting Practices* and the *Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices* both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth 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

CHART 2



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

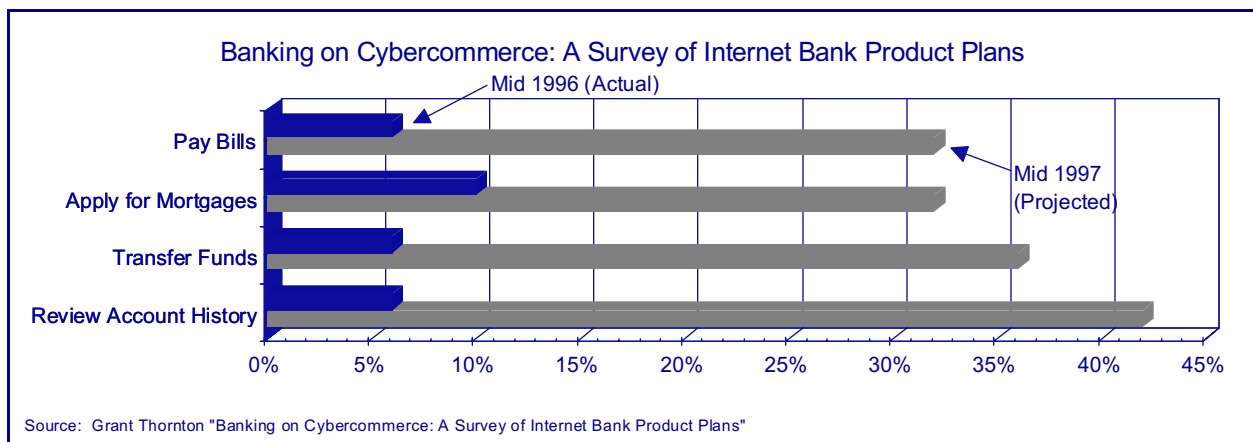


do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. 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 Chicago Region, 152 institutions have an Internet presence but only three allow customers to pay bills or

CHART 1



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 cyber-world 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 continue to grow. According to one software vendor,

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.

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 guidance, 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.

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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
(202) 942-3854*

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

Chicago Region's Economy Remains Healthy

- Currently high levels of production and tight labor markets suggest that growth in manufacturing output will be moderate and sustainable in the absence of a national downturn.
- A pick-up that is under way in commercial construction has been accompanied by rapid growth in construction-related lending by banks and thrifts. To date, new commercial space in the Region appears to match expanding demand.
- A significant share of low-income households face heavy debt burdens, and these consumers could be severely strained by rising interest rates or an economic slump.
- The 1996 Farm Bill may start influencing farmers' behavior this year even though many provisions will be phased in over seven years. Because the legislation reduces protections for farm producers, risk management practices of farmers and their lenders may be tested.
- Given these considerations, insured institutions in the Chicago Region may face moderate loan growth and continuing problems with portfolio segments such as credit cards.

Production Rebound in 1996 Set the Stage for Economy in Early 1997

Growth in factory output almost stalled about one year ago (see Chart 1) because excess inventories held by auto dealers and other firms necessitated slower production. After this adjustment, manufacturing output resumed its growth and now is expanding by more than 4 percent annually. This situation is positive for the Region, which is heavily influenced by developments in the manufacturing sector.

Even so, many manufacturers in the Region are facing prospects of moderate growth. This condition is the result of limited additional demand for many types of manufactured goods in the seventh year of the cyclical expansion. For example, if auto makers' sales forecasts of 15.5 million units are realized this year, the associated gain from 1996 will be only 3 percent or so. This pace pales in comparison with the 8 percent gains in 1993 and 1994, when the cyclical expansion was younger. In turn, slow growth in the motor vehicle sector will generate dampening spill-over effects to steel, tires, glass, and other related industries in the Chicago Region.

Implications: Growth in commercial and industrial (C&I) loans (see Chart 1) tends to lag shifts in the pace of manufacturing activity. Nationwide, C&I loan growth slowed to 6.7 percent last year from 12.7 percent in 1995. In the Chicago Region, growth slowed a bit less

sharply, to 8.8 percent from 13.7 percent.

If the historical relationship between industrial production and loans shown in Chart 1 continues to hold, a moderate pick-up in C&I loan growth may develop this year. This expectation is consistent with findings in the *Federal Reserve's January Survey of Senior Loan Officers*. Recent employment trends (see Chart 2) hint that demand for loans from the construction and finance-insurance-real estate (FIRE) sectors might expand more rapidly than from some other sectors if last year's job trends carry over into 1997.

CHART 1

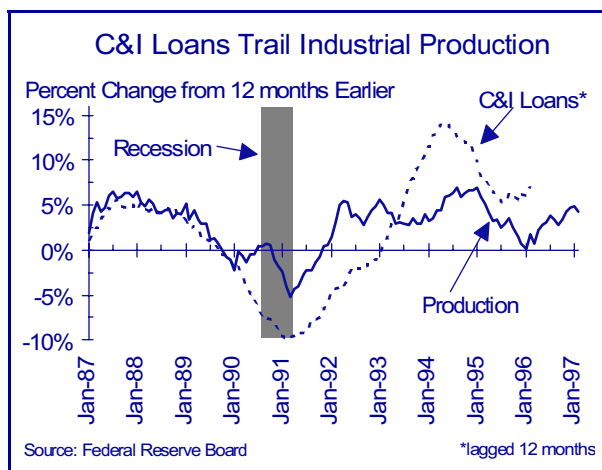
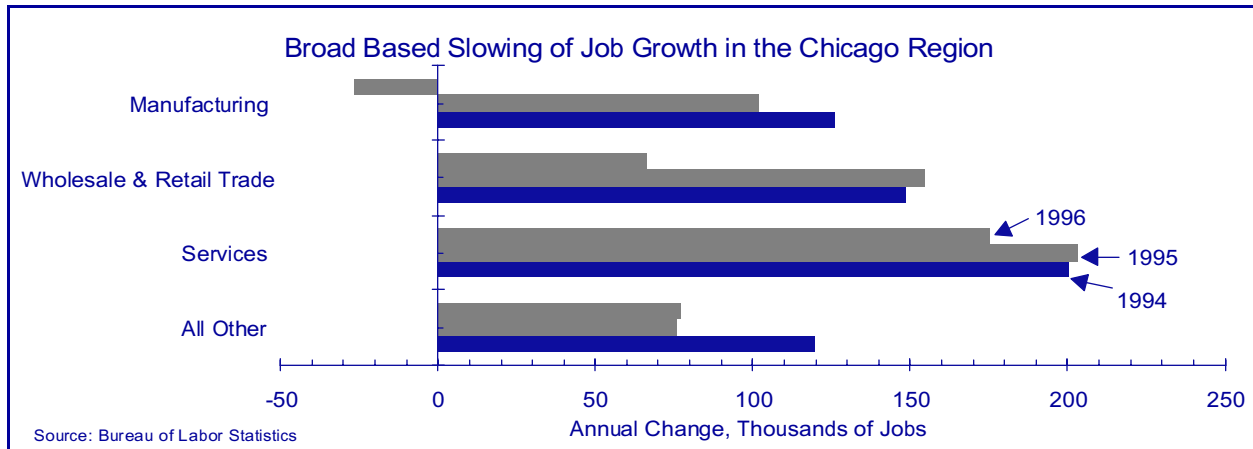


CHART 2



Job Growth Is Slowing...

Slower growth in demand and production already is reflected in the job market (see Chart 2). *Job gains in the Region slowed to 292,100 last year, just over one-half as large as in 1995.* The softening was broad based among industries. In fact, 26,700 factory jobs were lost despite the rebound in manufacturing output. Only the construction and FIRE sectors saw a pick-up, but they account for less than 10 percent of the Region's total employment.

Despite the slowing in job growth, the Region's unemployment rate remains low. The 4.5 percent unemployment rate for the Region at year-end reflected tighter labor-market conditions than nationally, where the rate was 5.3 percent. As a result of the continuing demand for workers and the current tightness in labor markets, wages are being bid up in a number of industries. Wages of manufacturing employees, for example, rose by 3.3 percent last year, faster than the 2.9 percent advance in 1995 and the largest increase since 1991.

...But Wage Gains Raise Policy Concerns

The acceleration in wage gains is just one of many indicators being monitored by policymakers. In late March, the Federal Reserve Board responded to persistent strength in demand and the potential risk of inflationary imbalances by raising the target federal funds rate by 25 basis points. Many banks reacted by raising their prime rates by an equal amount. The policy action was the first move toward restraint in more than two years. Should rates rise significantly in the coming months, activity in the interest-sensitive manufacturing sector likely would be dampened.

Implications: Should interest rates continue to rise,

insured institutions could be affected in a number of ways:

- Loan demand from interest-sensitive industries likely will weaken, and some borrowers may encounter repayment difficulties.
- Profitability is typically squeezed in a rising-rate environment because funding costs tend to rise more quickly than earnings on assets.
- Rising interest rates reduce the market value of fixed-rate securities.
- Banks that have shifted away from traditional core deposits as a funding source may face higher and more volatile funding costs as they borrow at market rates (see *Chicago Region Banks and Thrifts React to Changing Environment*).

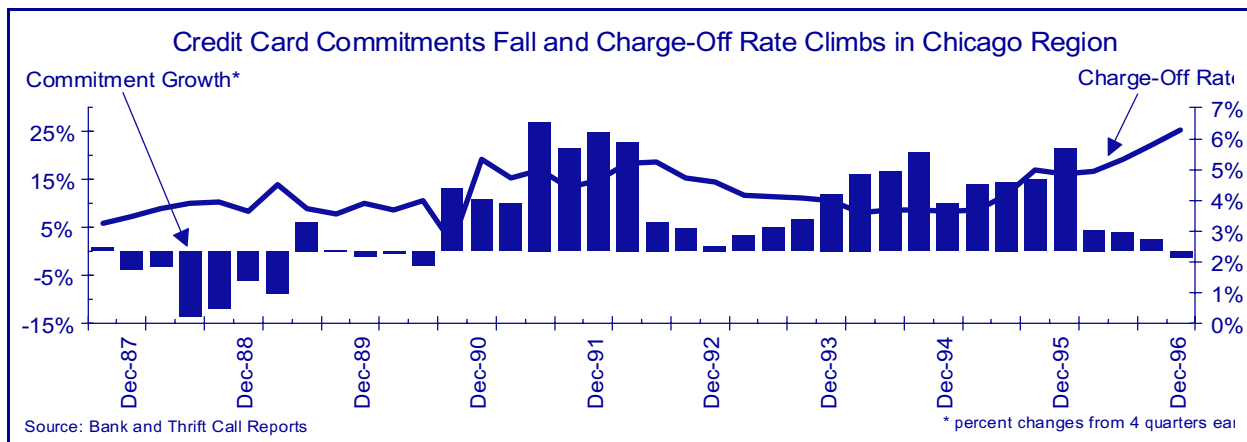
Mixed Developments in Household Finances

On the surface, high and rising bankruptcy rates in the Region seem hard to reconcile with low unemployment rates and generally prosperous economic conditions. Heavy debt burdens among some higher-risk borrowers and a late-1994 change in the bankruptcy law, which was followed by a surge in Chapter 7 filings, help explain some of the seeming contradiction.

A recent study of consumer finances by the Federal Reserve suggests that households' currently high debt obligations do not imply dire macroeconomic implications. For example, the ratio of debt payments to family income was 15.4 percent in 1995 for all families. This ratio differs little from 15.8 percent in 1992 and 15.6 percent in 1989. (These statistics reflect the ratio of debt payments to income for all families, not just those with debt outstanding.)

So far this decade, however, debt payments relative to

CHART 3



income have risen for lower-income families. Among families with incomes less than \$10,000, debt payments increased from 16.2 percent of income in 1989 to 21.1 percent in 1995. The share of families with incomes between \$10,000 and \$24,999 and debt payments equal to 40 percent or more of income rose from 13.9 percent in 1989 to 16.9 percent in 1995.

In contrast, high-income families experienced an easing of debt-payment burdens over the same period. Mortgage real estate financing accounted for a good deal of the decline. These divergent trends reflect that debt loads of low-income groups are already quite heavy and suggest that the repayment ability of these households could be severely strained if income growth falters.

Problems with consumer credit have been well documented. Credit card charge-offs remain a concern (see Chart 3) because the deterioration in these loan portfolios has occurred despite favorable economic conditions. Past-due residential mortgage loans have increased in tandem with credit card delinquencies. In the Midwest (which covers the FDIC's Chicago and Kansas City Regions), conventional mortgage loans past-due by 30 days are currently below their early 1996 peak but remain elevated at 1.71 percent. Associated with this rise has been a recent increase in the rate of initiated foreclosures to 0.14 percent from a low of 0.08 percent two years ago.

Implications: Growth in credit card commitments has slowed in this Region since warning signals developed over one year ago (see Chart 3). Nevertheless, commitments in this Region stand about seven times larger than balances outstanding, thus generating large potential exposure for some institutions. If the economy should

slump, the quality of this portfolio could worsen despite the corrective actions already undertaken by banks and thrifts.

Some institutions are reacting to the increased riskiness of, and increased competition for, unsecured consumer loans by encouraging customers to switch to home equity loans. The latest *Federal Reserve Survey of Senior Loan Officers*, however, reported that about one-third of the responding institutions also eased standards recently for home equity loans, in some cases because they were entering the market for low- or no-equity loans. Other reports suggest that a few lenders (not necessarily banks or thrifts) are allowing very aggressive loan-to-value ratios on home equity loans.

Commercial Real Estate Has Perked Up

CHART 4

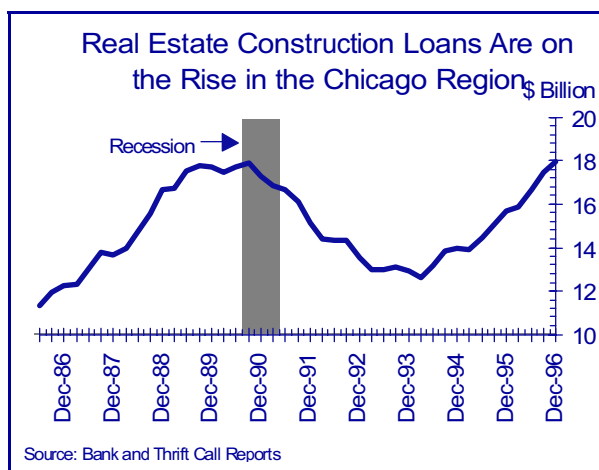


TABLE 1

VACANCY RATES ARE MIXED FOR COMMERCIAL REAL ESTATE							
	1990	1991	1992	1993	1994	1995	1996
SUBURBAN OFFICES							
CHICAGO	20.4	19.8	19.3	18.1	16.0	13.0	11.6
CINCINNATI (OH-KY-IN)	21.1	21.5	20.3	17.8	15.7	13.8	11.2
CLEVELAND	19.2	18.6	17.1	15.5	13.2	11.7	10.0
COLUMBUS	19.3	17.5	14.1	10.4	8.8	8.3	8.7
DETROIT	19.8	20.1	20.6	19.1	17.3	14.2	10.6
INDIANAPOLIS	23.3	23.5	21.8	19.2	14.9	11.4	8.4
MINN.-ST. PAUL (MN-WI)	21.6	20.5	18.7	13.8	10.6	8.4	6.0
ST. LOUIS (MO-IL)	14.8	14.3	13.6	12.0	8.3	8.4	7.1
DOWNTOWN OFFICES							
CHICAGO	14.0	15.0	17.9	19.7	18.6	17.9	16.4
CINCINNATI (OH-KY-IN)	12.3	15.2	15.7	15.8	14.7	14.7	14.3
CLEVELAND	12.8	18.8	22.3	22.7	21.4	19.1	17.8
COLUMBUS	12.3	12.5	12.4	10.8	7.0	6.7	7.5
DETROIT	13.2	14.6	16.0	19.8	21.0	20.2	20.4
INDIANAPOLIS	20.2	19.7	20.5	20.0	20.5	17.7	17.3
MINN.-ST. PAUL (MN-WI)	15.6	16.5	19.2	16.3	12.0	10.5	9.0
ST. LOUIS (MO-IL)	21.9	22.6	21.3	20.2	19.6	18.1	18.1
INDUSTRIAL SPACE							
CHICAGO	8.0	9.8	10.5	9.2	8.2	6.7	7.4
CINCINNATI (OH-KY-IN)	3.5	3.8	6.1	5.6	4.1	2.8	3.0
CLEVELAND	8.5	7.7	8.8	11.4	9.5	6.8	7.1
COLUMBUS	5.8	6.5	6.2	3.7	3.8	6.0	7.1
DETROIT	3.1	4.7	5.3	7.3	6.4	4.8	4.9
INDIANAPOLIS	7.4	6.7	6.3	4.8	4.1	4.1	5.2
MINN.-ST. PAUL (MN-WI)	5.9	7.0	5.8	4.0	3.4	3.9	4.1
ST. LOUIS (MO-IL)	3.9	2.6	2.4	4.2	5.3	5.5	4.2
SOURCE: CB COMMERCIAL PROPERTY INFORMATION SYSTEMS							

Expanding commercial real estate activity in the Chicago Region is in line with national trends. *Among the Region's banks and thrifts, this expansion has triggered a 42 percent increase in construction and land development loans since early 1994* (see Chart 4 previous page).

Declining vacancy rates for offices illustrate that space added in the past few years has been quickly absorbed, especially in suburban markets (see Table 1). Vacancy rates for industrial space, in contrast, generally edged up in the past year or two. The industrial vacancy rate for Columbus, though, has almost doubled since 1993, shifting from the lowest in the Region to among the highest. The upturn is widespread among major cities and suggests that construction in recent years may have supplied sufficient industrial space to meet much of the Region's current needs.

Table 1 illustrates that vacancy rates vary widely among cities over extended periods of time. Consequently, attention should be paid not only to the vacancy rate

level when evaluating conditions in a specific market but also to its direction and rate of change.

Implications: One lesson of the 1980s is that commercial real estate projects have a long gestation period. During this time period, a market's balance between supply and demand can shift dramatically and weaken borrowers' ability to service associated debt. Therefore, the combination of rapid construction growth and rising vacancy rates (in any area and for any type of building) should be regarded as a cautionary signal. Reports of increased construction on a speculative basis (i.e., lacking meaningful "take-out" financing or occupancy commitments) or of minimal equity involvement by developers also would raise concerns. To date, however, the FDIC's surveys of underwriting standards suggest that banks and thrifts are not participating significantly in the trend of rising speculative construction that has been mentioned in the press.

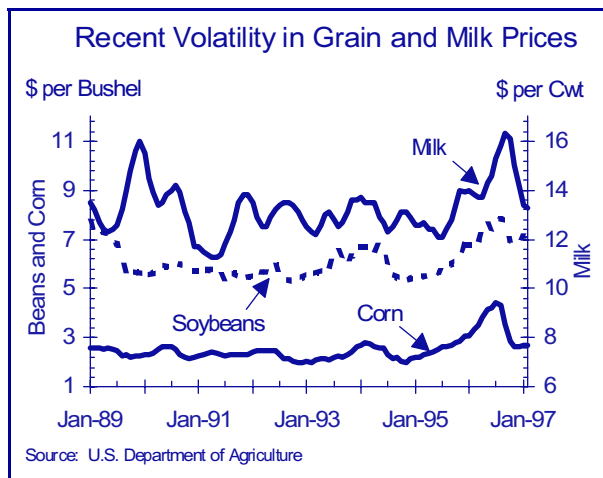
Agriculture in Transition

In the aftermath of last year's volatile grain prices and problems with hedging contracts, the farm sector now faces some significant changes in federal farm programs. The seven-year adjustment period under the 1996 Farm Bill will be one for learning how to manage potentially greater income volatility and perhaps new types of risk. Fortunately, most sectors of the agricultural economy are in a healthy condition as this transition gets under way.

Last season, prices for corn, soybeans, milk (see Chart 5) and hogs all rose significantly and helped boost net farm income. Various reports indicate that high crop prices also drove up prices for farmland. In the year ending in September 1996, the value of good farmland climbed by 14 percent in Illinois and 12 percent in Indiana, according to the Federal Reserve Bank of Chicago. The rate of appreciation softened in the second half of the year as crop prices retreated from their peaks. *Even so, midwestern farmland prices have been on the rise for the past five years.*

Implications: Farm incomes may become more volatile and farmers may face additional pressure to hedge in response to reduced protection from the government. Some farmers are comfortable using instruments such as futures contracts and options to establish prices for crops not yet harvested, but others are not. In fact, some producers may be increasingly reluctant to use available hedging tools after recent difficulties with hedge-to-arrive contracts.

CHART 5



Farmers may turn to their bankers, among others, for help in learning how to manage their liquidity and risks in the new environment. Bankers may need to consider whether steps taken by farmers sufficiently protect against downside risks and whether credit terms need to be adjusted to adequately protect the lender.

Joan D. Schneider, 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 Chicago Region's Bank Index (CRBI) both outperformed the S&P 500, gaining 12 and 11 percent, respectively, compared to an almost 8 percent gain for the S&P 500. So far in 1997, the CRBI has lagged the S&P Composite Bank Index.
- 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.

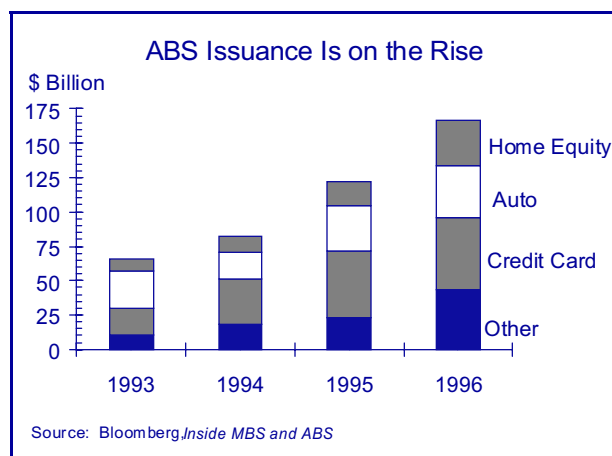
The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

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

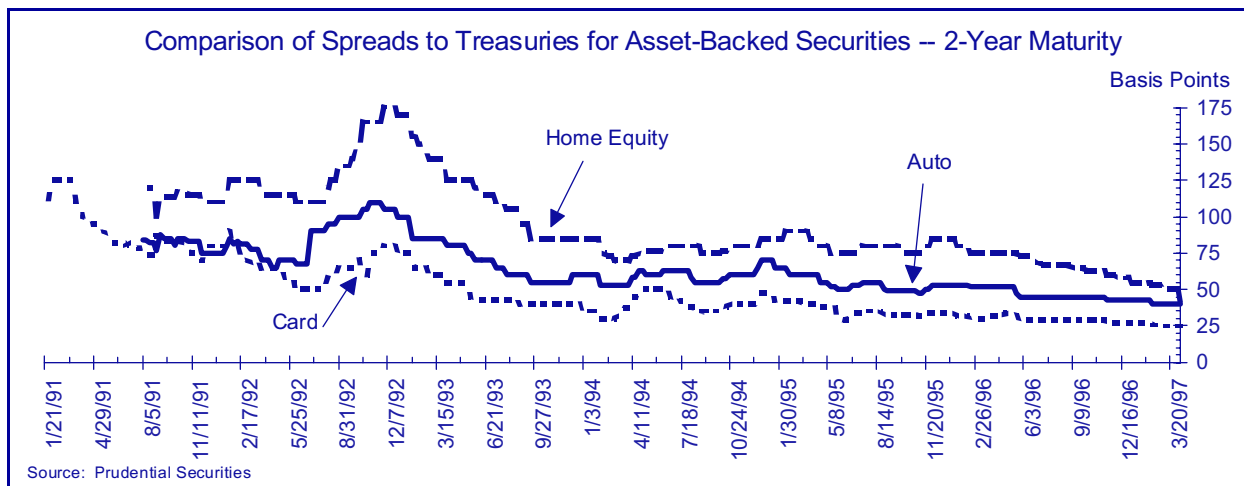


CHART 3

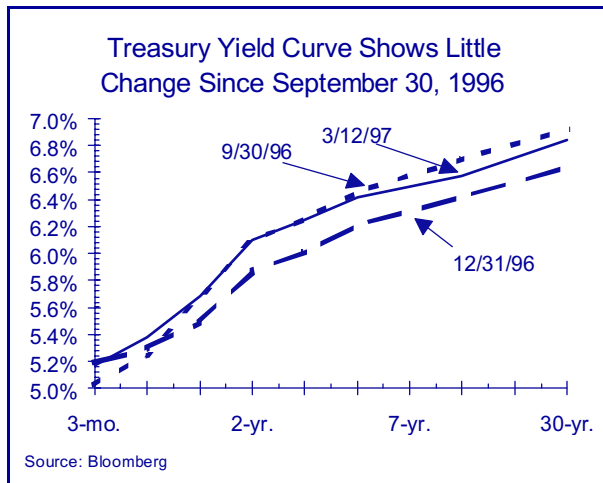
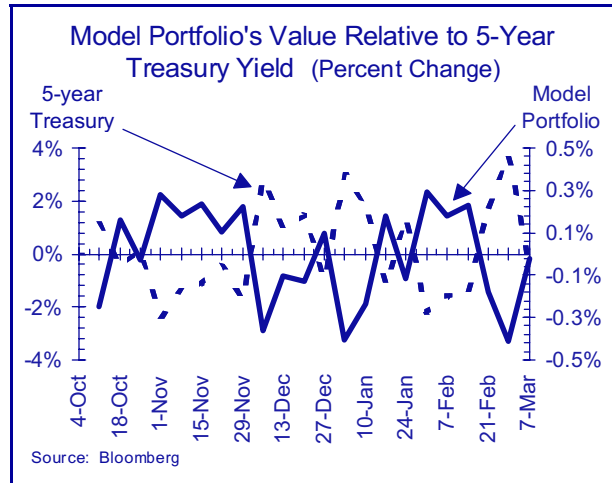


CHART 4



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.

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.

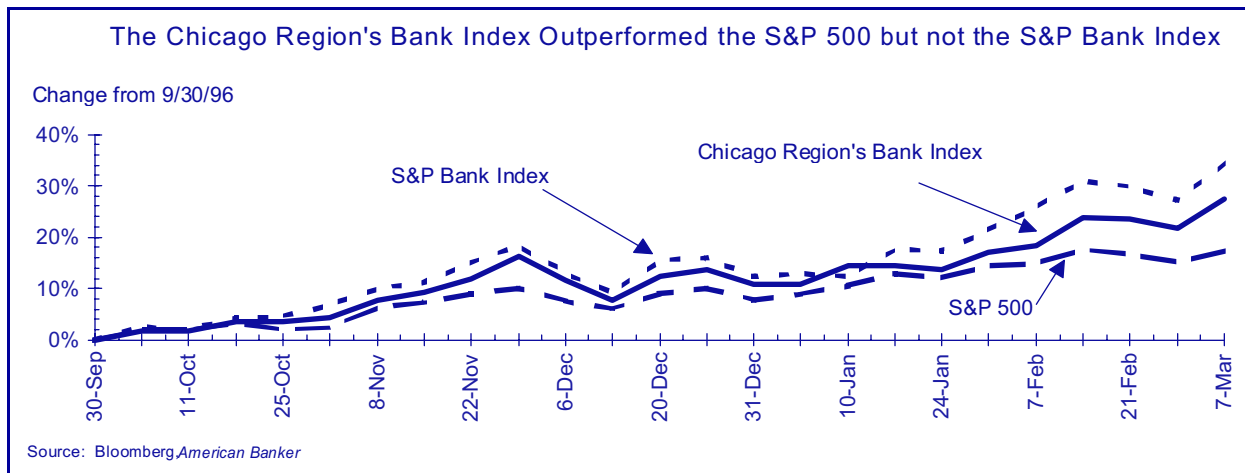
Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market Im-

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 bank index gained 37 percent compared to a 19 percent gain for the S&P 500. As shown in Chart 5, the Chicago Region's Bank Index (CRBI) gained a little less than 11 percent in the fourth quarter 1996. The CRBI gained 25 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 CRBI has gained 15 percent compared to almost an almost 20 percent gain for the S&P composite bank index and a 9 percent gain for the S&P 500 through March 7, 1997.

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 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

CHART 5

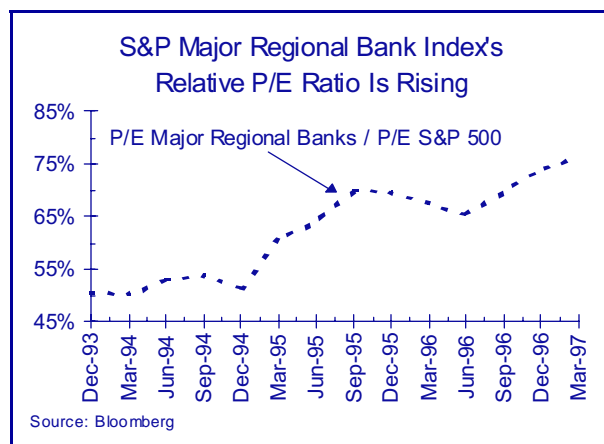


future earnings performance.

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

CHART 6



acquisitions.

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

Chicago Region Banks and Thrifts React to Changing Environment

- The condition of insured institutions in the Region remains sound, but structural changes may challenge existing internal control systems.
- The Region's banks and thrifts have reduced growth rates in consumer lending, but other loan portfolio segments experienced substantial growth in 1996. Overall, loans increased over 7 percent for the year.
- Funding strategies also are changing, with noncore sources playing a more important role.
- Without sufficient planning, insured institutions and their customers may be adversely affected by the Year 2000 problem, as costs to correct related flaws in computer systems are expected to increase as the

Overview

On an aggregate basis, the Region's banks and thrifts continue to reflect relatively strong financial conditions (see Chart 1). During 1996, they:

- maintained leverage capital at about 8 percent of average assets despite a significant increase in dividends paid;
- improved their aggregate return on assets to 1.1 percent; and
- except for consumer loan portfolios, reported low nonperforming and past-due asset levels.

Overall performance was positively influenced by a stable economy in the Region and is impressive in light of the significant structural shifts now occurring in the banking industry. Among these are:

- industry consolidation (the Region has 702 fewer insured institutions today than six years ago);
- technological advances; and
- increased competitive pressures from nonbank lenders.

In order to manage the effects of these changes and maintain profitability, the Region's institutions have altered growth patterns in their loan portfolios and funding bases. While these changes may make banks and thrifts more competitive, they also are likely to challenge existing internal control systems.

Institutions Shift Growth Emphasis from Consumer Lending

A slowing of consumer loan growth is one notable example of changing lending patterns. Consumer portfolios (including credit cards) remained weaker than other loan portfolio segments throughout 1996. Weaknesses included rising charge-off rates and past-due loan levels (see Chart 2 next page). The Chicago Region's institutions reacted to concerns with these loans in various ways, including:

- reviewing and improving underwriting standards;
- selling loans through the securitization process; and
- converting unsecured credits into home equity loans.

These actions, in addition to possible changing consumer behaviors in the Midwest and competitive pressures from nonbanks, resulted in a substantially reduced rate of growth (1 percent) for consumer portfolios in 1996. This pull-back is consistent with how insured

CHART 1

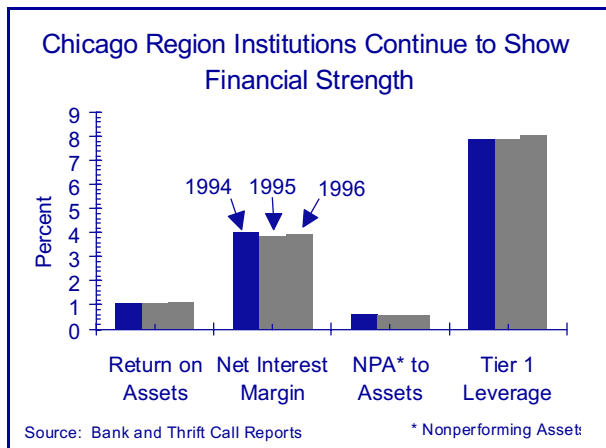
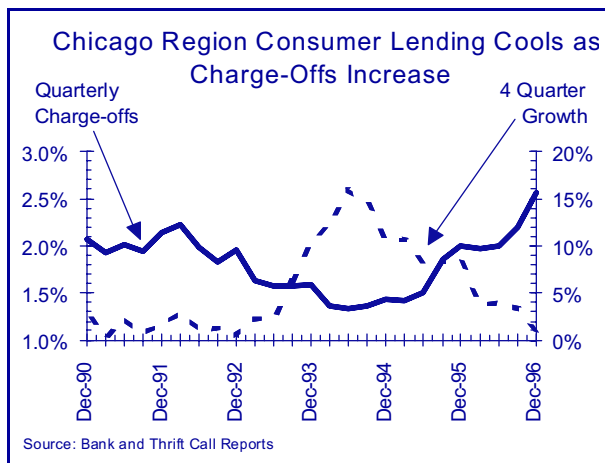


CHART 2



institutions have historically reacted to problems in other segments of their portfolios, such as construction and commercial real estate in the late 1980s and early 1990s.

With consumer lending falling off, the Region's institutions focused on growth in commercial loans and residential real estate loans (both increased between 8 percent and 9 percent in 1996). In addition, some smaller portfolio segments showed even higher growth rates. These include:

- Construction/Development 14 percent
- Home Equity Loans 14 percent
- Lease Financing 35 percent

Lease financing activity is currently centered in larger institutions (mostly in Ohio), while construction and home equity loan growth is widespread among small and large institutions throughout the Region. *For example, over one-third of insured banks and thrifts in the Region had growth rates of 30 percent or greater in construction loans during the year. Though many continued to reflect minimal exposures in this area, over 300 Chicago Region institutions had aggregate real estate construction loans that exceeded 50 percent of Tier 1 capital at year-end 1996.*

Implications: Loan production emphasis will likely continue to shift between different lending segments based upon economic conditions, available expertise, and perceived profitability. Shifting emphasis and rapid growth rates are not necessarily precursors to future problems. However, growth may place stress on insured institutions' management and control systems. Therefore, bank and thrift managers should ensure that loan production does not outpace underwriting and loan review resources.

Given past problems with commercial real estate lending, recent construction loan growth is of special interest (see *Chicago Region's Economy Remains Healthy*).

Funding Patterns also Are Changing

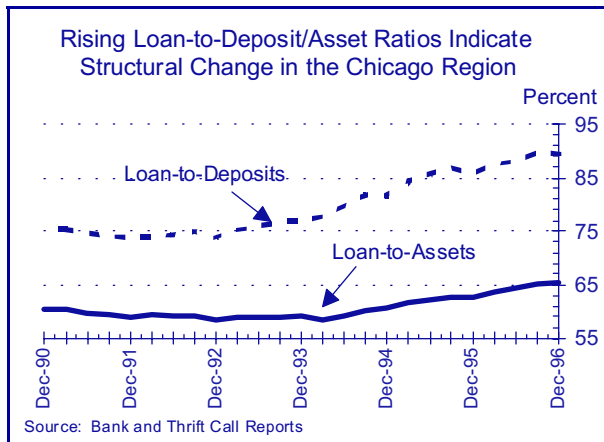
Loan growth and changing funding strategies have resulted in an aggregate loan-to-deposit ratio of about 90 percent for the Region at year-end 1996 -- an all-time high for the decade (see Chart 3). Nearly one-half of institutions in the Region reported loan-to-deposit ratios exceeding 75 percent at year-end 1996 (see Chart 4 next page). About one-half of this group were small banks (under \$100 million in assets).

Loan-to-deposit ratios normally have increased during periods of economic growth because lending tends to pick up. Banks also are now relying more on noncore sources to fund this growth (see Chart 5 next page). The current emphasis on noncore funding appears to be due, in part, to stiff competition from financial service companies. These entities have made numerous alternative investments available to consumers who traditionally invested in insured deposits.

In addition, banks have found some noncore funding cheaper than raising deposits. This situation may be especially true in the Chicago Region where large banks in some major metropolitan areas tend to pay higher rates on certificates of deposit than the U.S. average.

Some of the funding sources used as alternatives to core deposits include foreign deposits, large time deposits, short-term debt, and Federal Home Loan Bank (FHLB) advances. While only the largest institutions tend to use

CHART 3



items such as foreign deposits, FHLB debt has become rather common. Nationwide, almost 4,000 commercial banks were members of the FHLB system as of September 30, 1996.

Implications: In the aggregate, Ohio institutions have the Region's highest loan-to-deposit ratio, exceeding 100 percent. However, a number of banks and thrifts in the Region show this structural shift toward more noncore funding. This trend may continue if insured institutions continue to face intense competition for deposits.

Increased use of noncore funding may lead to more volatile funding costs in a rapidly changing interest rate environment. However, some noncore sources, such as longer-term FHLB advances, can be relatively stable. Another mitigating factor is that institutions dependent upon noncore funding generally have loan portfolios with a sizable amount of consumer-related credits. The cash flows from the amortization and sale of these instruments can provide a substantial source of liquidity for individual institutions. Securitization of consumer mortgage and credit card debt also may establish more favorable avenues for obtaining funding.

Thus far, the described funding changes have not impeded aggregate loan production or adversely affected liquidity. Nevertheless, it is important that bank and thrift managers recognize changes to funding structures and ensure procedures are in place to adequately assess and manage liquidity risk, especially if an institution obtains a large portion of funding from limited sources.

Recognizing Risks and Costs Related to Year 2000 Conversions

Significant concern has been registered over the potential impact of the year 2000 on computer systems. This

CHART 4

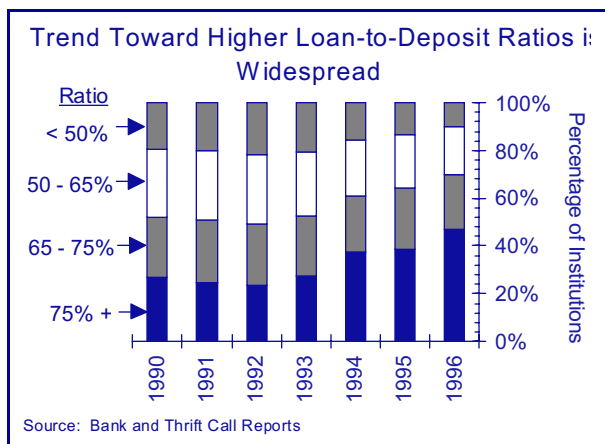
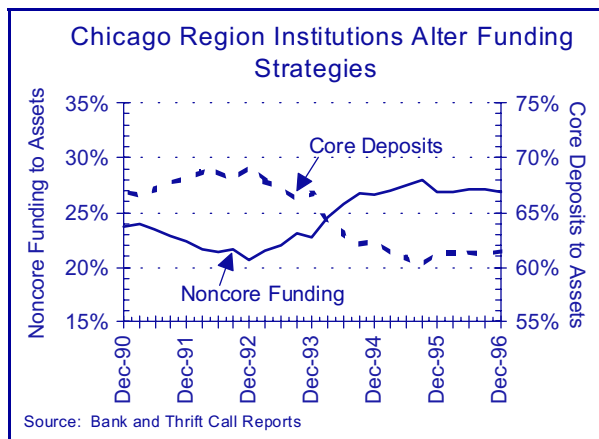


CHART 5



concern primarily relates to the fact that the year portion of dates in many computer systems is represented by just two digits (i.e., 96 for 1996). Therefore, some systems may interpret the date 01/01/00 as January 1, 1900, rather than January 1, 2000.

The effect on financial institutions may be especially significant because of their heavy use of computer technology. For example, deposit records, loan records, and management reports may be inaccurate if this flaw is not corrected. In addition, bank customers may experience similar problems that have the potential to disrupt their ability to conduct business or repay their debt.

During the second half of 1996, the *Financial Accounting Standards Board Emerging Issues Task Force* reached a consensus on the accounting treatment for this issue. In summary, it requires that both internal and external costs associated with modifying internal-use software to address the year 2000 problem be charged to expense as incurred.

Implications: Costs related to correcting any computer system flaws related to the Year 2000 will vary from firm to firm. Some experts estimate that costs may range from 50 cents to \$1.50 per line of code. Those who delay are likely incurring much larger expenses.

While these costs may be significant, lack of attention to this issue may be much more costly in terms of business disruption, potential computer systems failures, and degradation of financial control systems. Banks and thrifts should have appropriate plans in place to correct any significant flaws in their computer systems. In that regard, the FDIC's Division of Supervision recently issued Year 2000 Workprogram Procedures to assist examiners in raising the awareness of insured institu-

tions to the potential problems surrounding this issue.

Publicity Surrounding Subprime Lending Highlights Areas of Concern

Several subprime lenders have experienced difficulties lately. Problems noted have primarily revolved around the adequacy of reserves for their higher risk loan portfolios.

Estimated volumes of subprime lending activity have varied widely. Some news accounts estimated subprime mortgage lending at over \$120 billion, while subprime new and used auto loans were estimated at over \$70 billion in 1996.

Much of this type of lending activity is conducted by nonbank entities. However, insured institution involvement in the form of direct loans and backup lines of credit to independent finance companies may be growing. In addition, some banking companies, seeing the



potential for substantial profits, have directly entered this market.

Implications: The onslaught of bad press may have some fallout effect. In the short-term, this fallout could negatively affect the value of asset-backed securities related to subprime loans. In addition, insured institutions that directly participate in this market also may be affected by a reduced ability to securitize and sell subprime loans at an acceptable price.

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