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how best to compete against—or participate in—these new real estate financing strategies.

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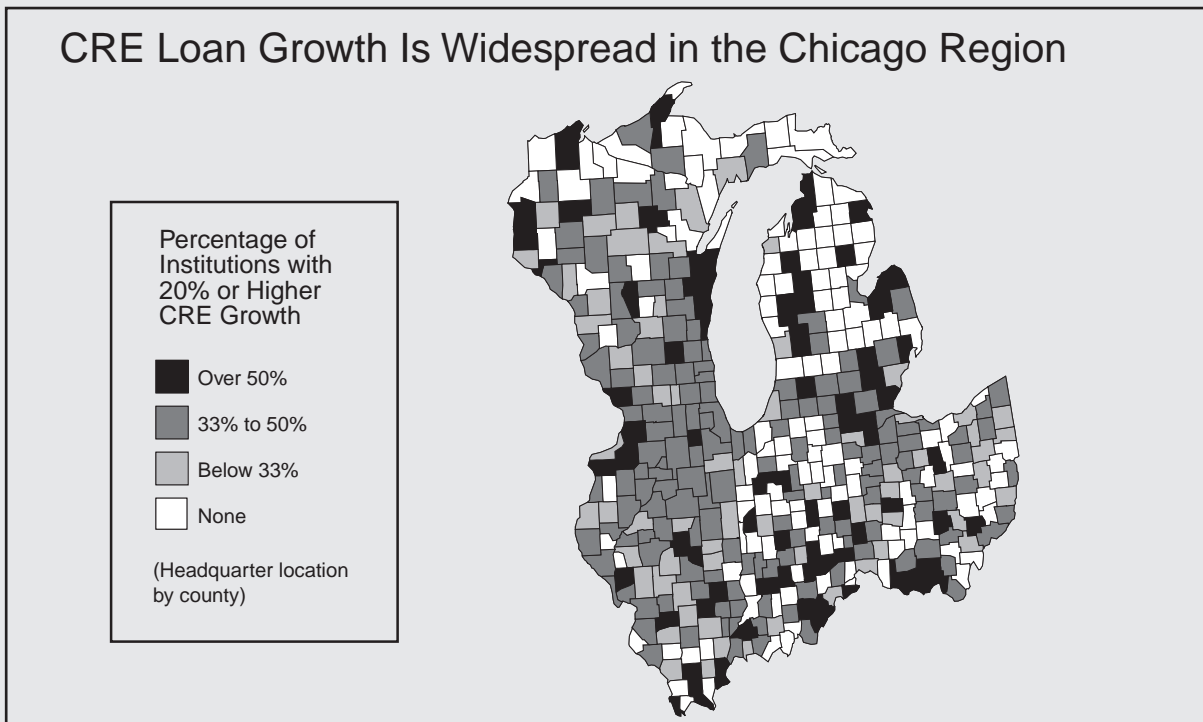
***Chicago Region: Widespread and Rapid Growth in Real Estate Lending***

Direct commercial real estate lending (construction and nonresidential) is important to many Chicago Region institutions. More than 40 percent of banks and thrifts in the Region reported aggregate exposures in this lending type exceeding Tier 1 capital at midyear 1997. In addition, some of these institutions, and others with less exposure, registered very strong commercial real estate (CRE) loan growth over the past year. About one-third of Chicago Region institu-

tions had CRE loan growth of 20 percent or higher. These banks and thrifts are dispersed throughout the Region, in metropolitan and nonmetropolitan areas alike (see Chart 5).

Rapid growth rates are not necessarily precursors to future problems but can cause stress on insured institutions' management and control systems. In addition, competitive pressures caused, in part, by the financial innovations described in this article may be resulting in a slight increase of reports of liberalized underwriting practices. (See *Regional Banking: Credit Quality Risk Management Becomes Even More Important as Economic Expansion Ages.*)

CHART 5











some households. A downturn in the stock market could wipe out some of households' net worth and dent their optimism about economic conditions.

Over one-fourth of the Region's insured institutions experienced 20 percent or faster growth in 1 to 4 family residential loans over the past year. Home equity loans rose rapidly at a larger share of the Region's institutions, in part because some portfolios were fairly small initially. *Nearly 40 percent of banks and thrifts in the Region expanded their home equity lines by 20 percent or more in the past year.* Some of the home equity loans may be especially vulnerable to any softening in residential market values in light of anecdotal information that institutions' attempts to gain market share have, in some cases, resulted in loan-to-value ratios of 100 percent or more.

**Agriculture: Appreciating Land Values and Volatile Prices**

Ten years of appreciating land values have brought the current value of farm real estate in the Region to about 95 percent of its peak in 1980 (see Chart 3). The appreciation, in turn, has contributed to relatively low measures of debt loads (e.g., debt-to-assets ratio) among Chicago Region farmers (see Chart 4). It also has boosted the value of farm real estate holdings as a percentage of total farm assets to the highest level since 1983.

*While farmland prices have trended upward, commodity prices have tended to fluctuate widely.* For example, prices received by farmers for milk gyrated consider-

ably in the past year. Prices broke out of the \$12- to \$14-per-hundredweight (Cwt) range experienced since 1992, first climbing to over \$16 per Cwt and then plunging to around \$12.50 per Cwt recently (see Chart 5, next page). Such volatility adds pressure in a market already undergoing structural change.

Many dairy farmers also are responding to challenges from lower cost producers, which have expanded noticeably in the West. California, where operations average 438 cows per herd, displaced Wisconsin, where the average is 52 cows per herd, as the leading milk-producing state in 1994. The challenge of lower cost competition from large operators is especially important in **Wisconsin**, where dairy goods account for 52 percent of the state's receipts from farming. Dairy farming also is important to the agricultural sectors in **Michigan** and **Ohio**, where it generates 20 percent and 13 percent, respectively, of each state's agricultural receipts.

*Other agricultural markets important to the Chicago Region also are experiencing volatile prices.* Despite favorable production estimates, price movements for corn and soybeans may be more pronounced than usual this season because of very low reserves. The unpredictability of weather and growing conditions may cause these markets to remain jittery and subject to large price swings until the harvests are in.

**Implications:** The value of farmland in the Region climbed by 61 percent from its 1986 low through 1995, thus contributing to the currently low debt-to-assets ratio. *As land values approach previous peaks and farmers face potentially increased price volatility resulting from the 1996 Farm Bill, lenders must*

CHART 3

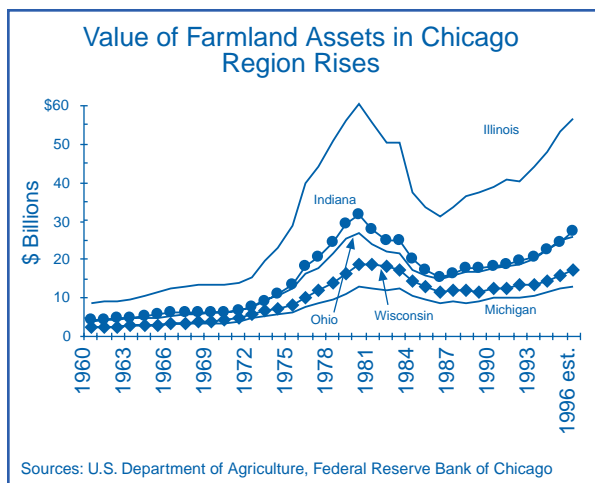
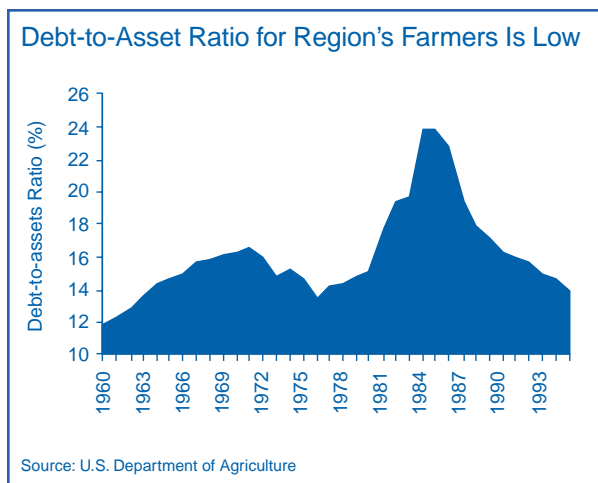


CHART 4

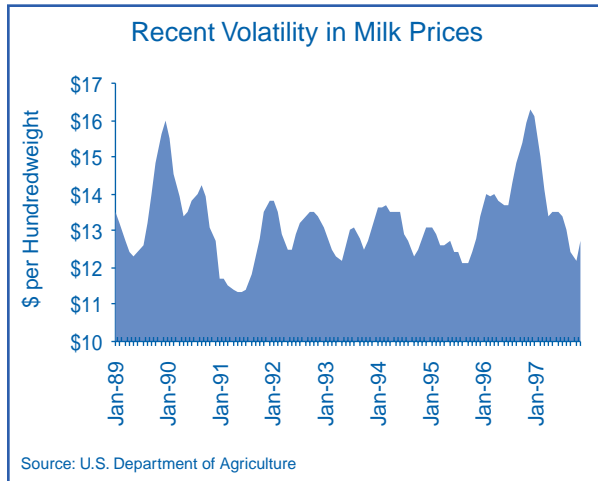


*evaluate whether real estate values will hold or appreciate further.*

In addition, the impacts of some industry-specific developments deserve watching. Modernization steps by some small dairy operators in the Midwest are an example. As they expand their herds and adopt more capital-intensive methods, these farmers' traditional financial arrangements may also change considerably. They may place greater reliance on debt financing, for instance, to pay for new buildings or equipment to mechanize tasks and realize production efficiencies. Larger operators, in turn, may rely more heavily on purchased inputs such as feed. All told, modernization by dairy farmers could cause both their capital and operating needs to shift from those to which they and their bankers have become accustomed.

*Joan D. Schneider, Regional Economist*

**CHART 5**



## Financial Markets

- **Bank holding companies of all sizes have issued trust preferred stock following the Federal Reserve's decision in October 1996 to count these tax-advantaged capital securities toward Tier 1 capital.**
- **Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget this year, there still exists the possibility that the Internal Revenue Service may alter the tax treatment of trust preferred dividends.**
- **Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the potential risks associated with excessive reliance on debt-like capital instruments.**

Bank holding company capital requirements were effectively relaxed in October 1996 when the Federal Reserve ruled that trust preferred stock may be included in the portion of cumulative preferred stock that can compose up to 25 percent of a bank holding company's Tier 1 capital. In the wake of this decision, financial institutions moved quickly to issue trust preferred stock. Trust preferred stock can be a less expensive form of Tier 1 capital for bank holding companies because of the tax deductibility of the dividend payments paid on this type of preferred stock.

Approximately 90 banking organizations issued an estimated \$21 billion of trust preferred shares from October 1996 through June 1997.<sup>1</sup> The dollar amount of trust preferred stock issued represented almost 95 percent of the incremental amount of Tier 1 capital added by those institutions during the period. A number of these institutions used the proceeds of trust preferred stock issues to fund stock buyback programs. As an example of the relative importance of these stock buyback programs, one large bank holding company's Tier 1 capital ratio would be 7.25 percent excluding the trust preferred shares, and 8.34 percent including the shares.

Rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital because of its limited life and debt-like characteristics. These characteristics include the tax treatment of trust preferred dividends,<sup>2</sup> the limited life of the shares, and the ability of investors to accelerate their claims against the bank holding company. Institutions contem-

plating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the possibility that excessive reliance on debt-like capital instruments could increase their financial fragility during times of economic stress.

### *Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative*



Trust preferred shares, also known as capital securities, are traded under different names depending on the underwriter, payment terms, and maturity. Some of the more common acronyms include TOPRS (Trust Originated Preferred Shares), QUIPS (Quarterly Income Preferred Shares), and MIPS (Monthly Income Preferred Shares).

Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary is owned by the bank holding company, and the trust preferred stock is sold to investors. The trust upstreams the proceeds from the sale of the preferred shares to the bank holding company in exchange for a long-term, deeply subordinated note with terms identical to the trust preferred shares. (The subordinated note must be the sole asset of the trust and subordinated to all other debt of the bank holding company.)

On a consolidated basis, the trust preferred stock is treated as a minority interest of the bank holding company, and the subordinated note is eliminated as inter-

<sup>1</sup> The amount of trust preferred stock outstanding is not delineated in Call Reports.

<sup>2</sup> Trust preferred dividends, unlike dividends on traditional preferred stock, are treated as a tax-deductible expense at the bank holding company level and as taxable income by investors of the trust preferred shares.

CHART 1

