◆ Regional Outlook ◆

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In Focus This Quarter

◆ ***Bank Earnings: Competitive Pressures and Cyclical Risks***—**Intense competition to preserve or attract business can lead to relaxed underwriting standards and other changes to risk management practices that can reduce banks' ability to weather a downturn. As this economic expansion reaches an advanced age, prudent bankers will evaluate their lending standards and reserve adequacy with an eye to possible adverse changes in economic conditions.** *See page 3.*

By Ronald Spieker, Steve Linehan, George French

◆ ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***—**Commercial real estate markets in many parts of the United States have rebounded, and commercial banks are once again actively pursuing lending opportunities. Banks are not alone, however, as a broader and more competitive financing market has emerged. Securitization vehicles such as commercial mortgage-backed securities and real estate investment trusts are changing how real estate is owned and paid for.** *See page 9.*

By Steven Burton, Gary Ternullo

Regular Features

◆ ***Regional Economy***—**The New York Region continues to experience a modest job and labor force expansion…prices for single-family homes are rising, but demand remains uneven…tourism has become a major source of the Region's economic growth.** *See page 15.*

By Norman Gertner

◆ ***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…rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital.** *See page 21.*

By Kathy R. Kalser

◆ ***Regional Banking***—**Because of increasing competition for consumers' financial assets, banks are finding alternatives to core deposits for funding growth…a look at foreign banking operations in New York State…new auditing regulations for foreign branches and agencies established by the New York State Banking Department are meant to improve controls.** *See page 25.*

By Kevin P. Hemhauser, Suzannah L. Susser, Karen A. Wigder

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Bank Earnings: Competitive Pressures and Cyclical Risks

- **Rapid loan growth, record low credit losses, vigorous expansion of income sources, and cost-cutting continue to propel bank earnings to record levels.**

- **Intense competition to preserve and attract business can lead to aggressive loan pricing, relaxed loan underwriting standards, increased portfolio concentrations, and other changes to risk-management practices that can reduce banks' ability to sustain earnings and capital through a downturn.**

- **As this economic expansion approaches an advanced age, prudent bankers will allow for the possibility of an adverse change in economic conditions.**

As the U.S. economic expansion continues through its seventh year, the banking industry continues to run at full throttle. Earnings climb to ever-higher levels, driven by rapid loan growth, record low credit losses, aggressive expansion of income sources, and vigorous cost-cutting. Some analysts argue that banking has entered a new era in which the development of non-interest income sources and new risk-management techniques will insulate banks from swings in the business cycle.

Yet banks face risks that should not be overlooked. Assertions that bank earnings will be less sensitive to business cycles remain untested. Meanwhile, competition to attract and maintain business can result in relaxed underwriting standards and easing of loan terms, or increased focus on business lines whose risks are difficult to manage. Policies that boost short-term shareholder returns, including high dividends and stock repurchase programs, can reduce banks' capacity to weather a future downturn. There is evidence that these things are occurring to varying degrees in banking today. Accordingly, as this expansion reaches an advanced age, prudent bankers will give careful regard to the quality and sustainability of the earnings generated by today's strategic decisions.

Credit Quality

Variations in credit quality have been and are likely to remain for some time the primary source of large swings in bank earnings (see Chart 1). Banks manage the risks of large swings in credit quality by adjusting underwriting standards and loan terms, by diversifying loan portfolio exposures, and by supplying adequate amounts to the allowance for loan losses. In large part, the degree to which bank earnings can be sustained during a downturn will depend on decisions made about these factors during the expansion.

Some perspective on the cyclical nature of credit quality can be gleaned from Charts 2 and 3 (next page). As shown in Chart 2, bank loan growth has exceeded growth in gross domestic product (GDP) for ten of the past twelve quarters, even without considering the substantial volume of loans originated and sold in securitized pools. Moreover, Chart 3 shows that growth in loan losses has tended to follow episodes of rapid loan growth.

Credit standards are important tools for individual banks to manage these cyclical fluctuations in credit quality. According to the Federal Reserve's August 1997

CHART 1

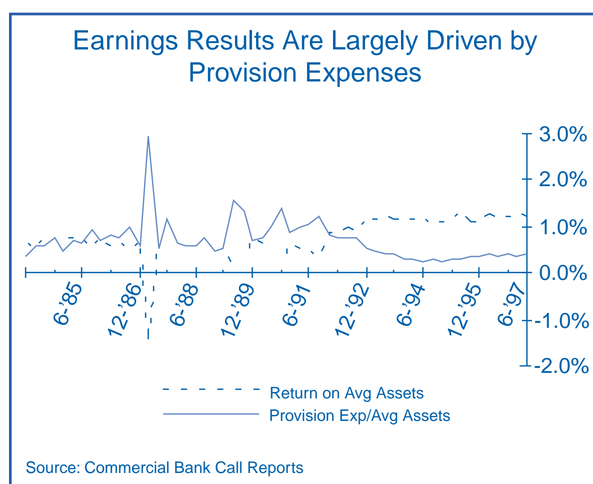
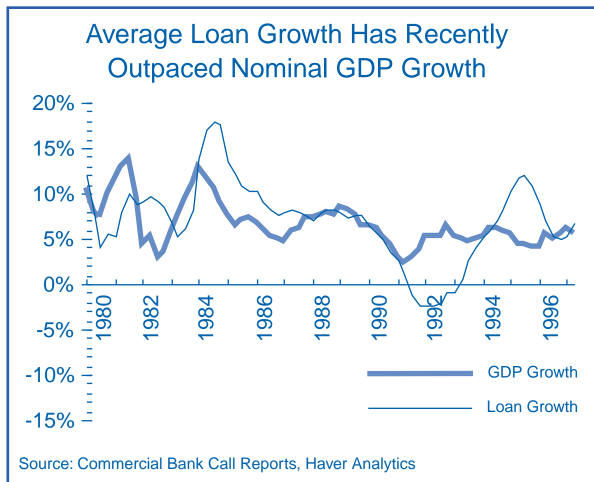
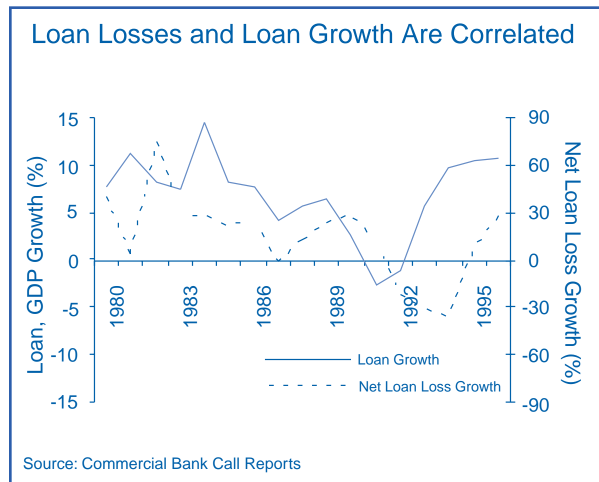


CHART 2



Source: Commercial Bank Call Reports, Haver Analytics

CHART 3



Source: Commercial Bank Call Reports

Senior Loan Officer Survey, during the preceding three months, a large percentage of banks had eased terms on commercial and commercial real estate loans, including reducing loan interest rates, increasing credit lines, and easing loan covenants and collateralization requirements. A "small but significant" share reported willingness to accept increased levels of risk on commercial real estate loans. In a similar vein, the Federal Deposit Insurance Corporation's (FDIC) ***Report on Underwriting Practices*** (second quarter 1997) did not note any widespread problems with underwriting practices but reported that about 24 percent of institutions examined that were actively involved in construction lending were "frequently or commonly" funding speculative construction projects. About 18 percent of institutions examined that were actively involved in business lending "frequently or commonly" made unsecured business loans that lack documentation of financial strength.

Maintaining an adequate allowance for loan losses is another important way for banks to sustain earnings and capital during downturns. The aggregate allowance held by commercial banks has decreased from 2.74 percent of total loans in the first quarter of 1992 to 1.90 percent in the second quarter of 1997; 166 banks reported negative loan loss provisions in the second quarter.

Although in the aggregate these reserve numbers remain high relative to the early to mid-1980s, when reserve levels ranged from 1.20 percent to 1.74 percent, the Office of the Comptroller of the Currency (OCC) recently issued an advisory letter expressing concern about declining reserve levels and the need to maintain an adequate allowance. This letter was a response to weakness in the credit card sector and to trends in the market for syndicated commercial loans, including increasing leverage, declining spreads, and a weakening in other underwriting terms, all stemming from increasing competitive pressures.

Diversifying loan portfolios is another way for banks to help reduce susceptibility to economic downturns. It has often been noted that the trend toward interstate banking and branching may improve loan diversification. It should also be noted, however, that many banks retain high concentrations of credit exposure to specific economic sectors. For example, commercial real estate lending and construction lending has been a source of volatility in bank earnings since the real estate investment trust (REIT) crisis of the 1970s. As discussed in ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***, banks are leading a resurgence in commercial real-estate lending. As Table 1 shows, 28 percent of FDIC-insured institutions grew their total commercial real estate and construction portfolios more than 30 percent from mid-1996 to mid-1997, and 16 percent had total commercial real estate and construction exposures[1] exceeding 200 percent of equity and reserves. Concentrations and rapid growth do not necessarily portend difficulties, but the greater the concentration of credit to a specific sector, the greater the importance of strict adherence to sound underwriting policies and standards and the maintenance of adequate loss reserves.

The most immediate concerns about credit quality have been expressed regarding credit cards and some other

[1] Includes loans secured by multifamily dwellings and nonfarm nonresidential structures, as well as construction loans.

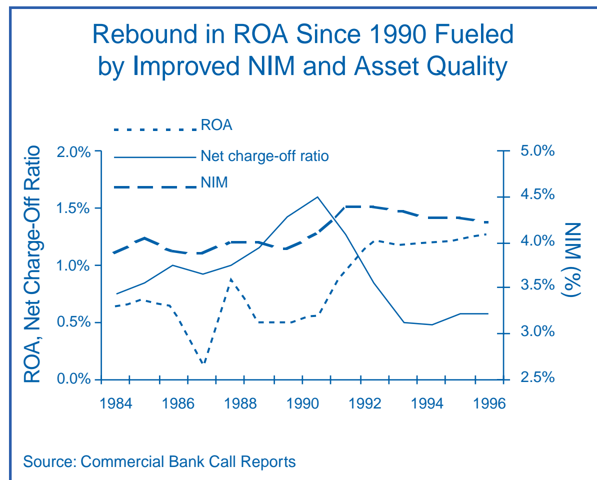
consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 1991. Noncurrent rates on these loans are at near-historic highs of 1.94 percent, and some examiners are commenting that these rates would be even higher were it not for some of these balances being rolled over into home equity debt consolidation loans with loan-to-value ratios as high as 135 percent. Home equity lines are a rapidly growing business for some banks; 25 percent of banks and thrifts grew their home equity lines by more than 30 percent during the year ending mid-1997 (see Table 1).

Except for credit cards and some other consumer loans, loan losses are at historically low levels. Nevertheless, lending decisions that assume a continuation of favorable economic conditions should be closely examined this far into the expansion. Institutions that maintain strong underwriting standards, an adequate allowance for losses, and prudent diversification of the loan portfolio will be best positioned to sustain earnings and capital during a downturn in credit quality.

Net Interest Margin

Net interest margin (NIM) is another primary driver of bank earnings. Indeed, a sharp improvement in NIM helped lead the banking industry's dramatic recovery from the last recession (see Chart 4). Commercial banks' NIM has declined slightly in recent years, but at 4.23 percent still remains near the top of the range within which it has fluctuated since 1984 (see Table 2, next page).

Chart 4



Source: Commercial Bank Call Reports

The banking industry's rapid loan growth in recent years has been one of the factors supporting the current high NIM. (Since loans generally yield more than securities, a higher proportion of loans generally results in a higher yield on the total portfolio of earning assets.) Economic fundamentals cannot sustain rapid loan growth indefinitely, however. Accordingly, a

Table 1

Rapid Loan Growth Is Occurring at a Significant Number of Institutions (4 qtrs growth ending 6/97)	Percentage of Institutions with Loan Category Growth Approximating		
	20% to 30%	30% or More	Total Over 20%
Total Loans and Leases	11	13	24
Construction Loans	4	36	40
Commercial Real Estate Loans	9	27	37
Total CRE	10	28	38
1-4 Family Residential Loans	11	17	29
Home Equity Lines	4	25	29
Total Residential	12	18	29
Credit Card Loans and Related Plans	4	17	21
Other Consumer Loans	9	18	27
Total Consumer Loans	9	18	27
Commercial Loans	9	26	35

Source: Bank & Thrift Call Reports

Table 2

1997 Commercial Bank Performance Compared with Historical Averages			
	6/30/97	Industry Averages 1984-1996	
	Annualized (%)	Low (%)	High (%)
Net Interest Income/Average Earning Assets	4.23	3.89	4.36
X Average Earning Assets/Average Assets	86.50	86.21	88.42
= Net Interest Income/Average Assets	3.66	3.36	3.89
+ Noninterest Income/Average Assets	2.13	1.10	2.13
– Noninterest Expense/Average Assets	3.50	3.05	3.90
– Provision Expense/Average Assets	0.40	0.28	1.28
+ Other Items/Average Assets	0.03	–0.02	0.15
– Taxes/Average Assets	0.68	0.18	0.64
= Net Income/Average Assets (ROA)	1.25	0.10	1.20

Source: Bank & Thrift Call Reports

risk in the current environment is that in the effort to support their NIM by generating new lending, banks may make compromises in loan underwriting, pricing, and portfolio diversification.

Recent pricing trends have tended to weaken NIM, offsetting to a degree the effects of rapid loan growth. On the liability side, over the past six years, commercial banks' average annual deposit growth rate of 3.2 percent has been outpaced by the 4.9 percent average annual growth rate of earning assets. As a result, nondeposit borrowings have increased significantly in importance, rising from about 12.6 percent of earning assets in 1991 to 19.1 percent at mid-1997. Since the average cost of nondeposit borrowings has exceeded the average cost of deposits over the period by an average of 135 basis points, the greater use of relatively higher cost borrowings to fund earning asset growth has been an obstacle to wider margins. The slower deposit growth can perhaps be attributed to the increasing array of choices available to small savers; its effect is that bank funding is becoming more expensive and more interest-rate sensitive.

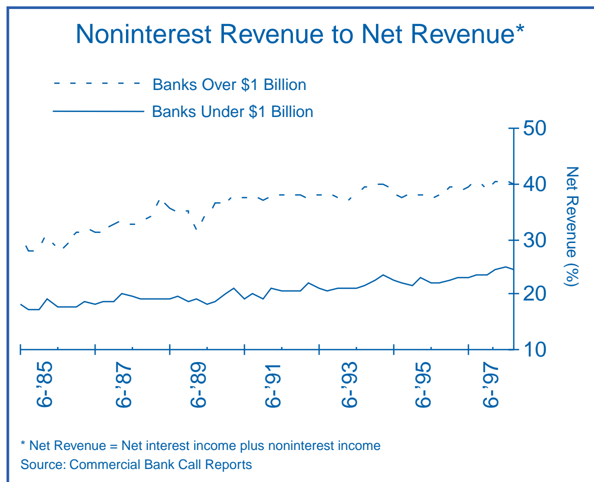
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads on investment-grade debt are at all-time lows. Reportedly, some deals are being done at minimal or no risk-adjusted spreads simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures on institutions not able to achieve the volumes necessary to efficiently utilize this new funding vehicle.

The thin spreads available from high-quality lending may tempt some institutions to finance higher yielding, riskier credits in an effort to preserve or boost profit margins. For example, recent forays by some banks into subprime lending (see ***Subprime Lending: A Time for Caution***, Third Quarter 1997) may be one indication of how competitive pressures on NIMs are affecting bank behavior. Over the long term, institutions that manage their NIMs with a prudent regard for how their newly booked business may fare during a cyclical downturn will have a better chance of sustaining earnings performance through the business cycle.

Growth in Noninterest Income

Industry analysts often cite the increasing contribution of fees and other sources of noninterest income as evidence of the evolution of the banking industry. As Chart 5 (next page) illustrates, for commercial banks with over $1 billion in assets, noninterest income now averages over 40 percent of net revenue (net interest income plus noninterest income). In contrast, banks

CHART 5



with under $1 billion show a profile of reliance on more traditional banking activities, with only 25 percent of revenue from these noninterest sources.

Noninterest income growth is being driven both by new business lines and higher deposit-related fees. Examples include fees from sales of mutual funds and other nondeposit products, investment banking activities such as securities underwriting and asset management, and increases in traditional fee sources such as from automated teller machines. Increasing securitization of assets, in which the accounting conventions convert interest income to noninterest income, has also affected the growth in reported noninterest income.

With the exception of trading revenue, noninterest income has historically shown a growth trend that has not been especially sensitive to economic cycles. However, newer fee-based businesses such as mortgage banking, mutual funds, and securities underwriting may ultimately share the same cyclical characteristics as traditional bank lines of business, and therefore may not reduce banks' historical exposure to economic cycles.

The Effect of Expense Control on Earnings Performance

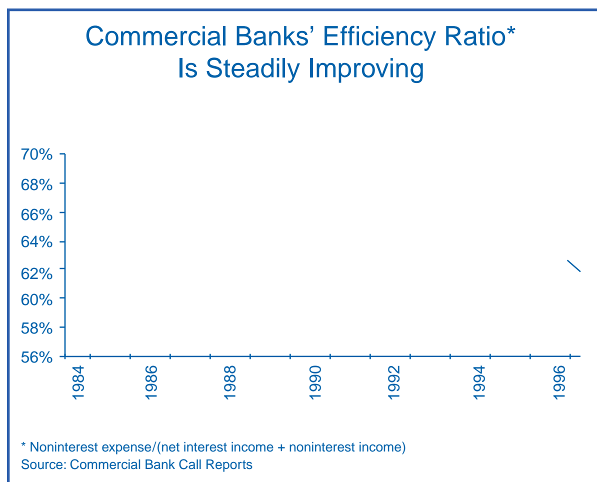
Cost-cutting efforts in banking continue to show their effects. Since 1991, commercial banks' efficiency ratio,[2] a measure of an institution's effectiveness in generating revenue, has steadily improved (see Chart 6).

Other measures of productivity have shown similar improvement. For example, commercial banking assets per employee doubled, from $1.5 million to $3 million, between 1984 and 1997.

Growth in overhead expense has been contained largely through consolidation, technological advances, and low levels of problem assets. Mergers have resulted in the wringing out of redundant expenses. Information technology (IT) has been deployed to trim underwriting expense, manage customer relationships, speed back-office processing, and facilitate the creation of new products and services. Favorable economic conditions have reduced costs associated with loan collection and asset workouts.

Whether the downward trend in overhead expenses will continue is an open question. Should problem loans increase from their cyclical lows, collection and workout costs will increase (evidence of this effect can be discerned for the late 1980s in Chart 6). The rapid change in information technology may prompt increasing expenditures. The 1996 Atlantic Data Services/Tower Group ***Survey of Information Technology Services in Banking*** noted that the banking industry is "faced with an aging IT infrastructure." The survey suggests that most technology-related expenses could increase at a 5.6 percent compounded growth rate until the year 2000 and that expenses for outside services could increase 11 percent over the same period. The ability to generate future revenue gains may depend on additional bank investment not only in technology but also in the development of new products and services.

CHART 6



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

In any event, cost-cutting is not without its risks. For example, reductions in personnel, or excessive reliance on automated underwriting procedures (see ***Will Credit Scoring Transform the Market for Small-Business Lending?*** Second Quarter 1997), may raise concerns about the effectiveness of internal administration and control processes. Cost-cutting that cuts too deeply into customer service can erode franchise value. Mergers can reduce redundant expense, but at some point there may be diseconomies to managing a large organization.

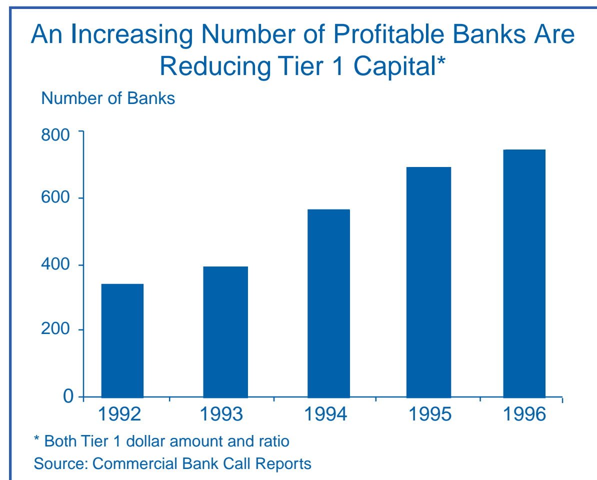
The Role of Capital in the Management of Earnings

Management, shareholders, and analysts often evaluate earnings in relation to the level of capital using measures such as return on equity (ROE) and earnings per share (EPS). One result has been pressure on banks to continue to grow ROE and EPS; these objectives have been made progressively more difficult to attain by the significant level of capital that has built up over the past five years.

Finding effective ways to deploy historically high capital levels appears to be one driving force behind the recent rash of mergers and acquisitions, high dividend payout ratios, increased stock repurchases, and the development of alternative types of hybrid capital such as trust preferred stock (see ***Financial Markets***). For example, during 1995 and 1996, major merger and acquisition deals included some $835 billion in bank and thrift assets. During 1996, commercial banks with over $1 billion in assets had an average dividend payout ratio over 89 percent, up significantly from the 67 percent payout rate of 1994. Banks with under $1 billion in assets averaged 55 percent for 1996 and 52 percent for 1994. In addition, banks and bank holding companies have issued some $21 billion in trust preferred stock during the last nine months, some of which has been used to fund the almost $42 billion in share repurchase programs announced by large banks during 1996 and early 1997.[3]

While the book value of equity and other capital ratios has increased at the aggregate industry level, a number of banks are reporting declines in equity capital and leverage capital ratios despite positive earnings (see Chart 7). For all institutions, the ability to actively manage capital accounts going forward will depend largely on having earnings available above the levels needed to fund dividends and growth, after assuming capital protection adequate for the level of business risk. Bankers and examiners will need to carefully review strategies that increase bank leverage or increase business risk without considering the potential effects of a downturn in credit quality or other weakening in the economy.

CHART 7



Summary

The most profitable period for U.S. banks in the post-World War II era is paradoxically occurring during a time when banks' traditional business lines are coming under greater competitive pressure than ever. While the industry as a whole is adapting well to these competitive pressures, there may be a tendency for some insured institutions to respond by accepting greater risks to preserve or gain business.

The nature of banking is to profit by taking calculated risks, and naturally more profits will be made during the expansionary phase of a cycle than during a downturn. Nevertheless, the institutions that are best able to sustain their earnings and capital over the complete cycle will be those that allow for the possibility of an adverse change in business conditions, and prudently balance the levels of risk taken with the expected returns.

Ronald Spieker, Chief, Depository Institutions Section
Steve Linehan, Assistant Director, Analysis Branch
George French, Deputy Director

[3] Salomon Brothers.

Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets

- **Commercial banks are leading a resurgence in commercial real estate financing; many metropolitan markets are experiencing rapidly rising rents and single-digit vacancy rates, suggesting the likelihood of further development.**
- **New funds directed toward commercial real estate are being increasingly supported by commercial mortgage-backed securities and real estate investment trusts.**
- **Some analysts have expressed concern that these financing vehicles may serve to heighten competitive pressures that will lead to more aggressive loan pricing.**

In the wake of declining values and the large losses of the late 1980s and early 1990s, commercial real estate is making a comeback. There are two stories here of interest to lenders. The first entails the remarkable resurgence in commercial real estate demand. The second involves the major changes taking place in how real estate is owned and paid for and—of greater interest to banks—who is financing this expanding activity.

Commercial Banks Show Renewed Interest in Commercial Real Estate

Strong evidence of commercial real estate's rebound can be seen in its renewed attractiveness to lenders. ***Federal Reserve*** figures show that nearly $58 billion of new commercial mortgage debt was added to the market in 1995 and 1996 (see Table 1). While this new net lending pales in comparison with that of the late 1980s—when nearly $74 billion in net new debt was added in 1987 alone—it positively shines when compared with the $89 billion *shrinkage* of commercial real estate loans from 1991 to 1994. Table 1 shows that commercial banks are leading this resurgence with a $37 billion net increase in mortgage lending during 1995 and 1996.

Perhaps the most convincing evidence of commercial real estate's recovery comes from the market itself. Rising prices and tightening supplies of space in most major markets and for most property types suggest a growing demand for new commercial property stock. Numerous indices and market studies support this notion:

- As measured by ***Koll/NREI*** national composites, prices and rents turned up sharply after 1993, with rents surpassing their 1988 to 1989 levels by 1995 (see Chart 1, next page). For office properties in particular, the ten fastest-growing cities in terms of rental rates saw increases exceeding 20 percent in 1996.[1]

[1] Those cities are, in order, Minneapolis, Columbus, Dallas, Portland, Salt Lake City, Atlanta, San Jose, Phoenix, San Francisco, and San Diego.

Table 1

Banks Are Increasing Their Flow of Funds into Commercial Real Estate ($ Billions)

	1991	1992	1993	1994	1995	1996
Net New Borrowing, All Sources	$ –15.6	$ –47.1	$ –21.5	$ –4.4	$ 22.6	$ 35.1
Commercial Banks	3.1	–8.4	–4.3	7.5	18.0	18.7
CMBSs	1.3	8.7	10.3	11.3	10.6	16.1
Savings Institutions	–22.4	–18.5	–7.5	–6.8	–1.8	0.8
Life Insurance Companies	–5.6	–15.1	–13.4	–10.5	–3.3	–2.5
All Other Sources	8.0	–13.5	–6.6	–5.9	–0.9	2.3
Equity Capital Flow, All Sources	$ 4.9	$ 3.1	$ 17.4	$ 21.6	$ 21.5	$ 30.3
REIT Equity Offerings	1.6	2.0	13.2	11.1	8.2	13.0
Pension Funds	–4.8	–4.3	–0.7	9.6	13.8	14.3
All Other Sources	8.1	5.4	5.0	0.9	–0.5	3.0

Sources: Federal Reserve, National Association of Real Estate Investment Trusts (NAREIT), LaSalle Advisors Investment Research

- Property capitalization rates, which measure the annual income generated by a property as a percentage of its purchase price, are falling (see Chart 2). These falling rates indicate that investors are paying higher prices for each dollar of current income generated by the property. Overall, however, prices have not yet caught up with rents, which now exceed their previous highs in some markets, suggesting that the current recovery is not yet peaking.

- Declining vacancy rates reflect strong demand for office properties, which ***Grubb & Ellis*** cast as the hottest sector in its 1997 forecast. Nationwide, office vacancies have fallen dramatically, by 5 to 10 percentage points during the last four years (see Chart 3). Moreover, ***Torto-Wheaton Research*** estimates that 21 of the 56 metropolitan areas it tracks had single-digit vacancy rates at the end of first quarter 1997. Not surprisingly, many of the tightest markets are those with the greatest rent inflation.

While the unrestrained commercial development of the 1980s continues to cast a shadow over the industry, that shadow is fading as declining vacancy rates and rising rental rates for existing properties fuel optimism among lenders and investors and strengthen the case for new development. Lenders, examiners, and analysts, however, must be diligent in monitoring commercial real estate markets to identify possible imbalances between supply and demand. It is particularly important that lending decisions be made on the basis of economic feasibility and realistic property cash flow projections rather than solely on the basis of competitive pressures.

Borrowers' Financing Options Expanding

Although banks are clearly the largest source of financing for resurgent commercial real estate markets, a broader and more competitive financing market has emerged. In this market, financing often bypasses banks, being funneled instead through entities that purchase and securitize commercial real-estate-secured debt or the properties themselves, parceling them into smaller, more standardized, and thus more liquid pieces that are attractive to institutional and individual investors alike. This trend is illustrated in Table 1, which shows the increasing roles commercial mortgage-backed securities (CMBSs) and real estate investment trusts (REITs) have played in funding commercial real estate over the past five years. This increase in public

CHART 1

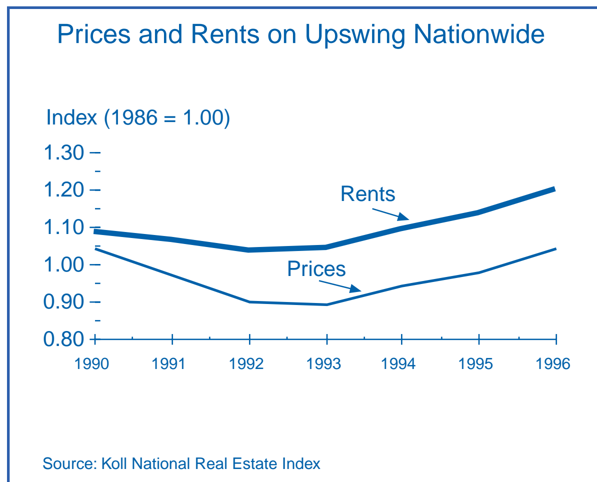


CHART 2

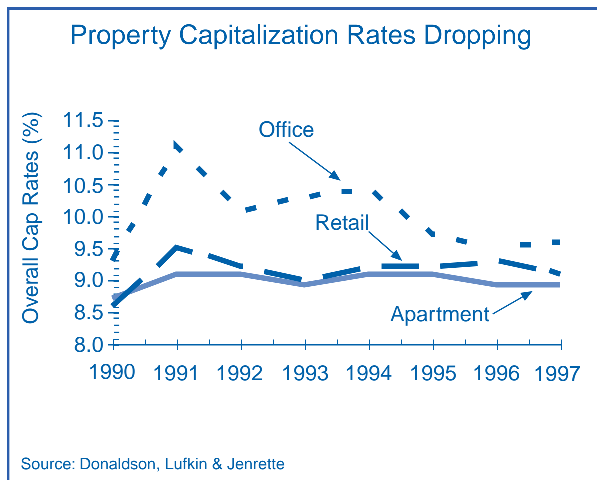
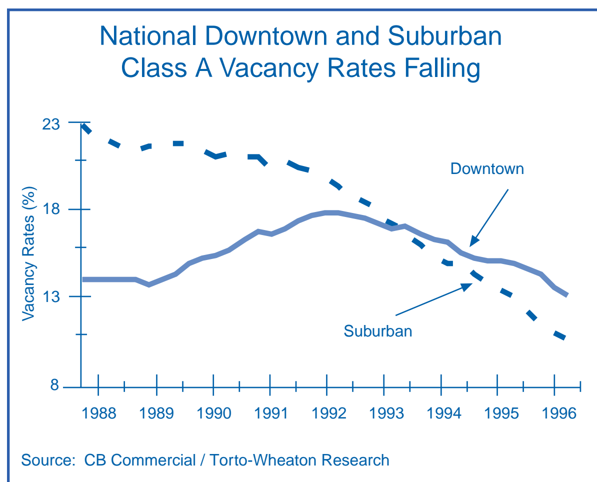


CHART 3



financing left financial institutions in 1996 with approximately a one-third share of all new net commercial real estate financing, down from well over half just a decade before.

From a lender's perspective, CMBSs offer several advantages over traditional portfolio lending. Most significantly, lenders can generate fee income from loan production and servicing activities while avoiding the excessive concentrations of credit risk that plagued lenders during the last real estate downturn.[2] According to ***Commercial Mortgage Alert***, outstanding CMBSs reached $125 billion in 1996 on a record $30 billion of new issuance. While outstanding volume is still dwarfed by the $3 *trillion* market for residential mortgage-backed securities (MBSs), the growth in CMBS volume has been remarkable considering that such securities were virtually nonexistent prior to 1991.

At present, most commercial banks are not active in issuing CMBSs, accounting for only $2.6 billion of CMBS issuance in 1996, according to ***E&Y Kenneth Leventhal Real Estate Group***. Rather, the primary source of these securities is investment banks, which generate substantial fees by converting existing loans into securities. CMBS issues also are being increasingly underwritten by *conduits*, which are entities created to originate mortgage loans for distribution to investors in the secondary market. ***Nomura Securities International*** estimates that such conduits accounted for over one-third of CMBS issuance in 1996, nearly double the volume of 1995. Only a handful of the largest commercial banks have set up conduit programs—the five largest banks accounted for $3.3 billion of the $10.2 billion in conduit issuance during 1996. Aside from this relatively small number of bank competitors, investment banks are among the largest and most active conduit issuers.

There is no fundamental reason why banks cannot take greater part in the rapidly growing CMBS market. In fact, they possess many distinct advantages over investment banks. Their distribution networks, lending experience, and back-office capabilities are naturally suited to facilitating loan demand, evaluating repayment risk, servicing loans, and monitoring a project's development. Obstacles of scale may preclude smaller institutions from directly issuing CMBSs ($500 million in volume is often cited as a minimum for efficiently assembling a deal). However, if the CMBS market develops like that for MBSs, standardized underwriting may enable small institutions to remain competitive either by cooperatively forming their own conduits or by selling their loans to existing conduits.

Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array of funding options. Moreover, the costs of public financing reflect efficiencies born of standardization and liquidity. In short, investors, including banks, can price, enter, and exit their positions in securitized debt more easily than could be done with whole loans. While improved efficiencies are a positive aspect of the growth in securitized investments, these efficiencies threaten to dictate bank pricing, thereby potentially reducing margins or driving institutions to lend on less economically feasible projects in an effort to preserve margins and market share.

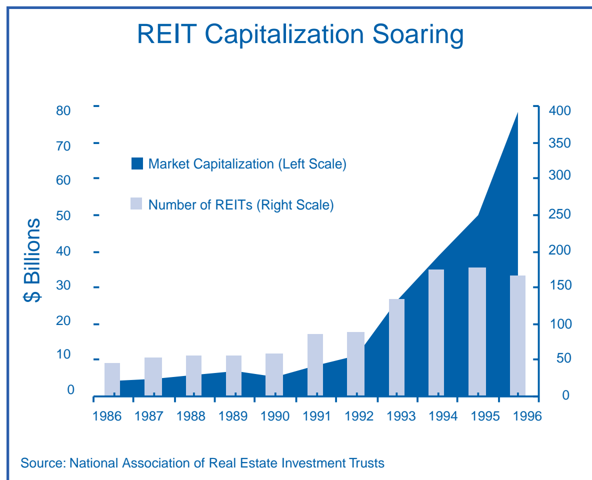
REITs: An Alternative to Traditional Capital Sources

Commercial real estate financing is evolving in other ways. REITs have become major players in the industry since 1993, accounting for fully one-fifth of funds flowing into real estate in 1996. REITs are much like mutual funds in that they allow indirect investment in real estate through purchases of equity in the REIT. The REIT itself holds title to the underlying properties and, provided it meets certain requirements, can directly pass through its earnings to investors without any intermediate tax. Although ***Moody's*** estimates place REIT holdings at less than 3 percent of all U.S. commercial real estate, outstanding REIT shares have grown considerably, with market capitalization doubling nearly three times in just four years (see Chart 4, next page). Accompanying this rise in capitalization has been an equally dramatic rise in bank lending to REITs. According to ***Loan Pricing Corporation***, bank lending to REITs surged to $12.8 billion in 1996, a 16 percent increase over 1995's then-record volume and more than a tenfold increase over the period 1990 to 1992.

The rise in REIT capitalization can be attributed in part to pent-up institutional demand for real estate. REITs

[2] While securitization of loans purports to shift credit risk to investors, many analysts and rating agencies have recently expressed concern over recourse arrangements, both contractual and voluntary, whereby the seller/servicer effectively assumes all or most of losses experienced by the security.

CHART 4



have a particular appeal to fund managers since they offer the benefits of investment diversification without the dual headaches of property management and asset illiquidity. Aside from the direct credit risk posed by lending to REITs, their rising popularity confronts banks with an indirect threat as well—the threat that banks could be crowded out of lending opportunities if investors find REIT funding structures more attractive from a cost and control standpoint. The degree to which this crowding out may occur is unclear, for according to ***Nomura Research***, REITs historically have borrowed 40 cents for each dollar of real estate held. However, well over half of this borrowing takes place through public offerings of secured and unsecured debt, leaving only a small portion to be financed by banks and other private lenders. Because REITs tend to focus on the highest quality projects, their increasing presence also creates concerns that banks may be driven to lend to less attractive or more risky properties to preserve market share.

Many analysts have also expressed unease over the rapid rise in the valuations of REITs, some of whose shares are priced at a considerable premium to the properties themselves. Anecdotal evidence suggests that premiums as high as 40 percent over market value have been paid for some REIT shares in recent months. Such market-based valuations create concern over the extent to which an REIT's capital structure allows it to pay more for properties than an investor who employs greater financial leverage. Accordingly, while REITs may make up a fairly nominal amount of overall real estate holdings, they may be quite influential in determining how commercial properties are being valued or appraised.

Commercial Real Estate Securitization: Some Broader Implications

Maturing CMBS markets could eventually improve the overall stability of commercial real estate markets not only by improving market liquidity but also by enabling investors to diversify and share their credit exposures among a greater number of participants. In addition, loan performance could become increasingly transparent to the general marketplace, thereby encouraging more uniform and prudent underwriting standards. However, concern naturally arises because CMBSs are a major source of commercial real estate market funding that has not been tested through a serious market downturn. This situation leads to questions concerning the impact they will have on property values and market liquidity and whether today's underwriting terms, driven largely by competitive factors, will stand up to tomorrow's market downturn. Another question is whether the standardized structures underlying these securities offer enough flexibility to borrowers to renegotiate loan terms—a critical workout tool during times of financial stress. The answers to these questions will ultimately determine the extent to which lenders and investors suffer as a result of the inevitable cyclical swings in commercial property values.

There are also questions about how REITs will affect commercial real estate markets. One argument is that the appetite for REIT investments, combined with the premiums that the trusts can pay for properties, will push the price of commercial space beyond sustainable levels. Those who hold this view see REITs, and other Wall Street innovations that increase the supply of funding, as potentially amplifying cyclical swings in real estate values. The contrary view holds that REITs will improve market efficiency by providing continuous pricing benchmarks through daily share price movements and thus enforce discipline upon developers and lenders. This discipline, it is argued, will prevent excessive development and dampen the severity of real estate cycles.

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estate-

based instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose how best to compete against—or participate in—these new real estate financing strategies.

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Falling Office Vacancy Rates Spur Development

Vacancy rates for office properties have been declining throughout the Region (see Table 2). However, aggregate commercial real estate loans held by insured institutions have yet to make a resurgence. As of June 30, 1997, loans secured by commercial real estate in the Region totaled $68.9 billion, or 7.29 percent of total loans outstanding; these figures are down from $76.6 billion and 8.72 percent of total loans outstanding at year-end 1990 (see Chart 5). Lending for real estate construction and land development loans also has declined from a high of $49.9 billion at year-end 1990 to $10.8 billion as of June 30, 1997. This pattern of moderation in commercial real estate lending is not uniform, however. As of June 30, 1997, 19.6 percent of banks in the Region that make commercial real estate loans reported growth in their portfolios of at least 30 percent from a year earlier. Also, 367 of these banks, or 41.4 percent, have commercial real estate loan portfolios that exceed 100 percent of equity capital.

According to ***Insignia/Edward S. Gordon***, office leasing jumped 59 percent in **New York City** during the first six months of 1997 compared with the same period in 1996. The midtown **Manhattan** market, the nation's largest office market, was particularly active. Midtown leasing activity in the first six months of the year rose 44 percent to 8.9 million square feet, pushing rental rates up 2.7 percent to an average of $33.86 per square foot. On **Long Island**, despite a strengthening local economy and a shortage of prime office space, rents have not yet risen enough to justify new construction. In **Westchester County**, cautious lenders are still holding back on development dollars, claiming that the wave of corporate turnovers and downsizings is not yet over in the county.

Reports from other markets across the Region indicate increased activity as well. **New Jersey**, the fourth-largest office market in the nation, is becoming an increasingly dynamic market. The amenities of the suburban campus environment offered by many New Jersey office complexes, coupled with easy access to housing and a skilled labor force, continue to attract

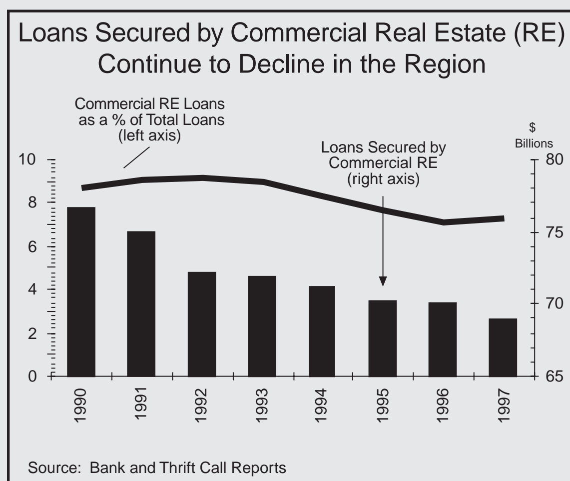
Table 2

Office Vacancy Rates Are Dropping

Metro Area	1991	1993	1995	1996	1997/Q2
Baltimore	19.1	17.2	13.8	11.5	10.5
Long Island	18.9	14.4	13.8	10.5	8.8
Mid-NJ	20.7	18.6	20.5	14.9	12.2
Northern NJ	22.5	20.8	16.2	12.6	11.2
Manhattan	16.5	15.1	14.9	11.6	10.6
Philadelphia	16.5	16.6	13.3	13.2	12.3
Wilmington	NA	19.5	13.1	12.8	12.8
Wash, DC	14.9	11.3	9.6	8.3	7.7
Westchester	21.5	22.1	22.4	17.0	17.0
United States	18.9	17.0	14.1	12.1	11.2

Source: CB Commercial Property Information Systems

Chart 5



companies seeking relief from New York City's high taxes and regulatory burden. *In the most competitive markets in northern New Jersey, a scarcity of Class A space may lead to speculative development as asset values quickly approach replacement costs.*

The suburban **Philadelphia** market also is becoming increasingly active. Developers are converting older industrial buildings to keep pace with demand; however, plans for new construction are minimal. Developers indicate that new construction is too time-consuming and can cost twice as much as renovating older buildings. In **Pittsburgh**, the office market continues to be suppressed by "rightsizing," technological innovation, and a slower economy. New speculative development in the city requires a large portion of the building to be preleased and some state and local government funding or tax incentives, according to ***Grubb & Ellis' 1997 Real Estate Forecast***. Absorption in the **Harrisburg** area has depleted the existing inventory, and rental rates are increasing. Demand for office space is strong in this part of Pennsylvania because of the backlog in demand and the need to replace obsolete space.

The recovery of the **Baltimore** market continues after downsizings and consolidations (particularly among banks) appear to have ebbed. The ***Society of Industrial and Office Realtors*** forecasts increased leasing activity in Baltimore's central business district, which should drive up sales and rental rates. The **District of Columbia**, the third-largest downtown office market in the country, behind New York City and Chicago, is still highly affected by federal government downsizing, which reports indicate will continue over the next three years.

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New York Region: Modest Job and Labor Force Expansion Continues

- **The New York Region continues to benefit from a modest economic expansion. During the first half of 1997, the Region added 333,000 new jobs. Over the same time, the Region's labor force grew at an annual rate of 263,000 workers. With more jobs available, more people are looking for work.**

- **Prices for single-family homes generally are rising throughout the Region. However, demand for new single-family homes varies widely.**

- **Tourism has become an increasingly important component of the Region's economy, pushing up hotel occupancy rates, increasing retail business, and stimulating traffic at the Region's major airports.**

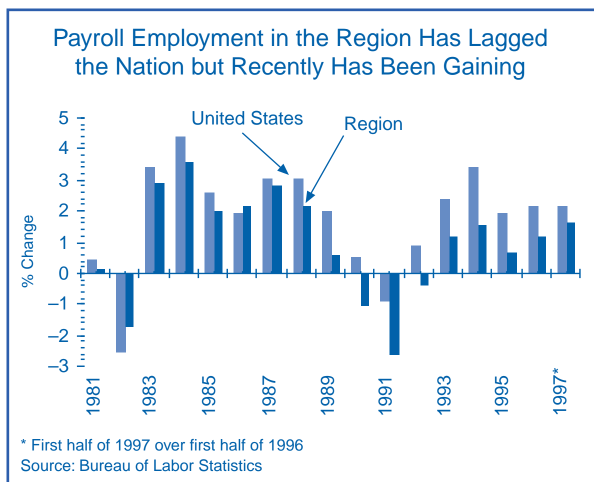
The New York Region continues to benefit from a strong economic expansion that is increasing both employment and the labor force. During the first half of 1997, the number of employed persons in the Region increased by 333,000, or 1.5 percent, over the first half of 1996. During the same period, about 263,000 individuals who had previously been neither working nor looking for work entered the Region's workforce, an increase of 1.1 percent. Overall, the Region continues to lag the nation in job growth, although the gap has been closing recently (see Chart 1).

With More Jobs Available, More People Are Looking for Work

As more jobs and employment opportunities have been created, more people have begun to look for work. Changes in the labor force roughly have followed the employment pattern in the Region, especially since 1995 (see Chart 2). During the first half of 1997, employment growth in every state in the Region and **Puerto Rico** exceeded or matched growth in the labor force, when measured on a year-over-year basis (see Table 1, next page). This has meant falling unemployment rates and tightening labor markets throughout the Region.

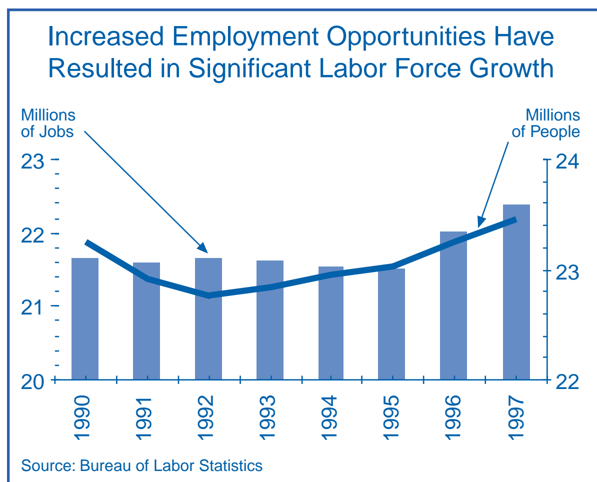
According to statistics published by the ***Bureau of Labor Statistics***, labor force participation rates—which measure participation by those already working or actively seeking employment—have risen for nearly all demographic subgroups over the past year. For example, formerly discouraged workers, who may have dropped out of the workforce during the downsizings of the early 1990s, are finding new employment opportunities and reentering the job market. Stronger labor market conditions are apparently encouraging older individuals to postpone retirement and pulling many retired workers

CHART 1



* First half of 1997 over first half of 1996
Source: Bureau of Labor Statistics

CHART 2



Source: Bureau of Labor Statistics

Table 1

Growth in Jobs Has Closely Paralleled the Growth in the Labor Force				
	Employment Growth (% Change)	Number of Jobs (Thousands)	Labor Force Growth (% Change)	Number of People (Thousands)
DE	3.2	11.7	2.7	10.2
MD	0.4	10.9	0	–1.3
NJ	1.7	64.3	0.9	34.8
NY	1.2	98.3	1.2	104.4
PA	2.2	121.3	1.6	95.4
PR	2.9	31.6	2.2	28.3

Note: Data represent first half of 1997.
Source: Bureau of Labor Statistics

back into the labor force. A combination of welfare reform and a strong job market also has led to a sharp increase in labor force participation for young women.

A 1997 study by ***Merrill Lynch*** found that rapid labor force growth serves as a safety valve, preventing excessive labor market tightening as new job opportunities become more abundant. The study also suggests that increased labor force growth may help to hold down wage inflation, because if the labor markets become too tight, wages would rise. Merrill Lynch cites the employment cost index, a measure of wage inflation that includes benefit costs, to support this argument. During the second quarter of 1997, that index was up just 2.8 percent from one year earlier. This rate matches the index low in 1995 and is probably the smallest annual rise in labor compensation in 50 years. The report forecasts that although some pickup in wage growth is likely at this stage of the business cycle, labor cost pressures will remain slight because there are still untapped pools of potential workers that will help cap wage pressures. For example, labor force participation rates for men ages 25 to 54 are still below 1980s levels and could easily rise further without straining the labor pool.

Despite the good news on job growth, the New York Region still has areas of high unemployment, with some of the larger cities reporting unemployment rates in the 8 percent to 10 percent range. The Region proportionally lost more jobs than the rest of the nation during the recession of the early 1990s, and its recovery has been slower. This is particularly true for the large metropolitan areas, such as New York City, Philadelphia, and Baltimore. There is a bigger surplus of labor in these areas that can act as a safety valve on local wages than elsewhere in the Region. In **New York City**, for example, as individuals became aware of new job opportunities, they began to reenter the workforce at a rate faster than the rate at which new jobs were being created. As a result, New York City's unemployment rate rose to double digits. Some economists believe that this surplus may draw employers to move or expand into the New York Region if labor markets tighten further in areas such as the Sun Belt and the Midwest. Moreover, as discussed in a previous ***Regional Outlook***, price inflation in the Region has been slowing relative to the rest of the nation. Historically, the Region has been a high-cost area. However, if these recent trends persist, the Region could become a more attractive place to do business.

Implications: Increased participation in the labor force signals improved optimism among workers that jobs can be found more easily. *More people working and looking for available work can be expected to stimulate demand for items such as homes, automobiles, and other consumer durables that require financing.*

Housing Industry Reflects Higher Prices but Uneven Demand

In general, prices for single-family homes continue to rise in the Region, although clearly not at the pace of the mid to late 1980s. According to data supplied by the ***Office of Federal Housing Enterprise Oversight*** (OFHEO), prices in the mid-Atlantic area (defined by OFHEO as New Jersey, New York, and Pennsylvania) have leveled off during the 1990s but are at or close to their all-time highs. Home prices are still more than 20 percent higher than prices in the United States as a whole (see Chart 3). Prices for Delaware and Maryland, which are not part of OFHEO's mid-Atlantic area, have trended somewhat lower but still exceed the U.S. average.

Information supplied by the ***National Association of Realtors*** (NAR) on median single-family home prices supports the OFHEO data. According to the NAR, most of the Region's metropolitan areas have experienced price increases over the past year (see Chart 4). However, there are exceptions—for example, Buffalo, Syracuse, Albany, and Newark all have endured falling or flat housing prices for several years.

Chart 3

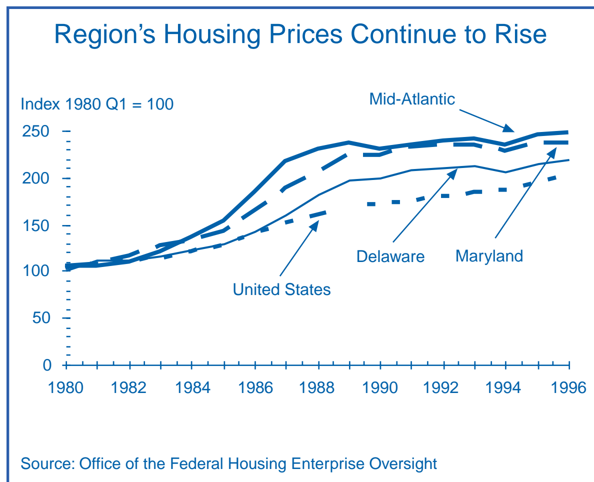
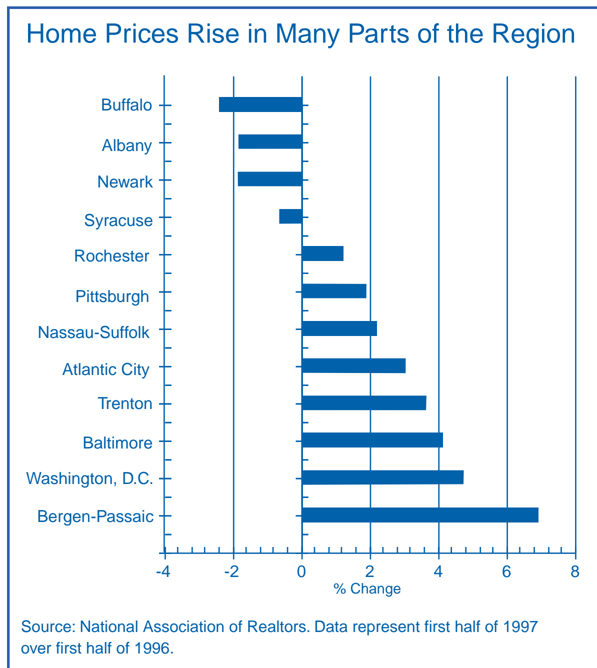


Chart 4

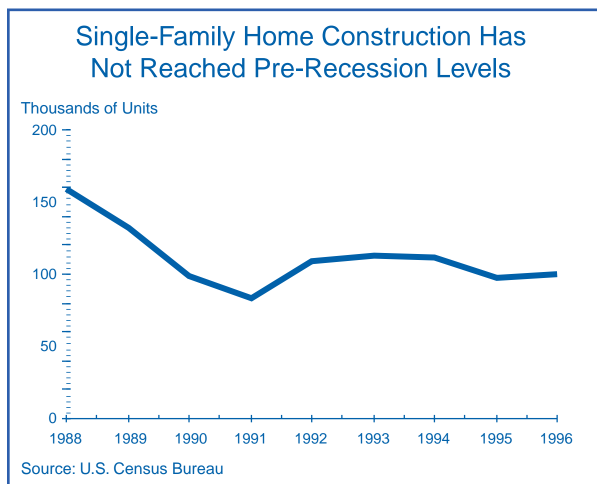


Data on Permits Tell a Mixed Story

In the Region, permits for single-family home construction have not reached their pre-recession levels. After recovering somewhat during the mid-1990s, permit activity fell off in 1995 and by 1996 was 37 percent below the 1989 level (see Chart 5). Between 1995 and 1996, newly issued permits grew only 2.7 percent. Despite the recent employment growth in the Region, which would normally stimulate permit activity, other factors apparently have played an offsetting role, including low population growth and limited availability of land. At present, **New Jersey** is the only state experiencing a surge in permits for single-family homes. While permits rose 25 percent on a year-over-year basis during the first six months of 1997 in New Jersey, permit activity in other states in the Region was barely improving or actually declining. Even **Pennsylvania**, which began the year with a sharp surge in single-family permits, has since trailed off.

In addition to examining trends at the state level, we also looked at new permits for single-family homes in the top 15 major metropolitan markets in the Region. Although these trends also vary extensively, they seem to loosely track with employment patterns at this level. For example, permits for single-family homes were up more than 47 percent in **Atlantic City** through the first six months of 1997 compared with the same period in 1996. Atlantic City is presently one of the fastest-growing cities in the Region. In addition, permit activity also was up 18 percent in **Dover** and 13 percent in **Harrisburg**, both cities also experiencing employment gains. In upstate New York, an area that has experienced weak or no employment growth for the past several years, new permit activity was down sharply. For example, in **Buffalo**, new permits for single-family homes dropped 28 percent through the first six months of 1997. In **Syracuse**, permit activity was off 25 percent, while in **Rochester** it was off by more than 7 percent. In other markets, however, permit activity did not appear to track well with employment patterns. In **New York City**, which is currently experiencing renewed employment growth, permit activity was off 2.5 percent. On the other hand, permit activity was up more than 6 percent in **Philadelphia**, which has had virtually no employment growth over the past year.

Chart 5



Home resale figures provide another indication that housing activity is erratic around the Region. Existing home resales (including single-family homes, condos, and co-ops) were up almost 10 percent from one year ago in Pennsylvania during the first quarter of 1997, but were up only 2 percent in New York State. Over the same period, housing sales were down more than 2 percent in **Maryland** and more than 3 percent in **Washington, D.C.** More recent data for **Albany** report that residential real estate sales were down 6 percent during the first six months of 1997 compared with the same period in 1996.

Housing Is Still Difficult to Afford

The inconsistency in housing markets may, in part, reflect the high cost of housing in many areas of the Region. A recent study of housing costs by ***E & Y Kenneth Leventhal Real Estate Group*** looked at the most and least affordable housing markets among 75 U.S. metropolitan markets. The study considered rental costs, home prices, and mortgage rates among other factors determining affordability. Median incomes were used as a proxy for local market incomes. Differences in taxes and tax deductions associated with home ownership also were considered.

Not a single city in the New York Region was among the 25 most affordable markets. The most affordable areas in the Region were **Buffalo** and **Rochester**, both, ironically, locales with weak economies. **Central New Jersey** and **Nassau and Suffolk Counties** on Long Island were considered to be in the 50 metropolitan areas having the most affordable housing. New York City ranked next to last.

Implications: Although housing activity has picked up in some areas, growth remains inconsistent. Improving employment conditions in the Region suggest improvement in the housing market and increased loan demand for residential mortgages. In the Region, residential mortgages for one- to four-family homes increased about 10 percent between June 1995 and June 1997, but these gains were not geographically uniform. For example, residential mortgages grew more than 12 percent over this period in downstate New York, an area regaining economic strength, but were down almost 3 percent in upstate New York, an area with a weak economy. Single-family homes in many places are still difficult to afford compared with other parts of the nation. *Areas identified as having low affordability could pose risks to banks originating mortgages. In areas of low affordability, home purchasers faced with a greater gap between their ability to afford a home and the costs of a home purchase must either stretch their budgets further to afford a house or leave the area to purchase elsewhere. To the extent that their budgets are stretched, the risks of personal financial difficulty increase.*

Tourism Is a Major Source of the Region's Economic Growth

The Region's economic expansion has drawn support from its strength in tourism and travel-related services. More than 266,000 individuals work in the Region's hotel and lodging industry alone, representing about 13 percent of the nation's total and generating more than $1.2 billion in wages and salaries. Tourism also has stimulated supporting businesses such as eating and drinking establishments, amusement facilities, airports, and travel-related services such as car rentals.

The benefits of tourism are being felt in many areas of the Region. For example, according to the ***Public Affairs Research Institute of New Jersey***, the tourist industry generated $18 billion in revenues in 1995, employed 348,000 workers, and produced $2.4 billion in tax revenue. In 1996, Atlantic City casino-hotels employed more than 40,000 people representing a total payroll of $2 billion. The number of annual travelers to New York City in 1996 was a record 31.2 million, according to the ***New York Convention and Visitors Bureau***. Even the ***Visitors and Convention Bureau of Center County*** expects visitors to spend well over $100 million next year in that part of Pennsylvania.

An example of the importance of tourism to one metropolitan area is shown by a recent study of Long Island. Although it is difficult to separate tourist from business travel, the recent study by the ***Long Island Convention and Visitors Bureau*** found that tourism supports 152,000 jobs on Long Island, or up to 12 percent of its workforce. They estimate that tourism is responsible for $2.8 billion in salaries and wages, or 10 percent of the island's entire payroll (see Table 2).

Given the importance of tourism, it is not surprising that Maryland is seeking to take greater advantage of

Table 2

Tourism Is Benefiting Long Island's Economy				
Industry	Direct Jobs	Indirect Jobs	Total Jobs	Total Earnings
Restaurants/Bars	54,235	19,481	73,716	$1.1 billion
Other Industries	4,923	7,008	11,931	$448.0 million
Commercial Sports	2,099	6,033	8,132	$255.9 million
Auto Rentals	1,925	4,972	6,897	$243.0 million
Miscellaneous Amusement	11,380	7,150	18,530	$162.4 million
Hotels/Motels	4,729	3,735	8,464	$154.4 million
Gasoline Stations	4,028	1,722	5,750	$108.1 million
Miscellaneous Retail Stores	4,672	1,998	6,670	$106.9 million
Passenger Transportation	2,299	1,550	3,849	$94.7 million
Producers/Entertainers	1,602	2,877	4,479	$83.0 million
Movie Theaters	1,269	2,506	3,775	$27.1 million
Totals	93,161	59,032	152,193	$2.8 Billion

Source: Long Island Convention and Visitors Bureau/Long Island Association. Data are for 1995.

tourism by making additional investments, according to a report by the ***Maryland Office of Tourism and Development***. In 1996, Maryland began remodeling the Baltimore and Ocean City Convention Centers. In addition, the state began the construction of two new National Football League stadiums and is spending additional sums on transportation, housing, and entertainment facilities designed to attract tourists. Like other parts of the Region, Maryland's hotel and lodging industry has seen increases in occupancy and room rates for five straight years.

A report by the ***New York–New Jersey Port Authority*** indicates that international travel has been a key source of growth in the area's tourism trade. This increase has been influenced by sustained economic growth throughout Asia and Latin America. According to the report, in 1996 a 6.9 percent increase in visitors from Asia and a 7.6 percent increase in South American tourists led the boom in international travel. Tourists from Europe, the largest single international source of visitors to the New York City area, advanced 2.4 percent to 2.2 million last year.

A ***Landauer Associates*** analysis of the hotel market suggests that growth in the hospitality market in the coming years will be stimulated by several economic variables, including the strength of corporate profits, employment growth, and travel patterns of domestic and international visitors. The strong demand in hotel occupancy is consistent with the rapid growth in international air travel at the Region's airports. According to a ***New York State Comptroller*** study, domestic passenger traffic at New York City's three airports increased by 4 percent in 1996 to almost 58 million passengers. International traffic grew by 5.1 percent to more than 23 million passengers. Over the past five years, these airports have experienced a 25 percent increase in international air travel.

Growth in tourism has fueled demand for hotel rooms and has pushed hotel occupancy rates around the Region to record levels. According to ***PKF Consulting***, which looks at the major tourist markets in the Region, New York City's hotel occupancy rate averaged a record 81.8 percent in 1996, up from 78.6 percent in 1995. In May, hotel occupancy stood at over 87 percent. Average daily room rates have risen to $175, compared with $156 in 1995. In Philadelphia, room rates reached about $120 in May, and occupancy rates stood at almost 84 percent. In Washington, D.C., occupancy rates were about 85 percent in May, with a room costing on average $132 per day. Strength in the tourist industry is stimulating demand for additional hotel space in New York City. Since there are few vacant building sites available, hotel development is taking the form of renovations of existing facilities. In 1995, approximately 1,550 rooms were added to Manhattan's supply, mainly through the reopening of hotels that had undergone major capital improvements. A recent article indicated that about 4,100 new hotel rooms are being planned in Manhattan, and some analysts say that New York City could easily support an infusion of 5,000 to 10,000 new rooms. That many rooms probably will not open

because of the expense of developing hotels, the difficulty of obtaining financing, the shortage of sites, and the potential for a quicker return on high-end apartment buildings. On the other hand, according to ***PKF Consulting***, the increasing number of investors interested in Manhattan hotels is pushing up asking prices. According to a report by ***Landauer Associates***, investors have been active on the debt side as well, with major investment banks originating lines of credit, commercial mortgage-backed securities, and mortgages. Wall Street firms are providing financing, filling a gap left by more traditional lenders such as banks and insurance companies.

Implications: A vibrant tourist industry has become increasingly essential to the Region's economy. *Tourism has stimulated a wide range of business activities, including lodging, entertainment, transportation, restaurants, and retail sales. This is beneficial for banks that have credit exposure to these industries*. The continued strength of tourism depends on factors such as a strong domestic and international economy as well as moderate transportation costs. All these factors appear sound at this time. Moreover, although there is some hotel construction taking place in some of the markets we examined, the supply of new rooms does not appear to have outstripped demand. Nevertheless, owing to the possibility of an unexpected change in economic fundamentals that could dampen tourism, prudent bankers will manage their credit exposure to hotel developers in the context of a well-diversified portfolio.

Norman Gertner, Regional Economist

Financial Markets

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

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

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

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

[1] The amount of trust preferred stock outstanding is not delineated in Call Reports.

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

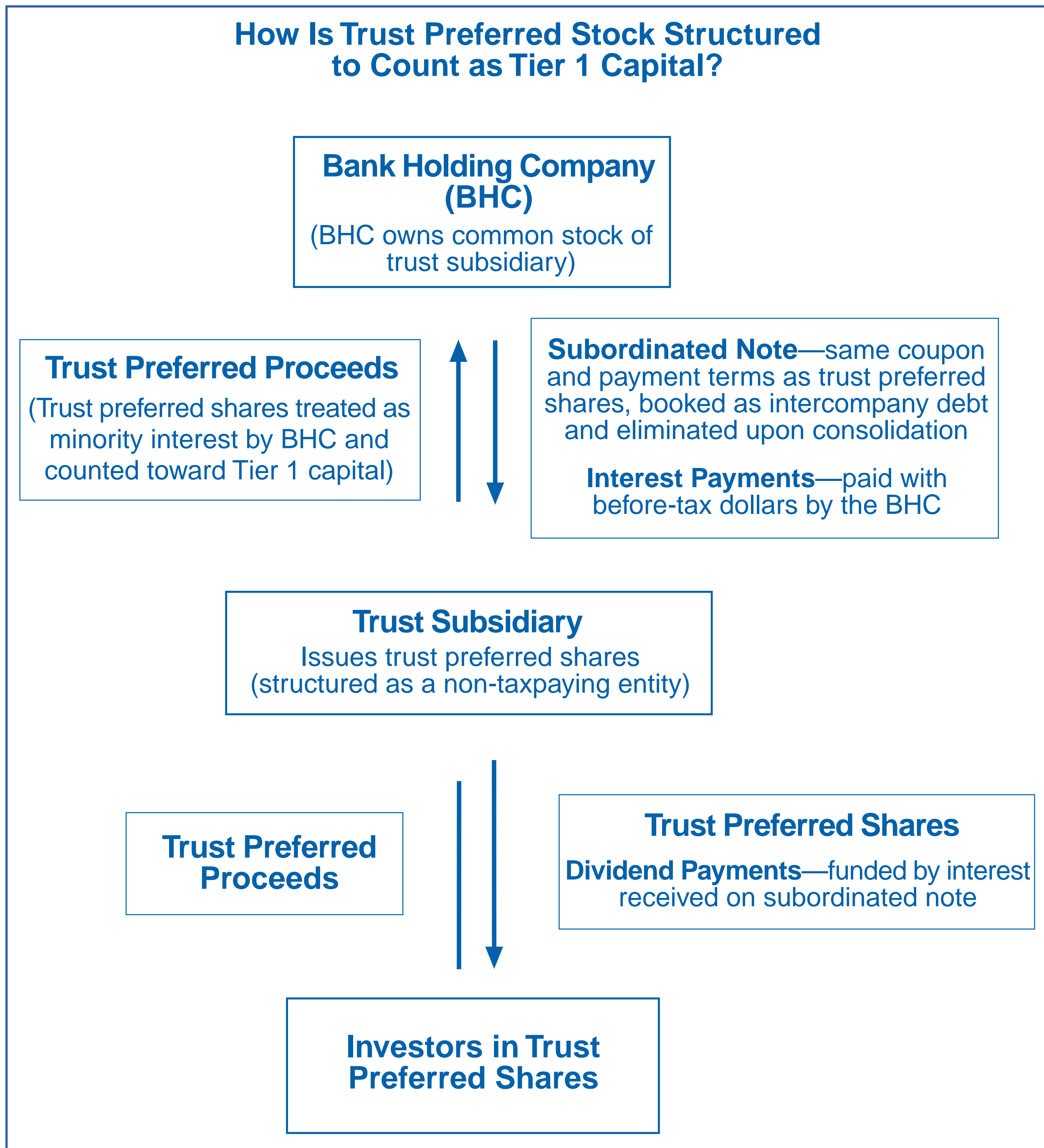
Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative

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-

CHART 1



company debt. The interest paid by the bank holding company on the subordinated note, which is tax-deductible at the bank holding company level, is used to fund the dividends on the trust preferred shares. In short, the issuing trust serves as a conduit for exchanging cash flows between the bank holding company and the investors in the trust preferred shares.

To be eligible for Tier 1 capital treatment, trust preferred dividends may be cumulative, but dividends must be deferrable for a minimum of five years. If the dividends are not paid for more than five years, the trust preferred shares could be exchanged for junior subordinated debt of the trust. After the exchange, the trust preferred holder could declare an event of default and accelerate the claim against the bank holding company. Trust preferred shareholders would then be treated similarly to deeply subordinated debt holders or preferred stockholders of the bank holding company.

Trust preferred shares typically have maturities of 30 years or more and contain call options and redemption provisions. The redemption provisions, which are subject to Federal Reserve approval, permit the issuer to redeem or buy back the preferred shares prior to maturity upon an adverse event such as the loss of Tier 1 capital treatment or the tax deductible status.

Banks are not permitted to count trust preferred stock toward Tier 1 capital because of the cumulative feature of trust preferred dividends. While bank holding companies are permitted to include up to 25 percent of Tier 1 capital as cumulative preferred stock, including trust preferred shares, banks must exclude cumulative preferred stock from Tier 1 capital ratios pursuant to the Risk-Based Capital Standards set by the Basle Accord.

Bank Holding Companies of All Sizes Have Issued Trust Preferred Stock

The flood of trust preferred stock issuance was prompted in part by the threat of extinction under the 1997 federal budget. Bank holding companies rushed to take advantage of a potentially short-lived tax loophole, while investors were attracted by the opportunity to earn higher rates than on similarly rated bank debt. Bank holding companies have used proceeds from trust preferred stock to retire or call more expensive outstanding preferred issues, to provide capital to bank subsidiaries, to finance acquisitions, and to buy back common stock.

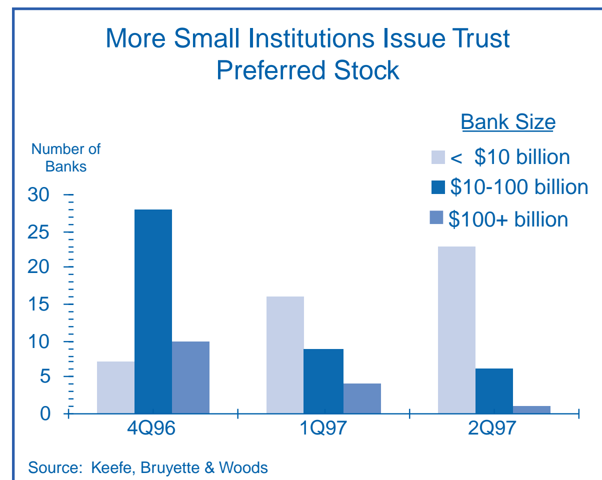
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated \$4.3 billion in the first quarter of 1997 to just under \$2.5 billion in the second quarter. Trust preferred issuance by larger banks declined as some approached their limit on Tier 1 trust preferred, while more smaller banks took advantage of the market for trust preferred stock. (See Chart 2 for a distribution of the number of banks in various size categories that have issued trust preferred stock in recent quarters.) Investment bankers are reportedly working on new structures that may make it easier and more cost effective for smaller institutions to issue these capital securities, perhaps through some pooling arrangement.

REIT Preferred Stock—Another Type of Tax-Advantaged Tier 1 Capital

Prior to the Federal Reserve's announcement last October, the REIT (real estate investment trust) preferred stock structure was the chosen way for financial institutions to issue tax-advantaged preferred shares. Bank-issued REIT preferreds lost favor once trust preferreds debuted, because the trust structure is less costly and easier to administer than REIT preferreds.

In an REIT preferred structure, the issuer establishes a corporation that elects REIT tax status. Proceeds from the preferred shares that are sold to investors are used to purchase qualifying real estate assets such as mortgage-backed securities or equity interests in real property. Cash flow from the real estate assets funds the REIT's

CHART 2



operating costs and preferred dividends. As long as the subsidiary continues to qualify for REIT tax status,[3] dividend payments on the common and preferred shares are tax deductible by the holding company.

Will the Tax-Advantaged Status of Trust Preferred Stock Continue?

Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget, the possibility still exists that the Internal Revenue Service (IRS) may alter the tax treatment of trust preferred dividends. (In the first half of 1997, the IRS issued a ruling that eliminated the tax-advantaged status of a specific type of preferred stock known as Step-Down preferred stock.) If the tax advantage is eliminated, REIT preferred shares might again become a more popular means of raising tax advantaged Tier 1 capital.

Issues and Concerns

A number of bank holding companies have embarked on stock buyback programs financed by trust preferred stock issuance, thereby boosting earnings per share by reducing the number of common shares outstanding, while maintaining Tier 1 regulatory capital ratios. Rating agencies and investment analysts, however, generally view trust preferreds as analogous to preferred stock or deeply subordinated debt of the issuer. *In fact, **Standard & Poor's** has announced that bank holding companies with trust preferred stock in excess of 10 percent of Tier 1 capital may be subject to a ratings review.* This announcement reflects the view of some analysts that trust preferred stock is a weaker form of Tier 1 capital than other forms of capital such as common and perpetual preferred stock, because of its limited life and treatment upon a liquidation of the trust.

A recent regulatory interpretation has underscored the debt-like nature of trust preferred stock. The Office of the Comptroller of the Currency (OCC) has determined that investments by banks in trust preferred stock should be treated as investments in debt securities.[4] The OCC cited a number of similarities between trust preferred stock and debt securities, including the fact that an investment in trust preferred securities is functionally equivalent to an investment in the underlying subordinated debt issued by the bank holding company, and that the trading characteristics of trust preferred securities are similar to traditional debt securities.

Banking organizations should be aware of the views of rating agencies and bank analysts toward trust preferred stock. In times of economic stress, excessive reliance on debt-like capital instruments could result in increased financial fragility of the overall organization, a higher cost of raising new capital, and potential ratings downgrades. In extreme scenarios, pressures on the bank to service the obligations (explicit or implicit) of the holding company could attract the attention of bank regulators.

Kathy R. Kalser, Chief
Financial Sector Analysis Section

[3] To qualify as an REIT, the subsidiary must comply with Section 856 of the U.S. Federal Income Tax Code, which requires that 75 percent of the REIT's income come from real property rents, interest income from mortgage debt on real property, and other related sources. In addition, the REIT must distribute at least 95 percent of its net income to shareholders.

[4] In a letter dated April 8, 1997, the OCC stated that subject to applicable rating and marketability requirements, bank investments in trust preferred stock would be treated as Type III investments under 12 CFR Section 2 1.2 (k).

Current Banking Trends in the New York Region

- **The New York Region's banks and thrifts continue to show solid midyear performance.**
- **Loan losses at the Region's credit card banks continue to rise.**
- **Institutions in the Region are turning to alternative funding sources as consumers place more of their savings in mutual funds and other nondeposit investment products.**
- **New York State continues its role as host to foreign banking organizations.**

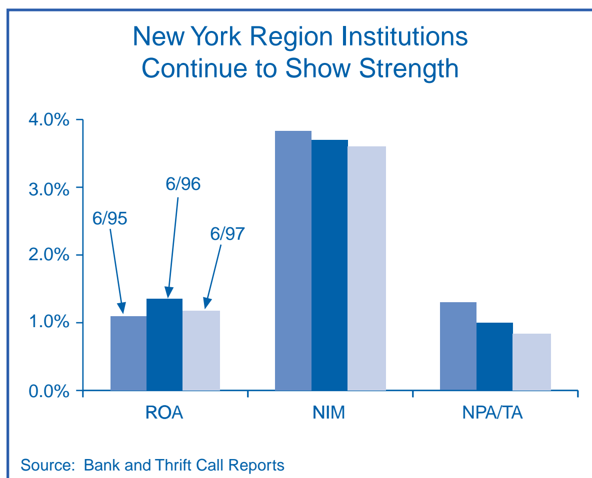
The Region's Insured Institutions Remain Healthy

The Region's banks and thrifts continue to report solid financial results (see Chart 1) despite a narrowing net interest margin and a modest decline in return on assets. For the quarter ended June 30, 1997, insured institutions in the New York Region reported:

- a return on assets (ROA) of 1.08 percent, down from 1.21 percent one year earlier when aggregate results were bolstered by noninterest income in commercial banks with assets over $1 billion;

- a modest decline in net interest margin (NIM) of 9 basis points to 3.59 from one year earlier (rising yields on earning assets have not kept pace with increased funding costs over the past year in commercial banks with assets over $10 billion); and

CHART 1



Source: Bank and Thrift Call Reports

- a decline in nonperforming assets (NPA) as a percentage of total assets (TA) to 0.84 percent in the second quarter of 1997 from 1.02 percent a year ago (the decline is primarily due to improvement in commercial real estate loan portfolios).

Thirty-nine insured institutions, with combined assets of $29.6 billion, reported net losses at midyear 1997. Together, these institutions lost a total of $39.7 million. Combined assets of these institutions equaled less than 2 percent of aggregate assets in the Region. Sixteen institutions reporting midyear losses were de novo institutions (those beginning operations since 1994), and six were credit card banks.

Credit Card Banks Show Declining Asset Quality

Credit card banks in the Region continued to report higher charge-off rates in the second quarter. Their weighted average charge-off rate was 5.67 percent as of June 30, 1997, compared with 4.86 percent on March 31, 1997, and 3.72 percent on December 31, 1996. However, past-due and nonaccrual rates declined to 4.5 percent in the second quarter of 1997, from 4.69 percent on December 31, 1996. This decline may be a result of the trend toward rolling delinquent credit card debt into home equity debt consolidation loans or may reflect more stringent underwriting and collection standards implemented by many credit card banks in 1996 (see ***Regional Outlook***, third quarter). Outstanding credit card receivables, which fell by 6 percent in the first quarter, increased in the second quarter to match the year-end 1996 level. On a positive note, ***Bernstein Research*** reported that personal bankruptcy filings showed slower growth in June than forecasted. They

project that bankruptcy filings will be relatively stable over the next three to four quarters.

Funding Patterns Change as Competition for Consumer Deposits Increases

Regional banks and thrifts are changing their funding strategies as a result of the increasingly competitive market for consumers' financial assets. As consumers shift an increasing percentage of their assets into mutual funds and other nondeposit investment products, banks have had to scramble to maintain deposit accounts. Mutual fund assets, which exceeded $4 trillion in July 1997, have more than quadrupled since 1989, while bank core deposits have shown little or no growth since the late 1980s. In 1980, banks held 54 percent of the total financial assets of financial institutions in the United States; by June 1995, that figure had fallen to 32 percent. In 1980, consumers placed about 34 percent of their assets in savings and checking accounts, compared with just 17 percent in 1995; this trend is likely to continue given the growth of mutual funds and 401(k) plans. *The stiff competition from financial services companies increases the need for banks to find alternative sources of funding.*

Insured institutions in the New York Region always have relied less on core deposits for funding than banks across the nation (see Charts 2 and 3). For example, the ratio of core deposits to assets as of June 30, 1997, for all insured institutions in the United States was approximately 53 percent, but the New York Region's average was only 37 percent. Conversely, noncore funding in the Region, which for this analysis includes time deposits over $100,000 (large certificates of deposit [CDs]), foreign deposits, federal funds purchased, and other borrowings, accounts for 46 percent of total assets. The national average in June 1997 was only 34 percent.

Large commercial banks in the Region drive this result. The ratio of noncore funding to assets at the Region's commercial banks with total assets over $10 billion is 53 percent, compared with 43 percent for all U.S. banks with assets over $10 billion. Reliance on noncore funding in the Region's largest banks has been increasing modestly over the past few years. The trend toward greater reliance on noncore funding by the Region's commercial banks continues in those banks with total assets between $1 billion and $10 billion, for which noncore funding to assets is 46 percent, compared with the national ratio of 31 percent in similar-sized banks. It is only in commercial banks with less than $1 billion in assets that Regional reliance on noncore funding falls into step with national ratios. *The Region's historically higher reliance on noncore funding may indicate a better ability for the Region's banks, especially the larger commercial banks, to adapt in today's changing environment. Still, the changing marketplace presents new challenges for all the Region's institutions.*

Since 1992, noncore funding has consistently outpaced growth in core deposits but continues to lag growth in mutual funds (see Chart 4). Spurred on first by "other borrowed money" (including term federal funds and Federal Home Loan Bank debt) and then by foreign deposits and large CDs, the Region's banks have shown that in the current environment, alternative funding sources are readily available to support asset growth.

CHART 2

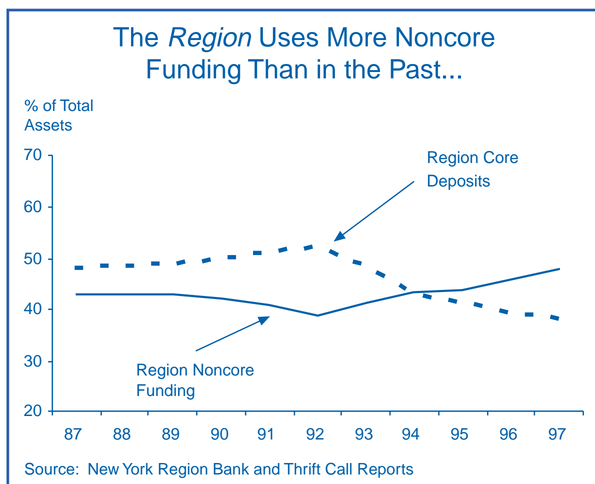


CHART 3

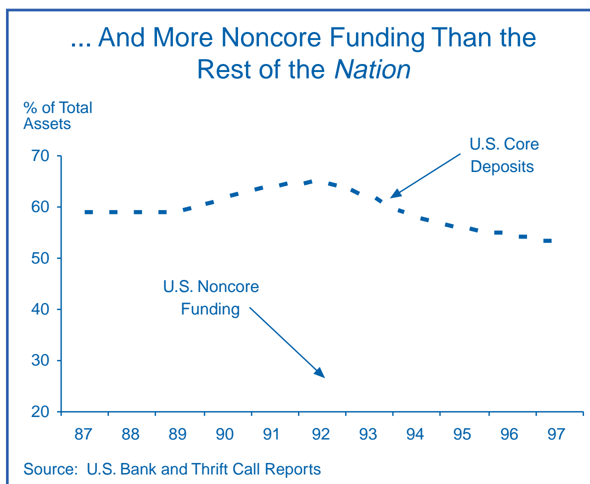
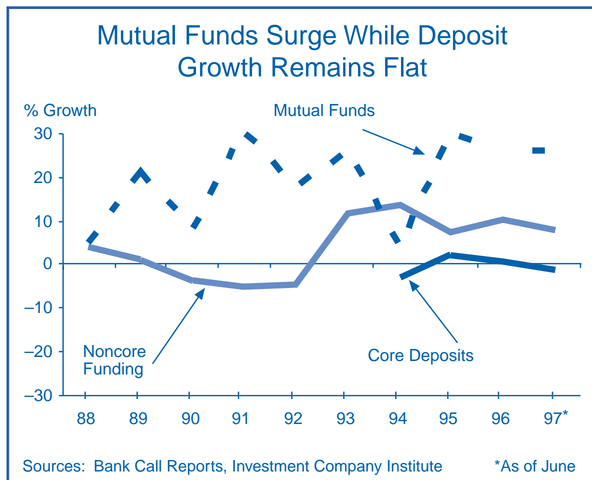


CHART 4



Pressure on deposit bases has led banks to turn to the capital markets as a source of funding, utilizing capital notes and subordinated debt. Securitization of consumer mortgage and credit card debt also is becoming a more popular vehicle to fund loan growth. According to ***CFO Alert***, overall debt issuance by banks doubled in the first half of 1997 compared with the same period last year. The favorable market conditions, including strong earnings and low interest rates, have prompted a significant number of smaller banking institutions to tap the public market for the first time and could widen the array of banks actively using the capital markets. Market experts predict that this trend is likely to continue, especially if interest rates remain low. However, an investment banker at ***Stifel Nicolaus & Co., Inc.***, noted that issuing senior debt for funding purposes does not yet provide community banks with a cost-effective alternative to deposits.

Increased use of noncore funding may lead to more volatile funding costs and liquidity concerns in an environment of rapidly changing interest rates. The relatively stable interest rates over the past few years have not provided a test for banks' performance under more volatile conditions. ***Stifel Nicolaus & Co., Inc.***, for example, warns that increasing interest rates could deflate the market for bank bond issues. However, some noncore funding sources, such as long-term Federal Home Loan Bank advances, can be relatively stable.

In addition, the costs of different noncore funding sources are converging. This makes it relatively inexpensive to use a variety of noncore funding sources, while providing more options in managing liquidity. For example, foreign deposits in 1997 cost about the same as large CDs. Banks also are finding that sometimes noncore funding is cheaper than retail time deposits (deposits less than $100,000) because of competition for funds. This may be especially true in the New York Region, where large banks in some major metropolitan markets tend to pay higher rates on retail CDs than the U.S. average. *Nevertheless, banks must recognize the potential liquidity and interest-rate risks that accompany noncore funding and ensure that proper procedures are in place to manage these risks.*

New York Is the Center of Foreign Bank Operations in the United States

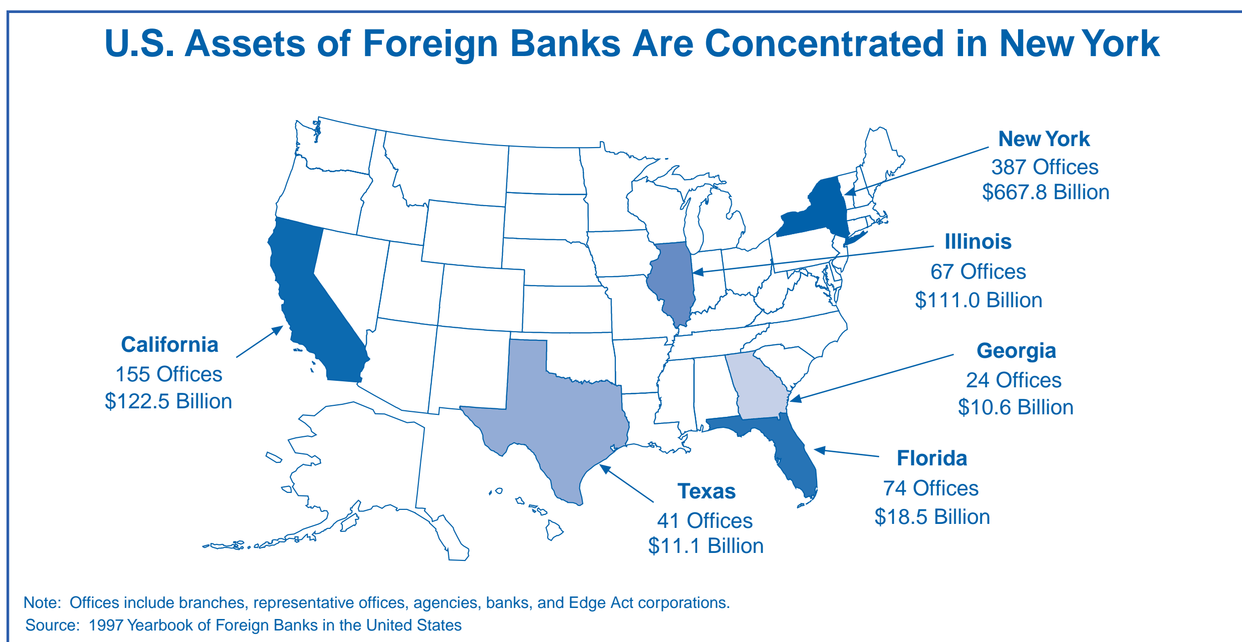
New York State has a long history of hosting foreign banks operating in the United States. In the 1960s, the appeal of overseas markets increased, and U.S. banks, led by the New York money center institutions, aggressively expanded their worldwide operations. This dramatic expansion changed the character of banking markets around the world and compelled major banks in Europe and Japan to increase their own international activity. As the U.S. dollar became the dominant currency in world trade and as foreign corporations turned to the growth-oriented economy of the United States for expansion, foreign banks recognized the need to establish a U.S. presence. New York, the principal financial center in the United States, became the entry point for many foreign banks.

New York State hosts 387 foreign bank offices, or 44 percent of total foreign bank offices in the United States. These offices have total assets of $667.8 billion, or 65 percent of assets, booked in foreign bank offices (see Chart 5, next page). Fifty-five countries have bank operations in New York State, with Japan having the largest representation. As of June 30, 1997, 15 insured branches[1], with aggregate assets of $6.6 billion, had estimated insured deposits totaling $2.4 billion. All insured branches in the Region are located in New York City. Thirty-four insured subsidiary banks[2] of foreign

[1] An insured branch is a branch of a foreign bank whose deposits are insured by the FDIC. FDIC insurance is required whenever retail deposit activity is conducted. Under the Foreign Banks Supervision Enhancement Act of 1991 (FBSEA), foreign banks wishing to conduct retail deposit taking activity may do so only through an insured, domestically chartered subsidiary bank. Branches that had FDIC insurance prior to FBSEA may continue to accept retail deposits, but no new insured branches may be established.

[2] An insured subsidiary bank is a separately capitalized institution whose parent is a foreign banking organization. Deposits are insured by the FDIC. These subsidiary banks have all the banking powers exercised by domestic banks.

CHART 5



banking companies had aggregate assets of $96.6 billion, with estimated insured deposits of $49.5 billion. These banks are located across the Region in Delaware, Maryland, New York, Pennsylvania, and Puerto Rico.

Foreign bank assets in the U.S. reached a record high of more than $1 trillion by year-end 1996. The increase in total assets of 2.8 percent, though modest, reversed a decline reported at midyear 1996. The ***International Banking Regulator*** characterized the rise in assets as impressive considering several negative circumstances, including the retreat of Japanese banks, a decline in foreign assets in California, and the significant changes currently taking place in the U.S. financial services industry. *Some analysts, however, contend that foreign banks will need to rethink their strategies and develop new product lines to ensure that they can compete effectively in an era of financial modernization.* In response, foreign banking organizations have developed nonbanking activities, boosted their retail operations, and increased off-balance-sheet activities, including derivative trading.

These initiatives into increasingly sophisticated business lines can add a new layer of risk, particularly if control procedures do not keep pace with innovations. Over the past few years, a number of dramatic and well-publicized incidents involving fraudulent activities have been uncovered at both domestic and foreign financial institutions. These events have proven costly to—and even threatened the existence of—the institutions involved.

New York State Adopts New Audit Regulations for Foreign Branches and Agencies

To maintain and enhance safety and soundness, the New York Banking Board adopted Part 5 of the General Regulations. Part 5 is titled *Internal and External Audits at Branches and Agencies of Foreign Banking Corporations*, and it establishes a set of new auditing regulations for foreign banks' New York branches and agencies.

"We learned our lessons from the control issues that arose in institutions such as Daiwa and Barings," said Acting Superintendent Elizabeth McCaul. "Thus, the New York State Banking Department is formalizing a regulatory framework, which will hopefully prevent other institutions from meeting the same fate. The Banking Department has always recommended the retention of internal or external auditors in the past. These new regulations enable us to require foreign banks, in certain instances, to hire qualified internal and external auditors."

Under the new rules, foreign branches and agencies with a ROCA Composite rating of 4 or 5 (see box) and a separate Operational Controls rating of 4 or 5 must

The ROCA Examination Rating System for Branches and Agencies of Foreign Banking Organizations Conducting Business in the United States

The term ***ROCA*** stands for ***R***isk Management, ***O***perational Controls, ***C***ompliance, and ***A***sset Quality:

- ***R****isk Management* is the process of identifying, measuring, and controlling risk. Primary components of sound risk management include a comprehensive risk assessment approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks.
- ***O****perational Controls* assessment measures the effectiveness of the branch's operational controls, including accounting and financial controls. Control procedures should ensure that operations are conducted in accordance with internal guidelines and regulatory policies.
- ***C****ompliance* refers to the branch's ability to comply with all applicable state and federal laws and regulations, including reporting and special supervisory requirements.
- ***A****sset Quality* is evaluated to determine whether a financial entity has sufficient capital to absorb prospective losses. The evaluation of asset quality in a branch differs from that of a separately capitalized entity because the branch relies on the financial and managerial support of the foreign banking organization as a whole.

The overall *Composite Rating* indicates whether, in aggregate, the operations of the branch may present supervisory concerns and the extent of any concerns.

retain the services of an independent *external* auditor, subject to the approval of the Superintendent of Banks. These auditors must then conduct certain specified procedures related to the office's finances and internal controls. On a case-by-case basis, foreign bank offices that receive a rating of 3, 4, or 5 in the specific area of Operational Controls, regardless of their Composite rating, also must engage an independent external auditor.

The Superintendent of Banks also is empowered to require internal audits if the bank's Composite rating is 4 or 5 and its Operational Controls rating is 4 or 5. Further, the Superintendent, on a case-by-case basis, may require foreign bank offices with an Operational Controls rating of 3, 4, or 5 to conduct internal audits.

Basic elements of a control system should promote the prevention and detection of error, safeguard assets, and ensure the reliability of financial records. An adequate control system is equally important to both domestic and foreign insured financial institutions, particularly as they undertake new strategies and business lines in the era of financial modernization. While examinations are not conducted to detect fraud or ensure the complete accuracy of financial records, an overall assessment of the control system remains an important examination function. Examiners' principal efforts should continue to be focused on the detection, exposure, and correction of important weaknesses in an institution's records, systems, and auditing procedures.

Kevin P. Hemhauser, Examiner
Suzannah L. Susser, Regional Manager
Karen A. Wigder, Financial Analyst

For More Information

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