◆ Regional Outlook ◆

Federal Deposit Insurance Corporation — Second Quarter 1998

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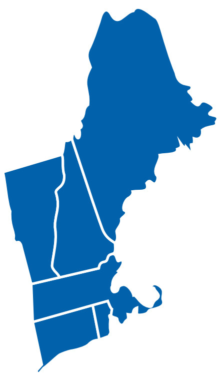

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In Focus This Quarter

◆ ***Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings*****—The accounting for transferring and servicing financial assets causes asset sellers, particularly high-growth lenders, to recognize significant noncash income related to retained economic interests in the sold assets. This is true whether a company securitizes its own assets or sells its assets as a conduit to another securitizer. Values are often driven by management assumptions about future performance of the sold assets. Major writedowns of gain-on-sale assets by some finance and mortgage companies underscore the importance of careful scrutiny of these assumptions by banks and their supervisors.** ***See page 3.***

By Allen Puwalski

◆ ***How Will the Expansion End?*****—Analysts are now focusing on when and how the current expansion will end. Although no one can accurately predict when a recession will begin, two possible scenarios have emerged. Each scenario has important implications for lenders as they prepare for the possibility of slower economic growth or recession.** ***See page 7.***

By Paul C. Bishop

◆ ***Trends Affecting the Allowance for Loan and Lease Losses*****—In today's environment, in which loan availability is abundant, growth is strong, and competition is fierce, some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the allowance for loan and lease losses (ALLL) relative to total loans at many insured institutions is declining. As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks associated with changing industry practices.** ***See page 11.***

By Andrea Bazemore

Regular Features

◆ ***Regional Economy*****—For many New England communities, hospitals or other large health services facilities are major local employers…recently, the health care industry's job growth has weakened, a trend that is of interest to insured institutions serving these areas…in early 1998, Asia's economic crisis was having only a modest effect on the Region's economy in the form of declining exports, scattered layoffs, and lower college enrollments by Asian students.** ***See page 16.***

By Norman Williams

◆ ***Regional Banking*****—Strong asset quality and efficiency gains push profitability…loan growth and asset growth are brisk…core deposit growth is disappointing…nonbank competitors continue to pick up market share…consumer credit problems remain on the horizon.** ***See page 20.***

By Daniel Frye, Cameron Tabor

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Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings

- **Gains generated from asset sales under SFAS 125 rely on management assumptions about the lifetime performance of the assets sold and may not materialize in cash if the assumptions prove incorrect.**

- **Gain-on-sale accounting has been most significant to securitizers, but nonsecuritizers can and do retain economic interests that give rise to significant gain-on-sale assets.**

- **Finance companies seeking to shift attention from gain-on-sale assumptions may find willing bank correspondents.**

- **The rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.**

Statement of Financial Accounting Standards No. 125 (SFAS 125), Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities, causes asset sellers, particularly high-growth lenders, to recognize significant noncash income. Applying SFAS 125, which became effective on January 1, 1997, can give rise to significant noncash gains and related assets if an economic interest is retained in assets sold. The value of retained interests in assets sold is quantified on the basis of management's assumptions about future charge-off rates, repayment rates, and the rate used to discount the expected cash flows from the loans sold. Because the value of these assets changes when actual performance deviates from the assumptions, the quality of earnings, capital, and liquidity for a lender that relies significantly on gains on sale must be considered carefully.

The recent writedowns of interest-only (IO) assets by a few major finance companies have led to a higher level of scrutiny of companies whose financial statements are influenced significantly by gain-on-sale accounting. The Securities and Exchange Commission has recently increased its scrutiny of publicly traded companies that use gain-on-sale accounting, and it may soon require assumptions regarding defaults, prepayments, and discount rates to be disclosed in financial statements. The same companies that enjoyed soaring stock performance thanks to high earnings growth caused by gain-on-sale accounting have seen their stock values tumble as they have had to write down their gain-on-sale-related assets.

Several major credit rating companies have recognized the significant effect of gain-on-sale accounting under SFAS 125 on interpreting financial statements. These companies have issued comments or reports dealing with SFAS 125's effect on the quality of earnings and capital of the companies they rate and how they adjust their analysis as a result. The consensus of these papers is that gain-on-sale accounting for companies that securitize often results in significantly higher reported earnings and equity compared to balance sheet lenders—without, in many cases, materially changing the underlying economics or credit risk to the originator of the assets.[1] Generally, the rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.

There Are Risks Associated with Gain-on-Sale Accounting

The asset booked in connection with an SFAS 125 loan sale is an IO strip that represents the present value of future excess spread cash flows generated by the transferred assets. Generally, asset-backed securitizations, including some classified as mortgage-backed securities, are structured so that each month the expected cash flows from the underlying assets will be sufficient to pay the investor coupon, the trust expenses, the servicing fee, and net charge-offs. The cash flow that the underlying assets will generate each month cannot be known with certainty because the underlying asset may allow for variable principal payments (e.g., credit card accounts), or the borrowers may default. Securitizations are structured so that there is enough cushion between the *expected* cash flows and the required payments and

[1] Duff & Phelps Credit Rating Company, "Securitization and Corporate Credit Risk." *Special Report Financial Services Industry,* July 1997; T. E. Foley and M. R. Foley. "Alternative Financial Ratios for the Effects of Securitization Tools for Analysis." *Moody's Special Comment,* September 1997; H. L. Moehlman, R. W. Merrit, and N. E. Stroker. "Capital Implications of Securitization and Effect of SFAS 125." *Fitch Research*, September 16, 1997.

expected charge-offs to absorb fluctuations in *actual* cash flows and *actual* charge-offs. This cushion is excess spread. As actual cash flows vary from projections, so does the excess spread generated.

According to SFAS 125, when a company sells assets and retains the right to future excess spread cash flows, the calculation of the gain on the sale includes the capitalization of this right. In many transactions, the gain on sale consists entirely of the fair value of the IO strip that represents this right—none of which is necessarily received in cash. In addition, with many transactions, cash receipt is further delayed while cash flows go to fund the spread account, which is analogous to an internal loan loss reserve.

SFAS 125 states that quoted market prices in active markets are the best evidence of fair value and should be used whenever available. Although there have been some sales of these IO strips, the number of sales is not yet sufficient to constitute an active market. When market prices are not available, SFAS 125 states that the estimate of fair value should be based on the best information available. In practice, fair value of the excess spread is determined by present valuing the expected cash flows using a discounted cash flow model.

The value of the right to future cash flows is determined on the basis of management's assumptions about the charge-off rate, the average life of loans, and the rate used to discount the cash flows. *These input assumptions drive the model results and, therefore, the magnitude of the gain.* The stability of the value of the IO will depend greatly on the extent to which the input assumptions accurately describe the pool performance over the life of the transferred assets. Changes in economic or market conditions that were not anticipated in the initial cash-flow assumptions will likely cause the pool of loans to perform differently than initially projected.

Gain-on-sale accounting is significant to securitizers. To illustrate the significance of the IO account to a securitizer's reported income, consider one major subprime lender. During fiscal year 1997, this company's IO asset grew by over $141 million. Despite a $28 million writedown of the IO asset, the net growth of the asset constituted over half of total revenue and over eight times net income. The revaluation of the IO was necessitated by higher-than-expected prepayment rates.

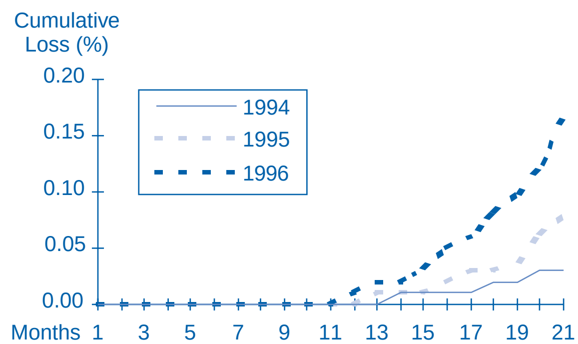
Current market conditions were not anticipated by many companies that benefited from high earnings related to gain-on-sale accounting. Several other major securitizers have reduced the carrying value of their IO assets in the face of either rising charge-off rates or higher prepayment rates. Writing down an IO strip largely represents a company's admission that it will not generate on a cash basis income that was booked previously.

Chart 1 displays the cumulative charge-off rates by vintage for ***Moody's*** index of home equity loan securitizations. The index consists mostly of prime mortgages, so the loss rates are still low. However, the rising trend in losses is noteworthy and reflects the growing influence of subprime securitizations on the index and the related decline in underwriting standards as competition has increased in this market. Loans originated in 1995 and 1996 are causing progressively larger and earlier losses. After 21 months of seasoning, the cumulative loss rate on loans originated in 1996 is .17 percent—almost six times the loss rate experienced by the 1994-originated cohort at the same age. Despite the continued low loss rates for the home equity market in general, subprime lenders are experiencing accelerated loss rates that are eroding the value of their interests in excess spreads.

There may be a tendency for management to base assumptions about expected loss rates on loans sold solely on past experience with similar loans. Such an approach may not capture changes in market conditions and trends. For example, the Moody's data demonstrate that loss rates on home equity loans, including first liens, have been trending upward rapidly. This trend implies that when estimating loss rates, management should consider the potential for changes in market con-

CHART 1

Vintage Analysis of Home Equity Loan Securitizations



Source: Moody's Investor Services

ditions over the life of the sold assets as well as the past performance of similar assets.

Like loss rates, prepayment rates have risen substantially in the subprime mortgage market. Several factors have contributed to the rise. One factor is the trend toward higher loan-to-value (LTV) loans in the mortgage market, which has allowed borrowers to obtain additional cash from their homes without waiting to pay down principal. Mortgage bankers report the tendency of some subprime borrowers, often debt consolidators, to maintain outstanding balances at the highest possible LTV. With maximum LTV ceilings rising, debt consolidators can refinance home equity loans without having to amortize existing debt.

Another important factor contributing to rising prepayment rates is competition among lenders for volume growth. To continue to grow volume, lenders have been sacrificing margins on loans to offer a better rate to borrowers. When estimating prepayment rates for subprime borrowers, it has been normal to expect that they would need to improve their credit rating, or "credit cure," before they would find it economical to refinance. Stiff competition for volume has allowed borrowers to find better rates without credit curing and has stimulated them to refinance prior to the time estimated at origination. Falling interest rates and a relatively flat yield curve are likely to increase prepayment rates.

In standard finance theory, uncertainty about the future level of losses and prepayment rates is compensated for by discounting the cash flows at a higher rate. Some analysts advocate using a discount rate similar to the required rate of return for equity investments. Faced with changing conditions, one large finance company that specializes in high LTV lending announced in December 1997 that it was increasing the discount rate it uses to value new IO strips from 12.5 percent to 33 percent.

The IO Strip Asset Is Growing at Insured Depository Institutions

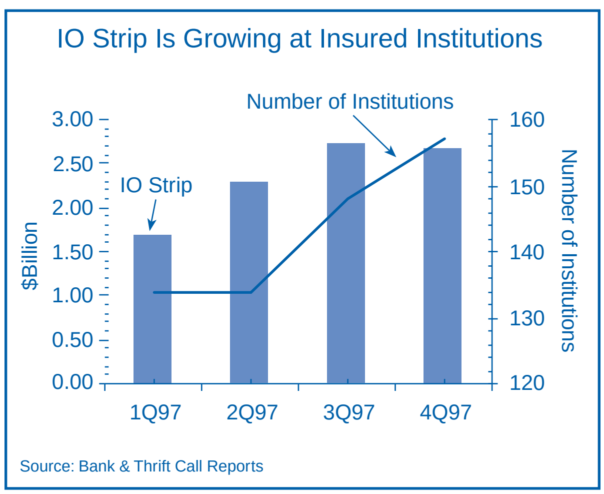
As of December 31, 1997, only 30 institutions reported this IO asset at more than 5 percent of tier 1 capital. However, some institutions have booked gains that should have given rise to a call-reportable IO strip but did not properly report the assets. Therefore, the current reporting may understate the prevalence of the asset.

Furthermore, the recent attention to gain-on-sale accounting from the public equity markets has at least a few large finance and mortgage companies seeking business strategies that shed IO strip-related volatility from their financial statements. One such strategy already in use is to leave the economic interest in excess spread with the correspondents that originate the loans. This is done as follows: The correspondent originates loans for purchase by a finance company. The finance company pays par for the loans, and instead of being paid an origination fee or a premium for the loans, the *seller* retains the right to excess spread generated over the life of the loan. The seller books a gain and an IO asset that capitalizes this right to receive future cash flows. The nature of the IO asset is exactly the same whether it arises directly from a securitization or from a sale of loans to a securitizer. *If this strategy is used widely by finance and mortgage companies, then IO strips are likely to grow among institutions that originate loans for sale to these companies* (see Chart 2).

For insured depository institutions, the capital effects of SFAS 125 need to be evaluated carefully. Analysis of the financial statements and leverage ratios of insured institutions should consider fully issues related to the quality of earnings and the stability of capital posed by the volatility of the IO strip. Insured institutions that engage in significant asset sales while retaining economic interests that give rise to SFAS 125–related assets are subject to distortions similar to those of nonbank financial companies.

The activity of originating and selling loans and booking associated gains can lead to capital ratios that

CHART 2



appear high by traditional bank standards. For several reasons, the leverage ratio can appear particularly high. First, although the asset may be more volatile than mortgage serving rights, there is no limit to the amount of IO strip that a bank can include in tier 1 capital. Second, the amount of IO strip booked increases capital by a gain on the net of the tax effect. The extent to which the amount remains in capital depends, of course, on the institution's dividend policy. Third, the denominator of the leverage ratio is reduced by the sale because the loans are no longer assets of the bank. The cumulative result can be a significant boost to the leverage ratio.

Several insured institutions report an IO strip at greater than 25 percent of tier 1 capital. For an institution whose primary line of business is originating and selling subprime mortgages, the asset can quickly reach a level exceeding tier 1 capital. In a little more than a year of originating and selling subprime mortgages to a major securitizer, one institution has amassed IO assets that it has valued at more than 150 percent of tier 1 capital.

The institutions that have concentrations of 25 percent or more of tier 1 capital in IO assets have a median leverage ratio of about 11 percent. In contrast, the median equity capital ratio for nonbank mortgage securitizers tracked by ***SNL DataSource*** is about 30 percent. Public debt markets or banks that lend to these finance companies appear to require significantly higher capital levels than regulatory minimums required for banks.

The potential for growth of the IO strip asset at insured institutions seems strong. In some circumstances, minimum capital standards for banks may require significantly less capital for IO asset exposure than the public equity markets. Perhaps more important, the quick rise of the significance of gain-on-sale accounting to the mortgage and consumer credit markets exemplifies the speed with which exposure to risk can be acquired through the securitization market. Strong demand for asset-backed securities coupled with changing accounting emphases, which in this case favor asset sellers, can lead quickly to substantial exposures.

Allen Puwalski, Senior Financial Analyst

Risk-Based Capital (RBC) Treatment of the Gain-on-Sale–Related IO Asset

If the IO asset derives from excess spread that absorbs charge-offs from the sold assets, then the IO strip constitutes recourse from the sold assets for RBC purposes. RBC standards require capital to be held against this exposure. In general, the capital requirement for this exposure is the amount of capital that would have been required for the assets had they not been sold. If the sold assets are one- to four-family residential mortgages, they may receive a 50 percent risk weighting. Subprime mortgages are not necessarily precluded from receiving this weighting.

In order to apply the 50 percent risk weighting, the capital standards require that one- to four-family residential mortgages be fully secured and prudently underwritten. The "fully secured" requirement precludes high-LTV loans with LTV ratios of greater than 100 percent from receiving reduced capital requirements, but the language of the RBC regulations does not necessarily preclude subprime mortgages in general from receiving the reduced risk weighting. Although the capital standards require that mortgages be prudently underwritten to qualify for the 50 percent risk weighting, it is not entirely clear how the term "prudently underwritten" applies to subprime mortgages. A higher expected loss rate alone may be insufficient cause for presuming that the mortgages are not prudently underwritten.

The rationale for reducing the capital requirement for traditional one- to four-family mortgage lending is related to the maturity of the market and consistently low loss rates. As noted above, the subprime mortgage market is changing rapidly, and loss rates can be much higher than in traditional mortgage lending. Accordingly, bank managements need to be aware of the potential volatility and risks associated with gain-on-sale assets associated with subprime mortgages.

How Will the Expansion End?

- **Despite a very low unemployment rate and high industry capacity utilization, inflation has been unusually subdued during this expansion, with price declines in some sectors.**

- **After seven years of expansion, most analysts expect the economy's growth to slow in the coming months.**

- **The last seven expansions have ended with an inflation-driven increase in short-term interest rates; in contrast, some analysts believe that the next recession will be caused by a period of falling prices for commodities, finished goods, and perhaps wages.**

- **Insured institutions that base lending and strategic decisions on assumptions of continued robust economic growth should scrutinize and test those decisions against possible adverse change in economic conditions.**

The current economic expansion is the third longest on record since World War II. Since mid-1991, when the expansion began, more than 15 million new jobs have been created and inflation-adjusted gross domestic product (GDP) has increased by nearly 20 percent. In fact, the unemployment rate reached a 24-year low when it fell to 4.6 percent in November 1997 and again in February 1998. At the same time, inflation has remained unusually low, at only 2.3 percent during 1997.

Analysts are now focusing on when and under what circumstances the current expansion will end. While no one can accurately predict *when* the expansion will end, two related but competing theories about *how* it will end have emerged in recent months. The first and more familiar scenario occurs when the Federal Reserve increases short-term interest rates to prevent a rapid increase in inflation caused by an overheating economy. The second scenario, a deflation-induced contraction, is less familiar in the context of recent recessions. This scenario posits a period of falling prices for commodities, finished goods, and, under the most severe circumstances, even wages.

Whatever the cause of the next downturn, its effects are likely to be important for the performance of lenders. During the 1990–91 recession, for example, the widespread deterioration of economic conditions was reflected in a number of indicators: Inflation-adjusted GDP fell by 2 percent; the number of business failures rose by nearly 40 percent; unemployment increased by more than 40 percent to 9.8 million; the unemployment rate peaked at more than 7 percent; single-family housing starts fell by almost 22 percent; and the bank card delinquency rate increased from 2.4 percent to 3.3 percent. This experience suggests that no matter what triggers the next downturn, dramatic adverse changes in the drivers of bank performance will likely result.

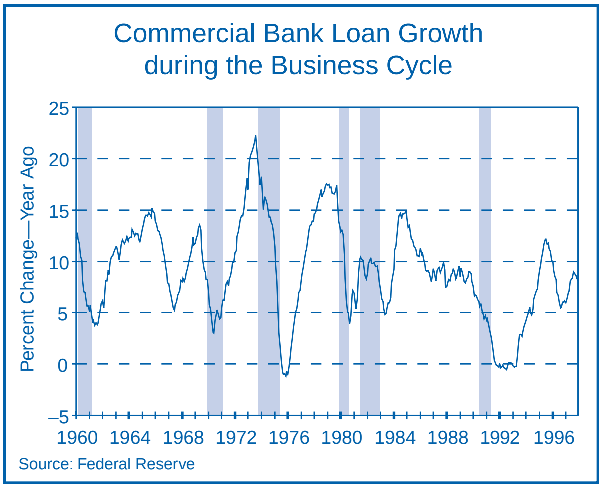
How Have Economic Expansions Usually Ended?

Although to some extent each business cycle is unique, virtually all of the post–World War II expansions have shown a similar characteristic: Toward the end of the expansion, inflation has accelerated. As the economy expands, the prices of inputs, including the wages of workers, are bid up as firms compete for resources to meet demand. The overall inflation rate will rise if prices increase across a large number of industries. Left unchecked, an increase in the overall price level may itself feed back into the labor market through demands for higher wages.

By raising short-term interest rates, the Federal Reserve can limit what might otherwise lead to a rapid increase in both wages and prices. Higher interest rates will reduce sales of capital goods, housing, and consumer durables, the demand for which is very sensitive to the level of interest rates. One reflection of this sensitivity is the changing pattern of loan growth over the business cycle. During periods of expansion, the demand for loans grows rapidly as businesses and households borrow to finance purchases of capital goods and consumer durables. If short-term interest rates are increased in response to inflationary pressures, loan growth will slow as businesses and consumers reduce their demand for loans. If interest rates continue to increase, loan growth may decline as it has done before and during each recession. The cyclical movement of loan growth (with vertical bars indicating periods of recession) is shown in Chart 1 (next page).

Looking more closely at short-term interest rates, Chart 2 (next page) illustrates the federal funds rate during the

CHART 1



last seven business cycles. While an increase in short-term interest rates has preceded each recession, it should be noted that an increase in rates is not sufficient to induce a recession. An increase in rates in 1984 was followed by a period of rapid growth that lasted until 1990. More recently, the increase in rates during 1994 was accompanied by a slowdown in the economy, but not a recession.

What Is Different about Inflation during This Expansion?

With history as a guide, one would expect inflation to rise as the current expansion matures. Chart 3 illustrates consumer price inflation during the four longest postwar expansions, including the current one. The chart shows the inflation rate at various points after the expansion began. During the expansion between 1975 and 1980, for example, the inflation rate was nearly 12 percent at the start of the expansion but fell to just over 6 percent after four quarters. Inflation remained at approximately 6 percent until the twelfth quarter of the expansion, after which it accelerated to more than 12 percent by the end of the 20-quarter expansion.

The current inflation trend differs from previous expansions in two ways. First, by the later stages of previous expansions, inflation was accelerating (see Chart 3). In contrast, there are few signs of accelerating consumer price inflation during the current expansion. In fact, it appears that the rate of inflation is declining; the United States has experienced disinflation.[1] Second, among expansions that have lasted more than 20 quarters, the current rate of inflation is one of the lowest since World War II. Consumer inflation is both decreasing and low by historical standards.

What Are the Two Views about Future Inflation?

Two views have developed about how the current expansion will end. The debate, couched in terms of the expected rate of future inflation, is of more than academic concern. The Federal Reserve's decision about

[1] In popular discussions of inflation rates and the price level, terminology is sometimes used loosely. To clarify, a declining rate of inflation, properly described as disinflation, means that prices are increasing at a progressively slower rate over time. Deflation is defined as a generally falling price level or, equivalently, a negative inflation rate.

CHART 2

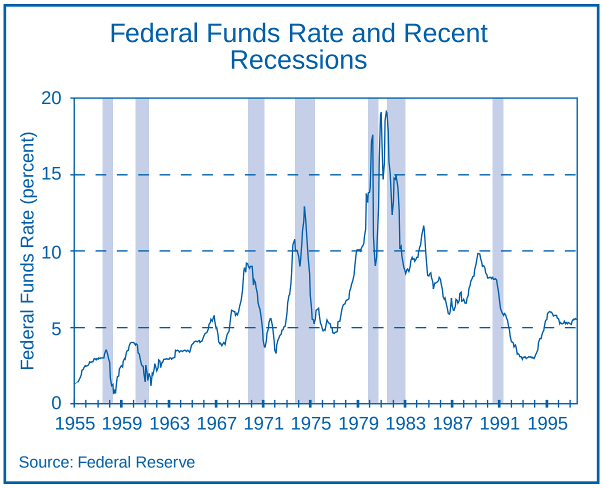
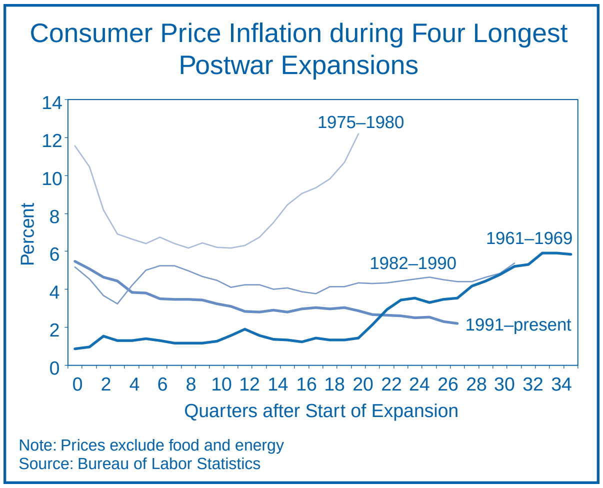


CHART 3



whether to change short-term interest rates may be influenced by arguments on either side of the debate.

The Traditional View

Although inflation has been tame during this expansion, adherents of the traditional view believe that impending inflation still poses a danger to the longevity of the expansion. Evidence cited to support this view includes a very low unemployment rate and rising inflation-adjusted wages. The reasons for the low inflation rate include low energy prices, inexpensive imports, and brisk domestic and international competition. These factors have delayed the onset of inflationary pressures, but they will not remain favorable indefinitely. The underlying dynamics have not changed significantly from those that led to rising inflation during every other recent economic expansion. This is also the view of the Federal Reserve Open Market Committee, as stated in the minutes of its November 12, 1997, meeting:

> *The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors…the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.*
>
> ***—Federal Reserve Bulletin, February 1998, p. 104***

The Deflation View

Alternatively, some analysts suggest that a recession may be brought about by a period of deflation. Advocates of this scenario base their view on the unusually low and falling inflation rate in the United States, even after seven years of economic expansion. They also suggest that the national economy of the 1990s is markedly different from that of the 1970s and 1980s. Intense global competition is now the norm and not the exception. Worker productivity growth is believed to be higher than the official data show, meaning that wage growth will not translate as readily as before into price increases. The U.S. economy is more prone to a period of falling prices than at any time in the recent past, especially in view of decreasing rates of inflation and deflationary forces originating from the ongoing Asian financial crisis.

What Does the Evidence Show?

Because determining economic policy is necessarily a forward-looking process, policymakers look at many indicators to determine the likely future course of inflation. A brief review of some of the more popular indicators reveals contradictory readings that can support either the inflation or deflation scenario.

Wage Growth

The national unemployment rate is currently very low, signaling that labor markets are near capacity in terms of their ability to create new jobs. The nation's unemployment rate was below 5 percent for nine months during 1997. This rate has been well below what many analysts thought possible without a sharp rise in inflation. As labor market conditions have tightened, wage growth has increased. Since 1993 the rate of growth has been on a steady upward trend, from a low of just over 2 percent to about 4 percent in the first quarter of 1998.

Capacity Utilization

Capacity utilization, the percentage of industrial capacity that is currently in use, has risen since early 1997. Utilization has been around 83 percent since mid-1997, a threshold rate that has traditionally signaled impending inflationary pressures at factories, mines, and utilities.

Commodity Prices

Many commodities, such as metals, crude oil, and unprocessed food products, have exhibited weak prices during the past several months. Between mid-1996 and early 1998, the ***Knight-Ridder Commodity Research Board Price Index*** fell by more than 15 percent. Key to the decline was a 35 percent decrease in crude oil prices.

Finished Goods Prices

Since the data show that both labor and physical capital are at high rates of utilization, the traditional inflation scenario suggests that there will be increasing price pressures. In the manufacturing sector, such price pressures would likely show up first in the prices of goods as they leave the factory. The price of finished goods rose by only 0.4 percent during 1997, however. On a monthly basis, prices declined during eight months in 1997.

Service Sector Prices

The service sector accounts for a growing portion of all output and employment in the U.S. economy. Labor costs generally account for a much higher percentage of input costs in the service sector than in the manufacturing industries. Additionally, many service industries operate in local markets and are insulated from national or global competition. Consequently, inflation rates in the service sector are generally higher than in the goods sector. Service sector inflation has, however, been on a downward trend, falling from 5.5 percent in 1990 to 3.1 percent in 1997.

Import Prices

Since early 1996, import prices have fallen precipitously. The decline is due in part to the rising value of the dollar, which has reduced the cost of imports. Non-petroleum import prices have fallen by 5 percent since early 1996. Within that group, capital goods prices have decreased by 12 percent over the same period.

One factor that will continue to put downward pressure on prices is the turmoil in Asian markets. Asian exporters are now much more competitive with the rest of the world, following the drop in the value of their currencies. Consequently, U.S. firms that compete with Asian producers will be under greater pressure to cut prices. At the same time, reduced Asian demand for U.S. exports could lead to a ballooning trade deficit and a softening of export prices. In January 1998, for example, the United States reported a record-breaking trade deficit of $12 billion, caused in part by slower export growth.

From this brief review, it is apparent that signs of impending inflation are at best mixed. Clearly, U.S. labor markets are at or near full effective capacity, and the utilization of factories and physical capital is also very high. There is little evidence that these factors are causing an increase in prices at either the producer or consumer levels.

How Will the Expansion End?

Although no one can accurately determine when the expansion will end, most analysts are predicting slower economic growth in the second half of 1998. Indicators such as the unemployment rate suggest that growth will be limited by the availability of labor needed to produce an increasing supply of goods and services. Weak or declining output prices in some sectors could act as a further constraint on economic growth.

Among economists, the traditional view that the expansion will end following a rise in inflation and an increase in short-term interest rates appears to be the more prevalent view. Nevertheless, the possibility that the next economic downturn might be triggered by the ripple effects of declining output prices should not be dismissed, especially in light of the potentially adverse and less familiar risks associated with deflation. What is clear for insured institutions is that at this stage of the economic expansion, lending and strategic decisions predicated on an assumption of continued robust economic growth should be carefully scrutinized and considered in light of a possible deterioration of economic conditions.

Paul C. Bishop, Economist

Why Might Deflation Be a Concern?

The most significant difference between the inflation and deflation scenarios is reflected in the response of financial markets. One of the consequences of inflation is that a dollar in the future is of less value than today's dollar. In a deflationary environment, the opposite is true—a dollar in the future will buy more goods and services than a dollar today.

In a deflation scenario, debtors would see the real value of their financial obligations rise and might therefore be hesitant to borrow. A fixed monthly mortgage payment, for example, would be paid back with increasingly valuable dollars over time. Asset values could fall, especially since the purchase of an asset, such as a house, would require inflation-adjusted debt repayments that increase through time. Likewise, consumer credit debt obligations, such as payments on outstanding credit card balances, would become increasingly onerous. For households already experiencing credit problems, the prospect of a period of sustained deflation would worsen their financial position. At the very least, deterioration in credit quality would be expected, along with an increase in the number of business and personal bankruptcies.

Trends Affecting the Allowance for Loan and Lease Losses

- **Allowance for loan and lease loss (ALLL) levels are declining relative to total loans.**

- **Some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios.**

- **Significant growth in riskier loan types calls attention to the need to scrutinize closely the adequacy of the allowance.**

Weakening underwriting standards and significant growth in riskier loan types have increased the risk exposures of some insured institutions to an economic downturn. Meanwhile, the ALLL relative to total loans has declined in recent years. This article provides information on trends in the ALLL over time and by loan type and discusses the factors analysts consider when evaluating the adequacy of the ALLL. Special attention is given to issues related to the volatility of loan losses and the composition of the loan portfolio.

Historical Perspective on the Allowance for Loan and Lease Losses

The nation is currently witnessing one of the longest economic expansions since World War II. It is to be expected that some institutions will reduce their ALLL coverage during periods of improved economic conditions. However, in the current environment—in which loan availability is abundant, growth is strong, and competition is fierce—some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the ALLL relative to total loans for commercial banks has declined to the lowest point in a decade (see Chart 1). This allowance ratio has diminished because commercial banks' loan loss provisions have not kept pace with new loan growth. In some cases, banks have determined that their allowances are higher than necessary and have taken negative loan loss provisions, which are credited back to income.

This decline in reserve coverage has been broad based, with the exception of credit card specialists. Commercial banks with concentrations in commercial lending and large multinational banks have significantly reduced the level of reserves to total loans in recent years. Table 1 (next page) shows that since 1993, ALLL ratios at both commercial lending banks and multinational banks have declined 31 percent. Moreover, commercial lending banks with assets exceeding $10 billion have reduced ALLL ratios by slightly over 37 percent, or 98 basis points, over the same period.

The low level of nonperforming and charged-off loans, coupled with prevailing favorable economic conditions, is doubtless a significant factor in the reduction of

CHART 1

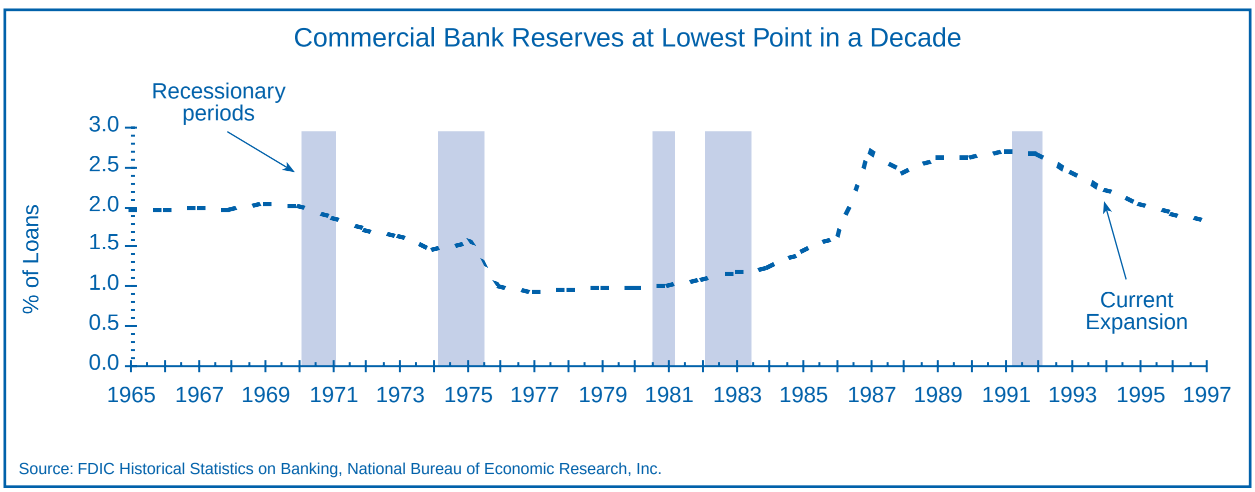


TABLE 1

Commercial Bank Allowance for Loan and Lease Losses to Total Loans by Lender Type							
Type of Lender	Number of Banks	Assets ($Billions)	1997	1996	1995	1994	1993
Multinational	11	$1,383	2.14	2.25	2.55	2.83	3.10
Commercial	3,207	$1,915	1.63	1.71	1.90	2.16	2.37
Credit Card	67	$202	4.21	3.48	3.21	2.89	3.35
Mortgage	286	$120	1.26	1.45	1.45	1.69	1.87
Agricultural	2,373	$120	1.53	1.66	1.69	1.75	1.83

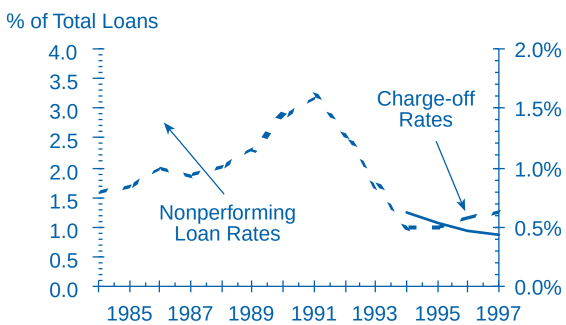
Definitions for lender types by order of priority: Multinational—assets >$10 billion and foreign assets >25% of assets; Commercial—C&I plus CRE loans >50% of assets; Credit Card—credit card loans >50% of assets; Mortgage—1- to 4-family mortgages and mortgage-backed securities >50% of assets; Agricultural—agricultural production and agricultural real-estate loans >25% of total loans.
Source: Bank Call Reports

ALLL levels. Asset quality indicators such as nonperforming loans and loan loss rates are at historically favorable levels. At year-end 1997, the banking industry's nonperforming loans were just under 1 percent of total loans, the lowest in 13 years. The industry's loan charge-off rates (with the exception of consumer loans) are also at historical lows. (See the ***Regional Outlook,*** first quarter 1997, for a detailed discussion of consumer loan losses.) However, even with the problems in consumer lending, the banking industry's aggregate loan loss rate is down significantly from levels in the early 1990s (see Chart 2).

As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks associated with changing industry practices. Insured institutions could experience strains on profitability and capital if allowance levels are inadequate. Given changing underwriting trends and loan delinquency patterns, a related question is whether reliance on past loss experience in setting the allowance will be an adequate measure for current losses.

CHART 2

Asset Quality Indicators Are at Historically Favorable Levels



Source: Bank Call Reports

Trends in Underwriting Prompt Regulatory Cautions

Over the past year, various underwriting and lending practices surveys by the FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve have noted easing of terms and weakening underwriting standards on loans, especially in commercial loan portfolios. *It is important to note that, in 1997, nearly two-thirds of the commercial banking industry's loan growth was centered in the commercial real estate (CRE) and commercial and industrial (C&I) loan categories* (Chart 3).

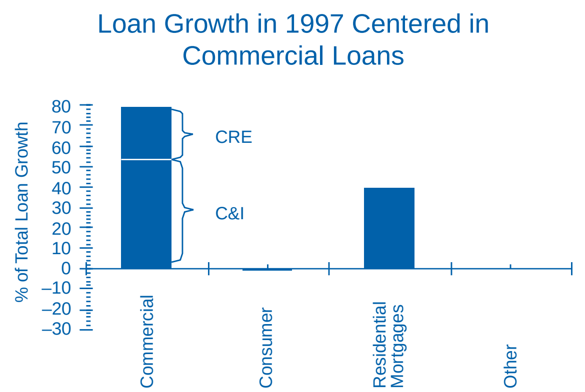
In the FDIC's ***Report on Underwriting Practices*** for April 1997 through September 1997, examiners noted "above-average" risk in current underwriting practices for new loans at almost 10 percent of the 1,233 FDIC-supervised institutions examined. Of the institutions with above-average risk, 12 percent did not adjust pricing for loan risk. Examiners noted that several of the 852 institutions examined that were making business loans had poor underwriting standards, including lack of documentation of the borrower's financial strength

(21 percent) and poor and unpredictable loan repayment sources (14 percent). Also, of the 571 institutions specifically involved in asset-based business lending, 20 percent often failed to monitor collateral. Furthermore, 20 percent of the 398 institutions examined that were actively engaged in construction lending repeatedly failed to consider alternative repayment sources, and 29 percent often funded speculative projects. In contrast, just one year earlier, in the ***Report on Underwriting Practices*** for April 1996 through September 1996, examiners reported that only 11 percent of the institutions examined that were actively engaged in construction lending often funded speculative projects.

The Federal Reserve's ***Senior Loan Officer Opinion Survey*** for November 1997 and February 1998 both indicated some easing of commercial business lending terms and standards. Also, the OCC's ***1997 Survey of Credit Underwriting Practices*** stated that the level of inherent credit risk continues to increase for components of both commercial and consumer loan portfolios. These underwriting trends have resulted in increased risk profiles for some insured institutions, while ALLL ratios at some institutions continue to decline.

In August 1997, the OCC issued an Advisory Letter voicing its concern about declining allowance levels in commercial banks. The OCC cited as primary concerns the apparent increases in credit risk reported by examiners, such as weakening underwriting trends in the syndicated loan market, easing of other commercial underwriting standards, and consumer lending delinquency and charge-off trends. Moreover, the OCC found that some banks were using flawed reserve methodologies for estimating loan loss rates, including an overreliance on historical loss rates.

CHART 3



Note: Percent of all loan growth for commercial banks in 1997
Source: Bank Call Reports

Factors Affecting Adequacy of the ALLL

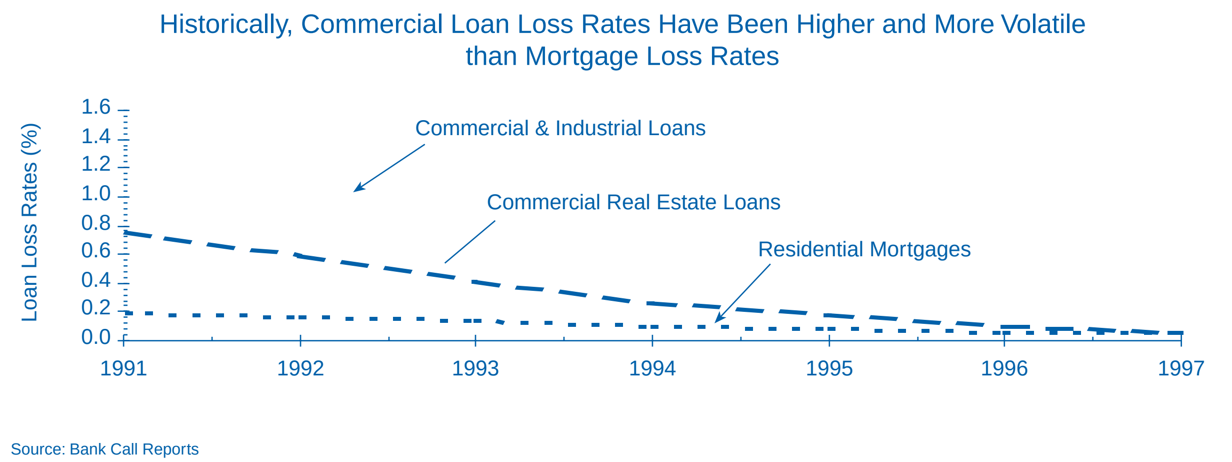
In using offsite data to assess allowance adequacy, analysts consider financial ratios such as the allowance to total loans, reserve coverage (allowance to nonperforming loans), loan loss provisions to charge-offs, and loan delinquency levels. These ratios are evaluated against historical benchmarks. At the same time, however, analysts supplement the analysis with consideration of the potential effects of current industry trends. For example, the banking industry is currently witnessing higher than normal losses in consumer lending spurred by increased bankruptcy filings and the migration of loans from current to charged off without intervening delinquencies. An institution that has a sizable consumer loan portfolio may therefore need to attach more weight to recent loan loss data in setting the allowance, since historical trends may not adequately reflect reserving needs.

Insured institutions exhibit different management and portfolio characteristics that significantly influence the level of the allowance. These characteristics include the diversification of a loan portfolio (diversification by borrower, loan type, geography, or industry), the history and recent trends of credit losses, management's practices in the recognition of losses, trends in past-due and nonperforming loans, underwriting practices, and economic conditions.

New techniques continue to be developed to improve the reliability of allowance estimates. Management information systems, which enable the collection of more refined historical data, coupled with the application of statistical techniques, are helping some institutions formulate more statistically reasoned allowance estimates. Loan management tools such as credit scoring systems, risk rating systems, and consideration of economic cycles in the review of historical loss and delinquency data all are aiding bankers in the reserving process. While these new techniques provide more analytically defensible estimates, they do not diminish the role of judgment in assessing ALLL adequacy.

The role of judgment in setting the ALLL is underscored by the volatility of loan losses over time.

CHART 4



"Volatility" in this context refers to the degree to which loan losses have diverged or might diverge from the long-run averages. Volatility in loan losses can result from changes in the business cycle, local economic events, and major one-time events. For example, a bank relying on a historic average loan loss calculation to derive its reserve level could find itself underreserved if it does not adjust its historical loss rates for deteriorating economic conditions and suddenly incurs greater loan losses than it had anticipated simply on the basis of past performance.

Generally, different types of loans experience varying loan loss rates because of the inherently different risks and varying levels of volatility within each type. Chart 4 shows that commercial loans, such as commercial and industrial loans and commercial real estate, historically have had greater losses than residential loans. Furthermore, the loss rates on commercial loans have not only been higher, they have been more volatile over the years, while average losses on mortgage loans have varied little.

Volatility in loan losses is determined not only by economic events but also by banks' willingness to take risk. Banks that adopt more liberal underwriting policies and high loan growth objectives may experience greater loan default risk and greater volatility in loan loss rates than suggested by their own past experience. For example, Chart 4 shows that mortgage lending has had low and stable loss rates on average. The recent growth in subprime and high loan-to-value mortgage lending, however, may result in increased volatility and losses for some lenders going forward.

All of these factors suggest that ALLLs would be expected to vary considerably both over time and across loan types. Table 2 shows that this has been the case. The ALLL is reported as a single line item on the Call Report. This makes it difficult to estimate how much of the ALLL is attributable to a particular loan type or to compare allowance levels for banks with significantly different loan portfolios. Table 2 shows the results of a statistical regression estimation of commercial bank allowance allocations across the various loan types for

TABLE 2

ALLL ALLOCATIONS HAVE VARIED OVER TIME AND BY LOAN TYPE (COMMERCIAL BANKS UNDER $1 BILLION)*

LOAN TYPE	1997 (%)	1996 (%)	1995 (%)	1994 (%)	1993 (%)	1992 (%)	1991 (%)
C&I	1.71	1.85	1.87	2.06	2.14	2.29	2.45
CRE	1.44	1.54	1.77	1.83	1.97	2.02	1.99
MORTGAGES	0.92	1.00	1.05	1.19	1.22	1.07	0.91
CREDIT CARDS	4.47	4.42	3.32	3.11	3.20	3.29	3.59

* ESTIMATED REGRESSION RESULTS
SOURCE: BANK CALL REPORTS

1991 through 1997 for commercial banks with under $1 billion in assets. Not surprisingly, CRE and C&I loans received relatively higher allowance allocations than residential mortgage loans, indicating that banks saw greater risk in these loan types. Also, credit card loans consistently received higher allocations than the other loan categories, and the allocations have increased in recent years owing to the increased delinquencies and charge-offs in this area.

Conclusions

The adequacy of the ALLL is measured not only relative to historical loan loss experience but also relative to current conditions that may cause losses to differ from past experience. Increased losses could result from adverse economic developments, from changes in banks' appetite for taking risk, or both. In this regard, reported weakening in underwriting standards is increasing some banks' risk exposure to an economic downturn. Institutions with high concentrations in riskier loans, significant growth in riskier loans, or weaknesses in underwriting may be most at risk. Especially for such institutions, the adequacy of the ALLL and its methodologies merits close scrutiny.

Andrea Bazemore, Banking Analyst

Health Care Industry Is a Significant Player in Boston Region's Economy

- **During the last recession, hospitals, clinics, and other medical service providers as a group increased their New England payrolls, while total nonfarm employment declined.**

- **Recent trends and legislative developments point toward the possibility of slower growth in total health care industry payrolls in New England and the nation over the next few years.**

- **For many New England communities, hospitals or other large health services facilities are major local employers. This has implications for the systemic credit risk of insured institutions serving these areas.**

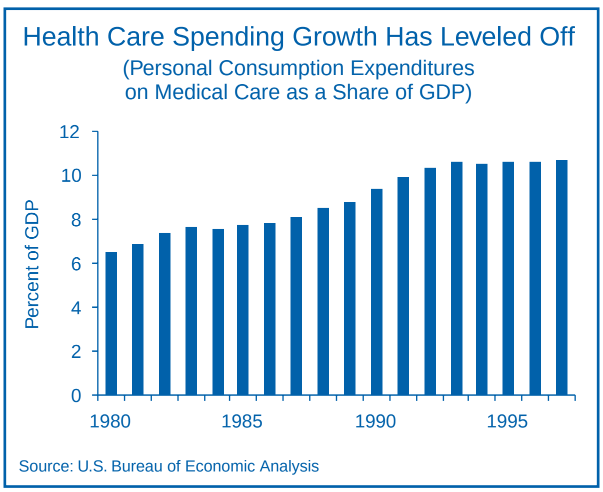
- **In early 1998, Asia's economic crisis was beginning to have a modest effect on the Region's economy in the form of declining exports, scattered layoffs, and lower college enrollments by Asian students.**

Rapid Growth in Nationwide Health Care Demand Has Slowed in Recent Years

In the 14 years before 1994, personal consumption expenditures (PCE) on medical care services generally rose at a faster rate than the growth in the U.S. economy, as demographic factors and an increasing emphasis on high-cost technology fueled health care spending. In recent years, however, that gap has narrowed. Chart 1 illustrates the relative cooling of medical care spending growth, with outlays essentially level at just below 11 percent of gross domestic product (GDP) since 1993.

This slowdown in the rate of growth was concurrent with the increased use of lower cost managed care plans by large employers. Greater government and private sector pressures on pharmaceutical makers and service providers to control cost increases also have played a part.

CHART 1

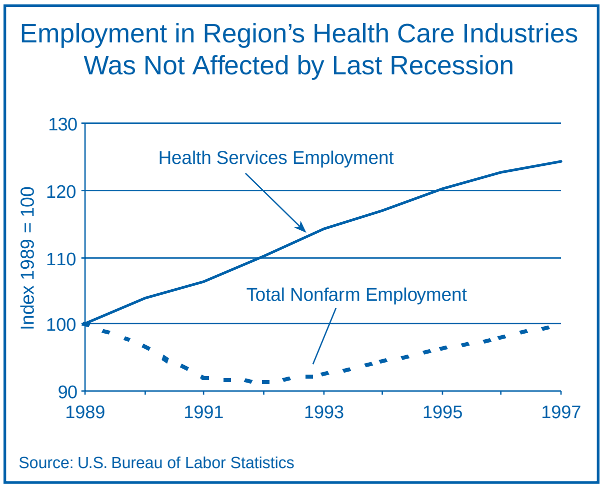


Widespread resistance to price increases that greatly exceed the rate of inflation has helped fuel a consolidation of players in the industry in recent years, and this trend shows no sign of abating. As a result, the industry could be positioned for a sustained period of much slower growth over the next several years. During the last recession, health care payroll growth in New England helped to offset job losses in other sectors. *Without an exuberant health services industry, the Boston Region's economy would have less of a safety net during the next period of economic contraction.*

Health Services Have Been a Major Force in the Region's Job Gains this Decade

Between 1989 and 1997, health services employment rose by almost 30 percent in the United States, while total nonfarm payrolls increased only about 13 percent. During the last recession, Boston Region employment in the health services industry (Standard Industrial Classification [SIC] code 80) never ceased its upward climb. By 1997, regional health services payrolls stood about 24 percent above where they were in 1989. In contrast, total nonfarm employment in New England dropped between 1990 and 1992, and by 1997 had only just returned to its 1989 level. Chart 2 highlights these trends in the Region's employment.

CHART 2

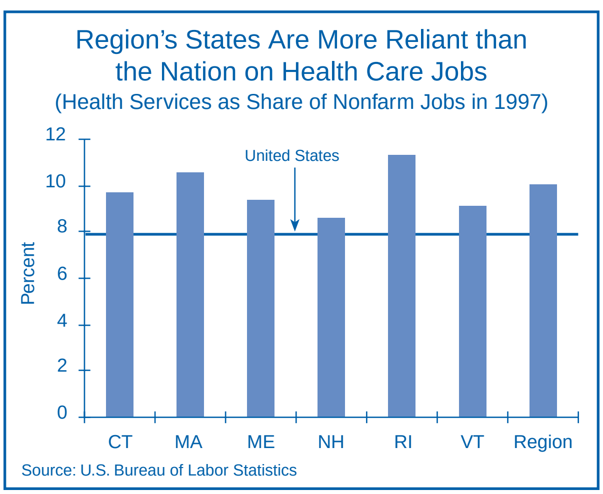


There Is a High Concentration of Health Care Jobs in New England States

Despite the fact that health services payrolls in the Region did not grow as rapidly as they did for the nation as a whole during the past several years, every state in New England continues to hold a larger concentration of health services employment than the nation as a whole (see Chart 3).

Rhode Island has had the Region's highest concentration of health services jobs since 1989. Rhode Island's sustained high concentration is due, at least in part, to long-running, large-scale declines in manufacturing payrolls and generally sluggish job growth in other sectors in recent years, rather than to any absolute advantage in its health services industry. This combination of factors has given the state the Region's highest ratio of

CHART 3



health services to nonfarm job growth during this expansion.

In many smaller towns and communities across the Region, health care services firms are typically among the largest employers. Chart 4 is based on data reported to ***Dun & Bradstreet.*** The map shows the number of top ten employers in each county that are in the health services industry (including public and nonprofit facilities, psychiatric and other nonacute care facilities, and related services not classified under SIC code 80). In 18 of the counties, a health care services firm is the single largest employer. Further, in all but three counties, at least one of the top ten employers is a health services firm.

Strong Health Care Employment Gains May Not Continue

Employment growth in New England's health services has been moderating in recent years, from annual rates near 4 percent in 1992 and 1993 to just 1.3 percent in 1997. This slowdown has occurred at the national level as well and may be an indication that years of consolidation are finally beginning to take a toll on the industry's payrolls (see Chart 5, next page). However, it is important to note that although growth may be settling into a slower pattern for the medium term because of

CHART 4

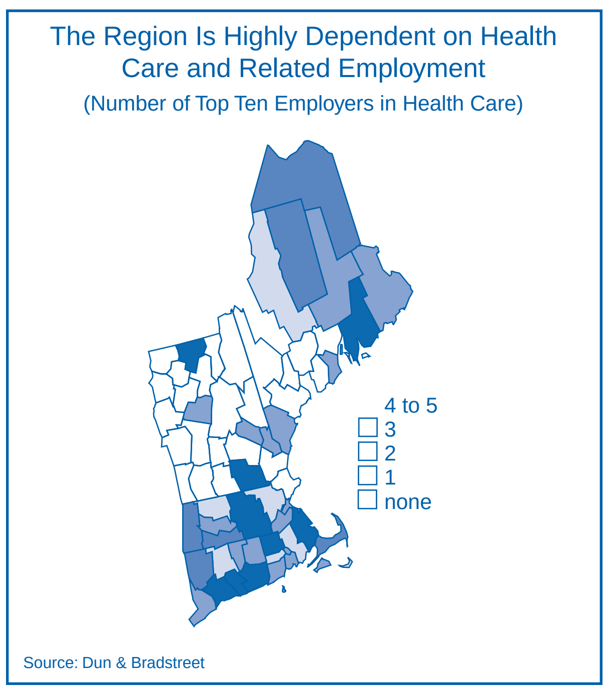
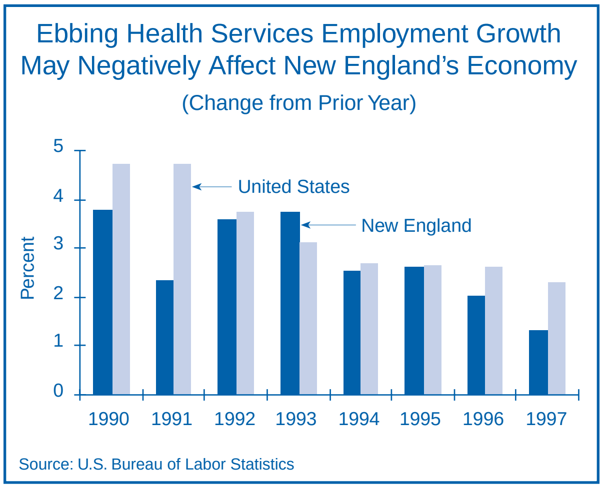


CHART 5



consolidation, long-run demographic forces should ensure future surges in demand (and most likely employment) for this industry.

New England's health services payrolls are likely experiencing a more acute effect from consolidation than those of the nation as a whole because several of the Region's states are among the nation's highest in terms of market share of managed care operations. A survey by ***Hoechst Marion Roussel*** in its ***Managed Care Digest***[1] ranked **Massachusetts** number one in both 1994 and 1995 (the latest year for which data were available), with 42 percent and 49 percent shares, respectively. **New Hampshire** moved from eleventh place in 1994 to second in 1995 (from 25 percent to 44 percent). In 1995, **Connecticut** ranked eighth and Rhode Island fifteenth. **Vermont** and **Maine** were much less influenced by managed care operations, with market share rates of 23 percent and 15 percent, respectively, in 1995.

Managed care organizations such as health maintenance organizations tend to exert significant cost control pressure on member facilities. As a result, payrolls (as one of the largest expense items) become primary targets for facilities to cut costs and bolster margins squeezed by fixed reimbursements per patient ("capitation") and other revenue- and price-control methods.

[1] ***Standard & Poor's Industry Surveys,*** *Healthcare: Managed Care,* July 3, 1997

Earnings at health services firms could be further squeezed by pending legislation. A leading proposal would make it easier for patients and member physicians to litigate against managed care plans (such litigation has been banned by federal law since 1974). Several states across the nation, including some in the Boston Region, are currently entertaining consumer-protection legislation that could increase managed care companies' regulatory burdens, adding costs and potentially cutting revenues. New Hampshire has legislation pending that might limit (through preadmission screening) the flow of new patients to nursing facilities. This plan, designed to limit growth in state Medicaid outlays (about 60 percent of U.S. nursing home revenues in 1996 came from Medicaid), potentially would reduce nursing facilities' revenues and earnings.

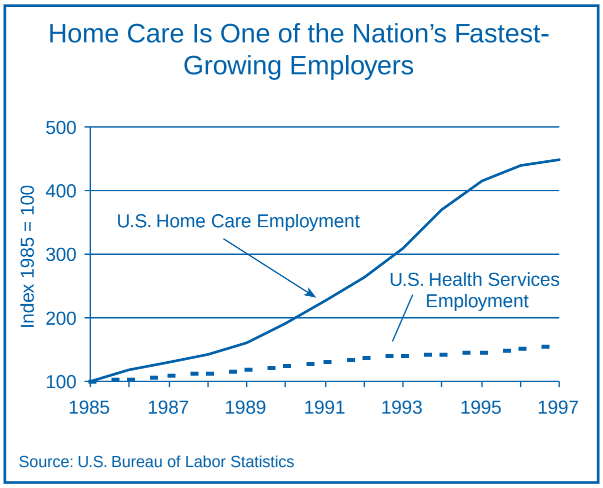
Recent cuts and alterations in Medicare and Medicaid also may hinder the rapid growth in home health care firms and adversely affect nursing homes and teaching hospitals (of which the Boston Region has a disproportionate share). Home health care firms often employ nurses and other professionals once limited to work at hospitals and other facilities.

A survey of 40 home health care firms by the ***Home & Health Care Association of Massachusetts*** released in April indicated that, because of recent reductions in Medicare reimbursement for home health care, 60 percent of firms surveyed expected to lay off staff this year. About 10 percent had already reduced their payrolls. According to the association, there are 175 home health care firms in Massachusetts, employing about 18,000 workers. The association predicted that layoffs at the state's home health care firms will be "considerable."

Growth in home care has been quite pronounced in recent years (because of the industry's young age). Although its employment remains far smaller than that of hospitals and doctors' offices/clinics, home care's rapidly advancing payrolls have helped to offset declines at traditional health services establishments (see Chart 6, next page).

Implications: Insured institutions with expertise in lending to the health services industry may find increasing opportunities to fund merger/consolidation-related deals in 1998. Such opportunities would help offset an expected decline in overall loan demand growth should

Chart 6



the economy slow. Also, many hospitals continue to place a priority on funding plant expansions, improvements, and new equipment acquisitions to distinguish themselves from their competitors (in the case of stand-alone facilities) or to better fit into a hospital system/alliance or provider network.

Systemic credit risks may be greater for institutions serving local markets with one or more large employers in this industry. With the strength of the local economy tied to the ongoing operations of a health care facility, a merger-related closure or reduction in employment could severely affect commercial, real estate, and consumer credit portfolios of local insured institutions.

Norman Williams, Regional Economist

Boston Region Economic Update

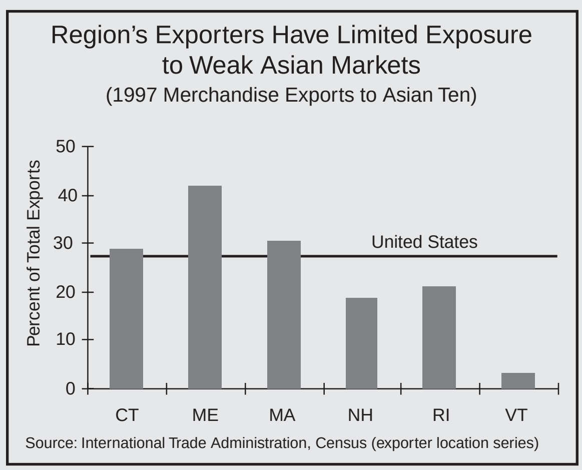
The Region and the nation are expected to see some moderation in economic growth in 1998, caused in part by the economic problems in Asia. Because the Region's exposure to Asia is only "average," it is likely that the effect here will be less than what is expected in some other parts of the nation, such as California.

Anecdotal reports seem to indicate that local fallout (declining sales, modest layoffs, or both) from Asia's economic woes has been limited to manufacturers and others with direct sales to the troubled Asian countries. Those affected include leather and textile, semiconductor, and scientific instrument manufacturers; makers of semiconductor manufacturing equipment; and local colleges and universities that "export" education services by enrolling students from the affected countries. Also, firms whose products compete with imports from Asia, such as Rhode Island jewelry makers and the Region's toy manufacturers, are seeing increased pricing and margin pressure and reduced sales in domestic and international markets.

In gauging the ultimate effect of Asia's problems on the Region, it is useful to examine merchandise export data.[2] Nationally, exports to the "Asian Ten" nations—China, Hong Kong, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand—accounted for 27 percent of total exports (see Chart 7) and 2.3 percent of GDP in 1997. In New England, Asian Ten sales were about the same, at 28 percent of total exports and an estimated 2.3 percent of the Region's combined six-state gross state product (GSP) in 1997.

Maine was the only state in this Region to greatly exceed the U.S. concentration of exports to the Asian Ten in 1997. Asian exports accounted for 42 percent of Maine's total exports, up sharply from a 32 percent share in 1996. However, the value of the exports was equivalent to 2.3 percent of the state's GSP in 1997 (as estimated by the author)—no more significant than the averages for the nation or the Region. For the past several years, Maine's highest value export category has been electronics and electrical equipment (such as semiconductors and computer parts). This category accounted for one-third of the value of total exports and 64 percent of the value of exports to the Asian Ten in 1997. Paper products accounted for another 13 percent of exports to Asia last year.

Chart 7



[2] Census' exporter location series was used in this analysis, which is based on where an export sale is reported, not where the underlying merchandise is manufactured.

Regional Banking Conditions

- **Strong asset quality and gains in efficiency continue to drive profitability measures to new highs.**
- **Loan growth is accelerating, and commitment growth suggests the trend will continue.**
- **Asset growth continues to outstrip core deposit growth, resulting in greater dependence on noncore funding sources.**
- **Consumer credit problems appear to be stabilizing but bear watching.**

Overview of Financial Performance

The Boston Region's insured institutions performed admirably in 1997 by many measures. Strong asset quality and noninterest income growth, coupled with ongoing gains in operating efficiency, continue to drive earnings to record levels. In 1997, the 452 insured institutions in the Region posted a collective return on assets (ROA) of 1.29 percent and a return on equity (ROE) of 14.97 percent. Both of these profitability measures compare favorably with the national averages of 1.19 percent and 14.07 percent, respectively, and represent solid increases over prior-year performance. The strong performance is driven largely by subsidiaries of the Region's three largest banking organizations ("Big Three"). These institutions account for 51 percent of the Region's total assets. However, as Table 1 indicates, the improved operating performance was broad based, with both large and small institutions finishing the year on a strong note. Only seven institutions (1.5 percent) reported operating losses during the year, and four of those institutions have been open for less than two years. The percentage of institutions reporting losses is approximately one-third the national rate.

This financial performance continues to be reflected favorably in examination results. The average composite CAMEL rating for the Region's insured institutions fell to 1.68 at year-end, the lowest that measure has been since March 1988. For examinations conducted during 1997, only four institutions were downgraded to a less than satisfactory level (composite rating of 3, 4, or 5), with 14 being upgraded to the satisfactory level. At year-end 1997, only 1 percent of the Region's banking assets was held by institutions with less than satisfactory composite CAMEL ratings.

Table 1

Profits Rise on Continued Improvement in Asset Quality and Operating Efficiency

	Nation		Boston Region		Big Three*		Assets > $1 Billion**		Assets ≤ $1 Billion**	
	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996
ROA	1.19	1.10	1.29	1.13	1.35	1.18	1.15	1.05	1.05	0.98
ROE	14.07	13.32	14.97	13.31	17.89	15.29	13.09	12.14	10.36	9.89
Past-Due Ratio	2.27	2.45	2.02	2.66	1.82	2.53	2.01	2.50	2.28	2.92
Net Charge-Offs/ Loans	0.56	0.53	0.44	0.48	0.57	0.57	0.29	0.36	0.15	0.26
Tier 1 Leverage	7.63	7.66	7.71	7.89	6.49	7.10	7.57	7.52	9.79	9.66
Efficiency Ratio***	60.70	63.40	63.30	65.50	61.80	64.80	63.50	66.20	64.60	65.10

* Subsidiaries of the three largest banking organizations headquartered in the Region
** Excluding subsidiaries of the Big Three
*** Efficiency ratio = Noninterest expense / (net interest income + noninterest income)
Source: Bank and Thrift Call Reports. All prior period data have been adjusted for merger and consolidation activity.

Asset Growth Accelerates in Strengthening Economy

The Region's insured institutions registered aggregate asset growth of 8.2 percent for the year (adjusted for merger and consolidation activity), well ahead of the compounded annual growth rate of 2.6 percent realized over the prior five-year period. The strong New England economy, coupled with diversification into nationally and internationally based loans and investments on the part of the Region's largest banking organizations, contributed to this growth. Loans were up 6.7 percent, with the course of growth taken by institutions of varying asset size being decidedly different.

The Region's largest banking organizations have focused on commercial loans and have actually curtailed investment in nonresidential real estate and consumer loans. These institutions often use risk-adjusted return on capital (RAROC) models to determine credit relationship and business line profitability. These models attempt to determine whether a specific group of assets is generating returns in excess of the institution's cost of capital or, in short, creating shareholder wealth. Institutions divest certain borrowing relationships and business lines that do not meet internal RAROC goals and, as a result, open the door for small and midsize banks to pick up additional business. The Region's remaining institutions have filled the void left by the Big Three, and institutions with total assets of less than $1 billion have been particularly active in real estate lending (see Table 2).

Competition remains keen and may in fact be heating up as institutions face heavy cash inflows resulting from the elevated level of refinancing activity that has occurred in 1998. Various underwriting surveys conducted by the three federal bank regulatory agencies have noted thinner spreads and easing of underwriting standards, and recent surveys appear to indicate that the trend toward easing continues at institutions of all sizes. The willingness of smaller institutions to take on assets that do not meet RAROC limits of the larger lenders may be contributing to their recent pickup in lending activity. Price competition may be the primary reason that loans, particularly lower quality loans, fail to meet the RAROC goals of the larger institutions. The higher yields required in RAROC models to compensate for higher risk are undercut by smaller institutions seeking to expand their portfolios. Clearly, consolidation within the larger organizations is creating an opportunity for community banks to garner increased market share of sound credits, but they must take care to maintain credit quality. In short, smaller institutions should ensure that business being won from the larger organizations is soundly underwritten and adequately priced to compensate for inherent credit risk.

Federal Reserve Board Chairman Alan Greenspan recently addressed the heightened competition brought about by the strong economy, stating, "We should all be aware that such an environment tends to reduce prudence." He added that in such an environment, insured institutions "tend to take a little too much risk for far too little return." Finally, in his Humphrey-Hawkins testimony in February, he stated, "we must be concerned

Table 2

Small Institutions Are Grabbing a Larger Share of the Commercial Real Estate Pie
1997 Growth Rates (%)

	Big Three	Assets > $1 Billion*	Assets ≤ $1 Billion*
Assets	8.1	8.3	8.6
Loans	6.8	5.9	8.8
Commercial Real Estate	0.2	2.2	10.3
Residential Real Estate	17.1	2.9	7.7
Commercial & Industrial	21.5	11.5	11.6
Consumer	–24.1	20.0	9.3
Loan Commitments**	28.6	20.8	19.8
Core Deposits	–1.4	3.0	5.1
Noncore Funding	19.7	29.4	25.8

* Excluding trust specialists, credit card specialists, and Big Three subsidiaries
** Excluding credit cards
Note: All data are merger adjusted.
Source: Bank and Thrift Call Reports

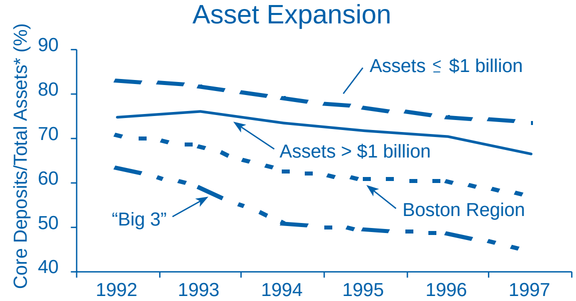
about becoming too complacent about evaluating repayment risks. All too often at this stage of the business cycle, the loans that banks extend *later make up a disproportionate share of total nonperforming loans.*" These words of caution should not be taken lightly.

Lackluster Core Deposit Growth Is Not Deterring Loan Activity

Asset growth was strong in 1997, but core deposits did not follow suit, rising only 2.1 percent on a merger-adjusted basis. In the prior five-year period, core deposits actually declined slightly. As a result, the percentage of assets funded with core deposits has fallen steadily and is now 57 percent for the Region as a whole (see Chart 1). The Big Three banking subsidiaries actually registered a decline of 1.4 percent for the current period, as smaller institutions increased market share, primarily driven by banks with total assets of less than $1 billion. Excluding trust and credit card specialists, these institutions registered core deposit growth of 5.1 percent, while all other banks over $1 billion saw core deposits rise 3.0 percent for the year. For all three groups of institutions, however, a greater reliance on noncore funding is evident. Chart 2 shows merger-adjusted growth rates for core deposits, loans, and loan

CHART 1

Slow Core Deposit Growth Raises Reliance on Potentially Volatile Liabilities to Fund Asset Expansion

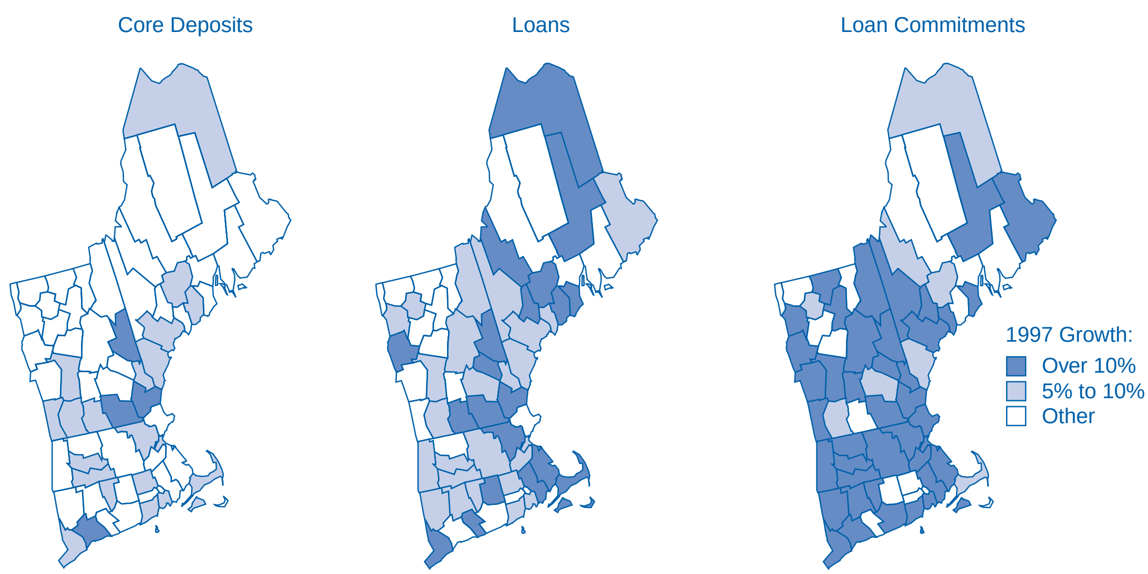


* All prior period data have been adjusted for merger and consolidation activity. Core Deposits = Total Deposits – (Certificates of Deposit > $100,000 and Foreign Deposits)
Source: Bank and Thrift Call Reports

commitments, by county, for all insured institutions headquartered in the county with total assets of less than $1 billion as of December 31, 1997. Institutions of this size are typically community based and are considered a good barometer of local conditions. As the chart indicates, the relative weakness of core deposit growth compared with loan growth was widespread in 1997, and loan commitment growth at these institutions suggests that the trend toward greater dependence on noncore funding will continue through 1998. As shown in

CHART 2

Loans and Commitments Are Growing Well Ahead of Deposits throughout the Region



Note: All insured institutions with assets less than $1 billion. Data reported by insured institution headquarters location, not customer location.
Source: Bank and Thrift Call Reports (merger adjusted)

Table 2, loan commitment growth was stronger and core deposit growth weaker for the larger institutions, which suggests that the trends depicted in Chart 1 will continue for these institutions as well.

To date, this shift toward noncore funding has not hurt net interest margins, as a favorable interest rate environment has enabled the industry to hold down the cost of core deposits with minimal disintermediation. The spread between the earning asset yield and the cost of funds continues to narrow as a result of competition and an ongoing shift from nonmaturity deposits to higher cost certificates of deposit. However, the erosion in spread has been offset by the positive effect of higher levels of capital and demand deposits, and lower levels of nonaccrual loans.

Maintaining a low-cost pricing posture for core deposits has supported margins; however, lackluster growth has resulted, and nonbank competitors continue to pick up market share. For example, according to the ***National Credit Union Administration***, Boston Region–based credit unions registered deposit growth of 6.5 percent in 1997. Also, on a national scale, the ***Federal Reserve Board's Flow of Funds Report (Fourth Quarter 1997)*** shows that household investment in money market mutual funds has been growing at a rate in excess of 20 percent over the past three years. While holding down deposit costs has clearly propped up earnings in the near term, in the long run, this strategy could reduce the ability to manage funding costs, and it heightens the importance of sound liquidity and funds management practices.

Consumer Credit Problems May Be Stabilizing but Remain at High Levels

In the first-quarter 1997 ***Regional Outlook***, the issue of rising personal bankruptcies and consumer credit losses was explored in detail. At that time, personal bankruptcies were at all-time highs and credit card losses were approaching levels not seen since the last recession. In 1997, personal bankruptcies reached a new high, as did net credit card losses. While the trend remains of concern, particularly because these levels are being met during a period of excellent economic performance, some signs have recently emerged suggesting that the deterioration in the consumer sector may be stabilizing.

According to the ***American Bankruptcy Institute***, 335,000 personal bankruptcies were filed nationally during the fourth quarter of 1997, down slightly from the peak of 353,000 reached in the second quarter. While the slowdown is a positive sign, fourth-quarter filings were still 12 percent ahead of the year-earlier quarter. For the full year, personal bankruptcy filings reached nearly 1.4 million and were 20 percent higher than in 1996. The slowdown in filings in the latter half of 1997 suggests that the filing rates are at least beginning to stabilize, although they remain at a high level. Another indication of stabilization was reported by ***Fitch IBCA*** in April 1998, citing a ***VISA*** report that first-quarter 1998 personal bankruptcy filings were estimated to be slightly below the year-earlier period. Fitch indicates that this would be the first year-over-year decline since 1994.

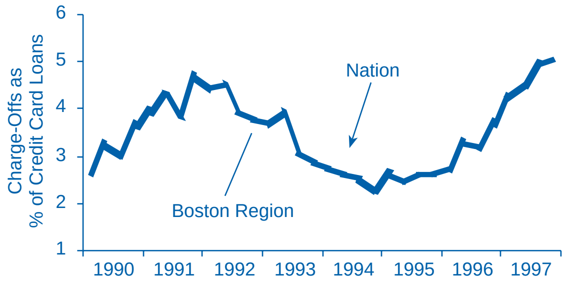
Bankruptcies in New England increased 31 percent in 1997, with **Maine**, **Massachusetts**, **New Hampshire**, and **Vermont** each reporting increases in excess of 30 percent, placing these states among the top ten in the country in terms of percentage increase. While the rate of increase in the Region is rapid, personal bankruptcy filings are typically low relative to the nation as a whole. Based on the ***Census Bureau***'s preliminary 1997 population estimates, the national filing rate was 5.0 per thousand persons, while the New England rate was 3.9 per thousand. Only **Rhode Island** (5.4 per thousand) registered a filing rate in excess of the national rate, and of the states with the greatest rate of increase, only New Hampshire (4.0 per thousand) was above the average for the Region.

Ongoing consumer problems continue to be reflected in the loss rates on consumer loans for the Region's and nation's insured institutions. As Chart 3 (next page) indicates, for the nation as a whole, the annualized net charge-off rate on credit card loans rose to a record high of 5.3 percent during the latter half of 1997, well above the highs reached during the recession of the early 1990s. The Region's loss experience is tracking closely with the national average.

Certain indicators suggest that net charge-offs will continue to be high through 1998. The percentage of credit card loans 30 days or more past due increased to 4.76 percent as of December 31, 1997, 22 basis points higher than the prior year-end. Therefore, insured institutions are entering 1998 with a greater volume of potential problems. Additionally, the rate of current-quarter recoveries to prior-quarter charge-offs has fallen steadily since 1995, from a peak of 22 percent to a low of 14 percent in the fourth quarter of 1997. This

Chart 3

Despite Solid Economy, Credit Card Charge-Offs* Have Exceeded High Point Reached during Last Recession



Source: Bank and Thrift Call Reports * Quarterly, at annual rates

trend may result from less timely recognition of losses in an effort to temper the rise in reported charge-offs (which also may be contributing to the rise in delinquencies). Another contributing factor may be a rise in the percentage of personal bankruptcy filers who are opting for Chapter 7 to 73 percent in 1997, compared with 69 percent a year earlier. Chapter 7 filers typically relinquish nonexempt property for liquidation and have remaining debts extinguished (i.e., not recoverable by creditors), whereas Chapter 13 filers try to work out some partial satisfaction of debt.

Direct exposure to consumer loans for the Region's insured institutions is modest, at 11 percent of total loans and 90 percent of tangible net worth. Nevertheless, consumer spending represents nearly two-thirds of the nation's economic activity, and any shocks to consumer confidence, such as a prolonged stock market correction, could rapidly spill over to other sectors of the loan portfolio if consumers rein in spending. The effects could be significant if the contraction in spending is severe enough to throw the nation into recession. While the credit situation appears to be stabilizing, the consumer sector should continue to be closely monitored.

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