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# ◆ Regional Outlook ◆

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FEDERAL DEPOSIT INSURANCE CORPORATION

FOURTH QUARTER 1998

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## FDIC BOSTON REGION



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## In Focus This Quarter

◆ **Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale**—The size and value of recent mergers and acquisitions (M&A) in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers. For banks, deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among important drivers of the trend. By identifying the rationale and incentives for bank M&A activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions. *See page 5.*

*By Steven E. Cunningham, John F. Sherman*

◆ **Risks and Challenges for Consolidating Institutions**—M&A activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. As premiums paid in bank M&A deals have escalated, some industry observers have questioned whether the promised benefits of the transactions can be realized. Institutions in the process of integrating an acquired entity may be especially vulnerable to a downturn in the economy. *See page 11.*

*By John F. Sherman*

◆ **Industry Consolidation Presents Unique Risks and Challenges for Community Banks**—Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope. Aside from merging with or selling to competitors, some small banks are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets. While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate these institutions' operations and risk profiles. *See page 14.*

*By Steven E. Cunningham*

## Regional Perspectives

◆ **Region's Economic and Banking Conditions**—During the first eight months of 1998, the pace of job growth in the Region appeared to slow...commercial real estate activity continued to accelerate, but exposure of insured institutions remained modest...profitability remains strong but is being helped by gains on securities. *See page 19.*

◆ **Mergers Continue at a Strong Pace**—The number of banks in the Region has declined 40 percent since 1988. *See page 22.*

◆ **Underwriting Standards Show Improvement**—Nationally, the percentage of FDIC supervised banks loosening standards is slightly higher than the percentage tightening, but Boston Region institutions show improvement since previous exams. *See page 22.*

◆ **International Events Continue to Act as Drag on Region's Economy**—Economic weakness in Asia hit the shores of New England in 1998...the Region has a greater exposure to trade with Canada than the nation overall...the outlook for Canada's economy in 1999 came into question as its currency and economic growth stumbled in 1998. *See page 23.*

*By Anthony DiBattista, Cameron Tabor, Norman Williams*

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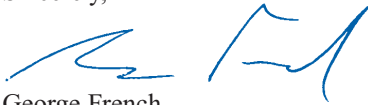
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Sincerely,



George French  
Executive Editor

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The *Regional Outlook* has three *In Focus* articles that address national issues and a *Regional Perspectives* article that analyzes the economic and banking conditions in each of the eight FDIC supervisory regions.

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## *Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale*

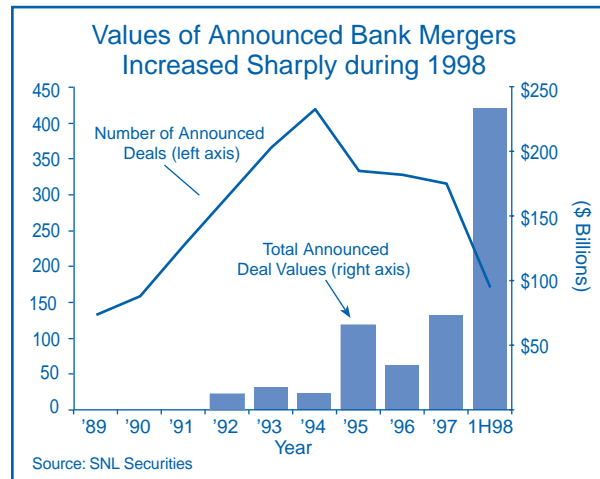
- The size and value of recent mergers and acquisitions in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers.
- Deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among the important drivers of bank merger and acquisition activity.
- By identifying the rationale and incentives for bank merger and acquisition activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.

Merger and acquisition (M&A) activity among banking companies is changing the industry's structure. The number of insured commercial banks in the United States, which held relatively steady during the FDIC's first 51 years of existence, has declined by one-third since year-end 1984, resulting in just under 9,000 commercial banks at the end of the second quarter of 1998. The number of banking organizations (bank holding companies, independent banks, and thrifts) also has declined precipitously since the mid-1980s.

The recent flurry in M&A activity by banking companies has attracted significant attention as the magnitude of transactions has escalated. As shown in Chart 1, the announced values of bank mergers have increased sharply in recent years. However, increased consolidation activity is not unique to the banking industry: The United States is now experiencing the fifth major wave of business M&A in this century, which is in turn part of an unprecedented level of worldwide M&A activity. According to data from *Mergerstat*, the value of M&A deals announced for all U.S. industries during the first half of 1998, measured both absolutely and as a percentage of nominal gross domestic product, exceeded the value of announced transactions for any full calendar year on record.

The factors that have contributed to this activity, including the availability of capital, technological change, and

CHART 1



globalization, are particularly important to the banking industry. Indeed, according to data from *SNL Securities*, the announced values of banking M&A have accounted for roughly one-third of all U.S. merger activity for the first half of 1998, exceeding any full calendar year percentage since the data have been collected (1989). This article will briefly describe the factors that are driving M&A activity in banking.

### *Why Are Banks Merging?*

#### **Deregulation**

Historically, state regulations and boundaries dictated the structure of commercial banking in the United States. Not until the 1980s did most states remove or substantially relax intrastate branching restrictions. Subsequently, the Riegle-Neal Interstate Banking and Branching Act removed most remaining restrictions to interstate expansion—restrictions that had been significantly liberalized by a 1985 U.S. Supreme Court decision (*Northeast Bancorp v. The Board of Governors of the Federal Reserve System*) that upheld the ability of states to reduce restrictions on entry by out-of-state holding companies.<sup>1</sup> As recently as January 1994 only 10 commercial banks owning 30 branches operated across state lines. By early 1998, 165 institutions owned 12,694 interstate branches.<sup>2</sup>

<sup>1</sup> "Interstate Banking—The Past, Present and Future," *FDIC Banking Review*, Fall 1996.

<sup>2</sup> Figures provided by the FDIC's Division of Research and Statistics.

There is some evidence that the recent increase in expansion and branching opportunities arising from deregulation has led to improved efficiencies and profitability, both from M&A activity and from intra-company consolidation of bank subsidiaries by multibank holding companies. In addition, the recent easing of Federal Reserve Board restrictions governing Section 20 securities underwriting subsidiaries of bank holding companies and favorable bank operating subsidiary rule interpretations by the Office of the Comptroller of the Currency have made expansions into new lines of business and mergers across financial sectors more feasible. For example, according to data provided by *SNL Securities*, since the beginning of 1997, 47 banking companies have purchased investment banking units, investment advisors, or broker-dealers.

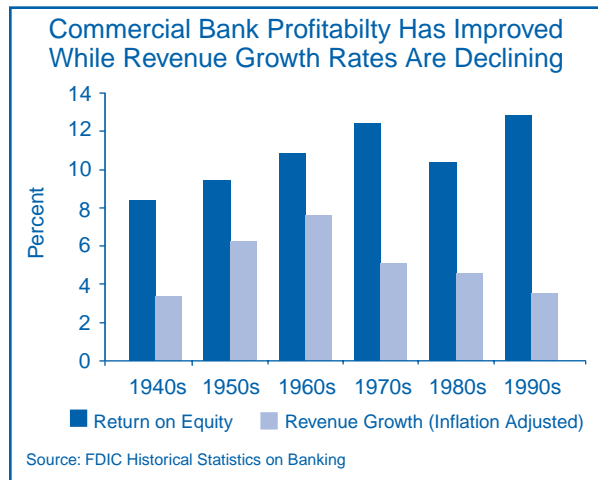
### Increasing Competition

Significant changes in the competitive environment also have contributed to the trend in bank M&A activity. One way to consider competition in an industry is through the “industry life cycle” framework. In this framework, an industry is generally categorized into one of four stages—start-up, rapid growth, mature, or decline. In each stage, firms are likely to take certain actions in response to the competitive environment. As discussed below, banking best fits the criteria for an industry in the mature stage. These criteria include declining revenue growth, improving profitability, increasing competition, and a shortage of investment opportunities relative to the amount of capital being generated.

As shown in Chart 2, over the long term, commercial banks have experienced the declining trend in revenue growth and the improving trend in profitability that characterize a mature industry. The average annual revenue growth rate by decade, adjusted for inflation, has declined since the 1960s. Profitability, as measured by the average annual return on equity by decade, has steadily improved since the 1940s, with the exception of the crisis period of the 1980s.

Competition in a mature industry often intensifies as competitors focus on sustaining market share as revenue growth rates slow. In banking, recent changes in the operating environment have stimulated a dramatic increase in competition. Specifically, barriers to entry into the industry have fallen: Capital is plentiful, experienced managerial talent is available (as a result of the many mergers), and regulatory restrictions have been relaxed. Technological and financial innovations also

CHART 2

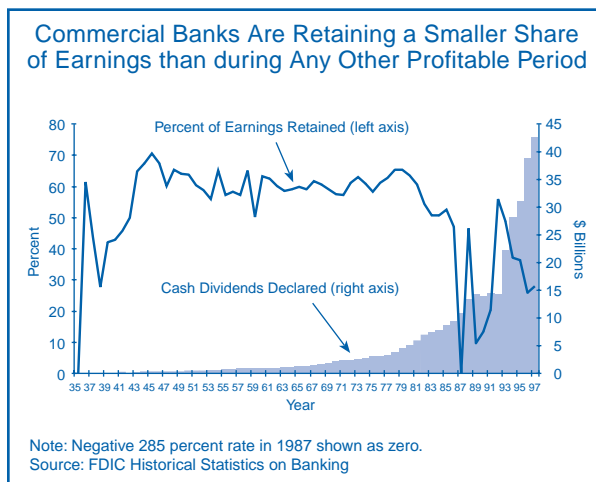


are influencing how banks compete by enabling them to manage disparate operations with broader product arrays more efficiently. Moreover, as a result of intensifying nonbank competition and continuing evolution in distribution systems, some banking services have come to resemble commodities. Consequently, brand loyalty appears to be declining and banks are experiencing reduced influence over pricing.

The final criterion for a mature industry, a shortage of investment opportunities relative to the level of capital being generated (“excess capital”), as discussed below, has become an obstacle for banks. Although generating and retaining capital increase the level of protection from insolvency risk for depositors and the FDIC, rising capital levels without a corresponding increase in profitability reduce returns on equity and, thus, returns to shareholders. Attempts to increase assets relative to equity capital in an industry with excess capital also can be undesirable because competition drives the yield on available investments to levels that either dilute current earnings or fail to compensate adequately for the amount of risk taken. (See “*Bank Earnings: Competitive Pressures and Risks*,” *Regional Outlook*, Fourth Quarter 1997.) Alternatives for managing capital in such an environment include dividends, share repurchases, and M&A transactions; banks have pursued all three.

Commercial bank cash dividend payments have reached record levels in the 1990s. In fact, the level of earnings retained over the past two years (26 percent in 1996 and 28 percent in 1997) was the lowest during a noncrisis period since the FDIC’s inception (see Chart 3). A large percentage of these dividend payments is made to bank

**CHART 3**



holding companies, which, in turn, use the funds to repurchase common stock—another means of reducing book capital, increasing financial leverage, and improving return on equity. According to data compiled by *Keefe, Bruyette & Woods, Inc.*, share repurchases by the top 25 banking organizations increased in each quarter during 1995 and 1996 and reached an all-time high of \$11.5 billion in the first quarter of 1997, but have declined steadily since then. There are at least two likely reasons for this trend. First, the continued escalation in share prices through the first half of 1998 made repurchases more expensive. Second, as share prices increase, the “pooling of interests” method of accounting for a merger becomes more attractive; however, it carries certain Securities and Exchange Commission restrictions on share repurchases both before and after the transaction. Therefore, as values rise, institutions considering future mergers are less likely to initiate repurchase programs.

The third capital management alternative, M&A, offers potential benefits to both parties to the transaction. M&A may permit acquirers to deploy excess capital while improving earnings through operating and financial economies, diversification of revenues and geographic exposures, and greater management



expertise. M&A also can provide access to new products—a common objective of competitors in mature industries. For institutions acquired through a purchase transaction in which ownership rights are relinquished, mergers provide a means of returning capital to shareholders rather than attempt-

ing to remain independent in an increasingly competitive environment.

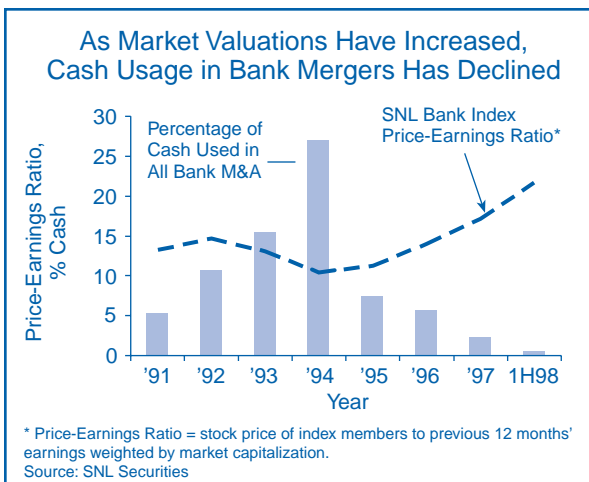
**Market Valuations**

The increased market values commercial banking companies have experienced through the first half of 1998 played a major role in recent M&A activity, as common stock increasingly has been used as “currency” in transactions, especially the largest mergers. More valuable stock allows banks to issue fewer shares to execute mergers, which reduces the potential dilutive effects to shareholders. Through mid-April 1998, the amount of cash used to fund all U.S. business mergers (13.4 percent) had reached the lowest point in ten years.<sup>3</sup> Similarly, the aggregate cash amount of announced bank deal values through the first half of 1998 was less than 1 percent and reflects a steady decline since 1994. There appears to be a strong relationship between bank stock valuations and the level of cash committed in bank M&A activity since 1991 (see Chart 4), although this relationship is obviously influenced by large, stock-based mergers.

Record earnings, positive market assessments of earnings quality and stability, and continued consolidation expectations sparked the upward trend in bank stocks through June 1998. The value of the *SNL Bank Index*, which is composed of publicly traded banking companies, quadrupled between January 1990 and June 1998 and far outstripped gains in the broader S&P 500 over the same period. The result was a rise in bank stock prices as a multiple of earnings per share (the price-

<sup>3</sup> As reported by the *Wall Street Journal*, April 16, 1998, p. C1.

**CHART 4**



earnings ratio) both absolutely and relative to the S&P 500. For example, according to the price-earnings ratio for the *SNL Bank Index*, at year-end 1994, investors paid \$9.76 per dollar of bank earnings; on June 30, 1998, investors paid \$22.88 per dollar of earnings. Over the same period, the price-earnings ratio of the *SNL Bank Index* relative to the S&P 500 increased from 65 percent to 79 percent.

From a corporate finance perspective, firms create wealth for shareholders by generating returns on invested long-term debt and equity capital that exceed their combined cost. Since long-term debt is used less in banking than in other industries, *Credit Suisse/First Boston* uses return on equity less the cost of equity capital as a proxy for measuring wealth generation by banks.<sup>4</sup> As shown in Chart 5, over the long term, increases in the price-earnings ratio for banks relative to that for the S&P 500 tends to track with the banking industry's ability to generate returns on equity in excess of the cost of equity capital. Through 1997, high levels of industry profitability, low market interest rates, and market expectations of more stable long-term industry earnings had driven the spread between the return on and cost of equity capital to unprecedented levels.

Following the strong performance through the first half of 1998, the *SNL Bank Index* lost 21 percent of its value during the third quarter of 1998 (all during the month of August) because of concerns about corporate earnings, international exposures, the flat yield curve, and the ability of banking companies to expand market-sensitive

revenues. Over the same period, the S&P 500 declined only 10 percent. Likely in response to relatively poor stock market conditions, only 75 bank mergers were announced during the third quarter of 1998—a 30 percent decline from the second quarter—with over half announced during July. According to *SNL Securities*, only 32 bank mergers were announced in August and September 1998, the lowest number for any two-month period since March and April 1997, when 31 mergers were announced. The August 1998 decline in the *SNL Bank Index* was the largest monthly decline since a 7 percent drop in March 1997. In addition, the average price-earnings ratio for the index relative to the S&P 500 during third-quarter 1998 was the lowest in eight quarters. Consistent with the aforementioned relationship between bank stock valuations and the level of cash committed to bank M&A activity, the amount of cash committed to mergers in September increased significantly.

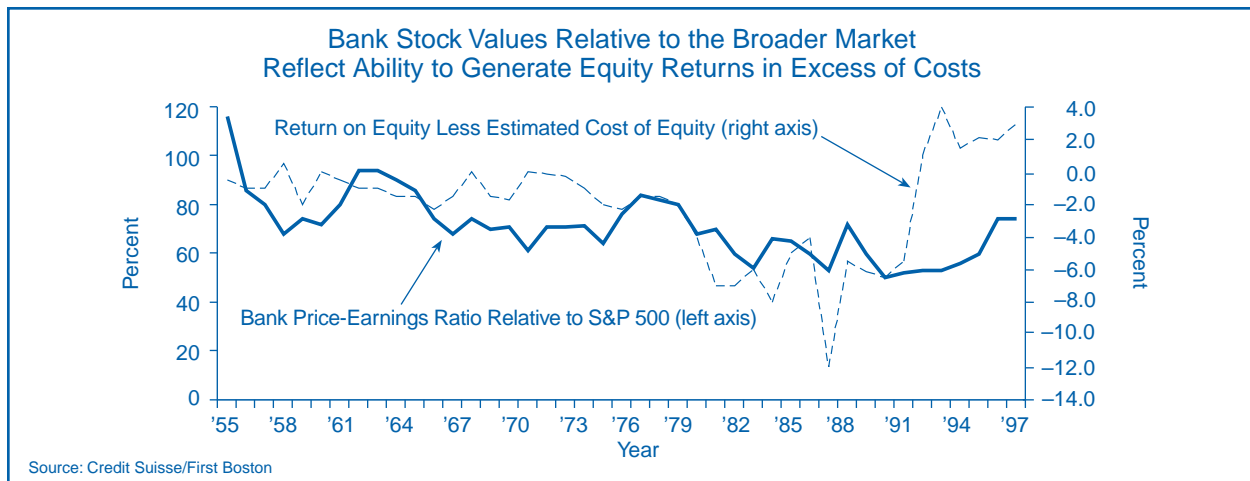
**Synergistic Opportunities**

A primary motive for M&A activity is to increase the value of the combined company by creating synergies. In other words, through some combination of cost cutting and revenue growth, M&A can produce additional wealth for shareholders of the combined company beyond what the companies operating independently could generate. Although each transaction has unique characteristics, most bank M&A generate additional value from some combination of operating economies, diversification of revenues and geographic exposures, financial economies, and transfer of management expertise.

Operating economies are achieved by eliminating overlapping administrative functions and infrastructure as

<sup>4</sup> "Value-Based Analysis of Banks," Credit Suisse/First Boston, *Equity Research—Americas*, June 4, 1998.

**CHART 5**



well as by using existing distribution networks to cross-sell products and services to generate revenue gains. However, the degree to which these benefits materialize will depend on the specific characteristics of the merger partners and their markets. For example, a review of 48 banking company mergers from 1995 through the first half of 1998, where the seller held more than \$1 billion in assets, revealed estimated cost savings that increased with the degree of market overlap (see Chart 6). Expected cost savings should translate into an increase in a firm's value. This appears to be the case in this sample, as the median price paid by acquirers as a multiple of the target's previous 12 months' earnings increased with the level of expected cost savings. Although perceived cost savings have contributed to bank M&A activity, whether the gains actually materialize hinges on execution, as discussed in *"Risks and Challenges for Consolidating Institutions"* in this issue.

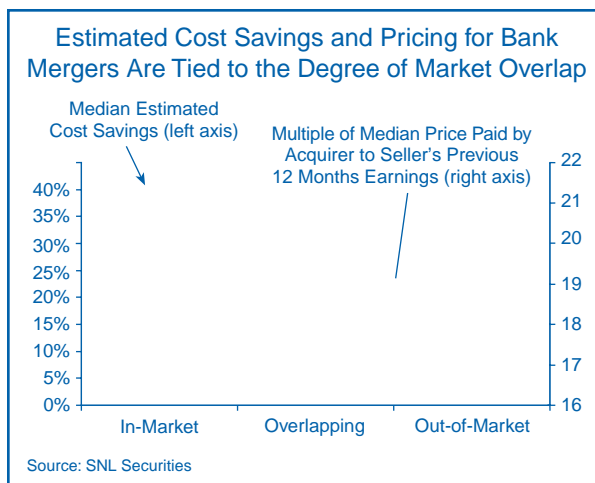
Whereas mergers in overlapping markets provide opportunities for cost cutting, value creation from revenue enhancements is more likely to materialize in M&A transactions across markets and industries. Such mergers can be expected to lead to increased diversification of revenues and geographic exposures. These expectations may be driving the recent trend in acquisitions of investment banking units and brokerage houses by banking companies. As traditional interest-spread income has stagnated, many institutions have focused on expanding noninterest sources of revenue. At June 30, 1998, noninterest income made up 40 percent of net operating revenue (net interest income plus noninterest income) for all commercial banks, compared with only 25 percent in 1984. Similarly, geographic expansion can

reduce a firm's dependency on local, undiversified economies. Supporting this notion, a May 1998 working paper by the *Federal Reserve Bank of Philadelphia* found that economic benefits are strongest for banks engaged in interstate expansion, especially for mergers that diversify macroeconomic exposures.<sup>5</sup>

As an institution's size increases through M&A activity, financial economies may result from greater access to nondeposit funding alternatives as well as traded and over-the-counter off-balance-sheet financial instruments. As of June 30, 1998, commercial banks with assets less than \$1 billion funded approximately 80 percent of assets with domestic deposits, compared with roughly 50 percent for commercial banks with assets greater than \$1 billion—reflecting how funding flexibility and accessibility increase with scale. Access to money and capital markets is enhanced for larger institutions through potentially lower transaction costs and increased coverage by securities analysts and rating agencies. For the same reasons, large banks are also the primary users of off-balance-sheet financial derivatives.

Differences in the ability of managers to operate institutions efficiently may also provide impetus for acquisitions. As Federal Reserve Board Chairman Alan Greenspan noted in recent testimony, "there are considerable differences in the cost efficiencies of banks within all bank classes, implying that there is substantial potential for many banks to improve efficiency of their operations, perhaps through mergers."<sup>6</sup> Thus, managers of more efficient banks may acquire less efficient competitors in an attempt to increase the latter's value through improved management. As shown in Chart 7 (next page), the efficiency ratios<sup>7</sup> of bank holding companies improved significantly from 1987 to 1997. However, continued disparities in efficiency among companies, as reflected by the upward slope of the lines in Chart 7, may offer additional opportunities for M&A activity.

**CHART 6**



**Technology and Globalization**

The application of technology to nearly every aspect of banking offers the potential for more streamlined oversight, management, and evaluation of far-flung

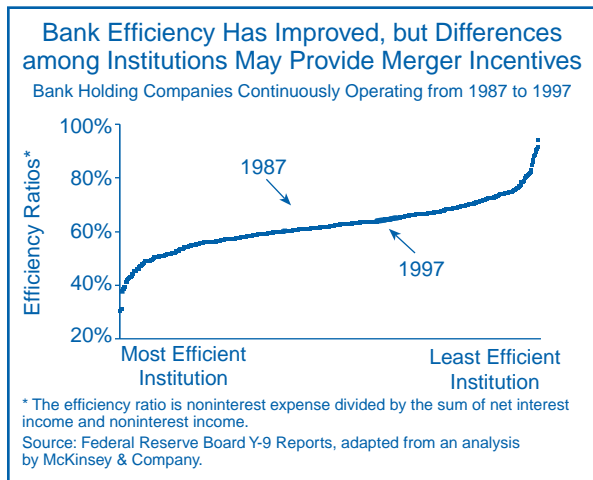
<sup>5</sup> *The Dollars and Sense of Bank Consolidation*, Working Paper No. 98-10, The Federal Reserve Bank of Philadelphia.

<sup>6</sup> Testimony before the Committee on the Judiciary, U.S. Senate, June 16, 1998.

<sup>7</sup> The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.



CHART 7



operations both domestically and internationally. Consequently, technology can facilitate merger activity. Moreover, some insured institutions may turn to mergers with compliant partners as a solution to Year 2000 computer problems.

In a June 1997 speech to the Institute for International Economics, Deputy Treasury Secretary Lawrence Summers credited information and communication technologies as a contributing factor to the trillion-dollar-a-day volume of cross-border capital flows.<sup>8</sup> Although the number of insured branches of foreign banks and the number of foreign offices of insured domestic banks have both declined in recent years, increasingly interconnected financial markets, firms, and customers have heightened the potential for competition across borders and continents.

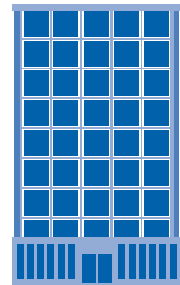
The scale, scope, and structure of many foreign competitors may promote combinations by U.S. institutions looking to enhance competitiveness in the global arena. Approval of proposed large mergers announced in early 1998 will elevate several U.S. banking companies to banking's global elite in terms of assets and market capitalization. Mergers among large European financial institutions in anticipation of the European economic and monetary union may spur U.S. multinational banks to consider strategic mergers across financial sectors.

<sup>8</sup> "Promoting Global Financial Stability: The G-7 Agenda," delivered to the Institute for International Economics, June 12, 1997.

### Management Incentives

Other factors that may drive M&A activity are related to managers' compensation, special reward structures, and job security. Industry observers have noted that executive salaries are highly correlated with company size and revenues. Some analysts have noted that compensation of bank executives rises as assets expand, regardless of the source of the expansion. *Bear, Stearns & Company* opined in June 1998 that bank mergers would continue partly because "executive compensation in banking is correlating more with asset size than with any other financial performance measure."

Special reward structures also may influence acquisition programs. Large salary increases and special merger bonuses have been observed recently for executives of large acquiring banking companies. Amassed stock holdings and options may offer significant wealth for managers who decide to sell. Additionally, managers may take actions to lessen the likelihood of takeover and the corresponding probability of job loss. Such defensive managers may undertake acquisitions to avoid having their own banks targeted for purchase.



### Summary and Conclusions

By identifying the rationale and incentives for bank M&A activity, regulators and industry participants can better understand and evaluate the risks and challenges facing merged institutions. The recent wave of banking industry M&A activity has been stimulated by a number of factors, including deregulation, increasing competition, market valuations, synergistic opportunities, technology and globalization, and management incentives. Although the pace of M&A activity may slow in the short term due to such factors as a stock market downturn or concern about Year 2000 implementation issues, the presence of multiple drivers will likely extend the consolidation trend well into the future.

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## *Risks and Challenges for Consolidating Institutions*

- **Bank merger and acquisition (M&A) activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies.**
- **As premiums paid in M&A transactions have escalated, some industry observers have raised concerns over whether the assumptions concerning potential earnings and strategic benefits can be realized.**
- **Institutions in the process of integrating an acquired entity are likely to be especially vulnerable to a downturn in the economy.**

Merging institutions are under great pressure to execute the combination smoothly and realize its anticipated benefits. On the basis of anticipated earnings improvement and other strategic benefits, M&A deals are often executed at premiums substantially above recent market prices. As a result, financial market participants closely scrutinize post-merger results. Senior management of the merged entities, who typically are instrumental in convincing shareholders to agree to the transaction, are responsible for ensuring that expectations are realized. Entities that have demonstrated a proficiency at executing mergers have been regarded favorably by the capital markets. For some organizations, merging has effectively become a line of business. Alternatively, those that struggle after a merger may experience poor financial performance and could potentially become targets for acquisition themselves.

### **Execution Risk**

The term “execution risk” often is applied to potential obstacles to integrating merging institutions. According to some analysts, execution risks are the primary risk in these combinations. These risks stem from a variety of uncertainties that arise following a merger: Can the new institution combine its management teams, integrate technological systems, realize the benefits of diversification, and maximize operating economies, all without interrupting services? Each of these uncertainties, summarized below, presents significant challenges to bank managers.

### **Management**

Combining the management teams of consolidating companies is a critical first step in the transition process. Lines of reporting and authority must be delineated, and compensation arrangements coordinated and aligned with corporate goals. All of this must be accomplished without alienating critical personnel. The most difficult aspect may involve intangible cultural differences. A recent poll by *Hewitt Associates*<sup>1</sup> of human resource managers of 218 large U.S. companies identified integrating organizational cultures as the “top challenge” in mergers. While some level of turnover must be expected, losses of key personnel and interruptions in service can result in dissatisfied customers, which in turn can lead to poor financial performance.

### **Technology**

Technological advances often are identified as the single greatest enabler of the wave of bank consolidation; however, smoothly integrating existing systems and maximizing potential benefits of technology can be difficult. A *Federal Reserve Board*<sup>2</sup> study of nine recent mergers concluded that the most frequent and serious problem merging institutions encountered was unexpected difficulty in integrating data processing systems and operations. The faster systems can be consolidated, the sooner cost savings can be realized; however, disruptions in service or breakdowns in control mechanisms may be less likely with a more measured integration timetable. Rather than attempting to integrate existing, sometimes incompatible systems, many merger partners have chosen to maintain parallel operations while integrating data processing systems over time. Year 2000 compliance efforts add yet another layer of complexity to these endeavors.



### **Diversification**

M&A transactions provide an opportunity to diversify risk exposures, thereby potentially decreasing earnings volatility and moderating the effect of economic down-

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<sup>1</sup> “Career Tracks: Personnel Execs: Toughest Job in Mergers Is Blending.” *American Banker*; August 10, 1998, p. 6.

<sup>2</sup> “The Efficiency Effects of Bank Mergers: An Overview of Case Studies of Nine Mergers.” *Journal of Banking & Finance*, March 1998, vol. 22, no. 3, pp. 273–291.

turns on an institution's performance. However, diversification creates added complexity for bank managers. They may have little practical experience with new product lines or new geographic markets and as a result they may not fully understand the risks involved in these new areas.

### Operating Economies

The degree to which anticipated operating economies are realized hinges on management's ability to carry out multiple objectives. To achieve anticipated revenue enhancements, managers of consolidating institutions have attempted to promote a culture of cross-selling new and existing products to a broader customer base in new markets, often through new distribution networks. At the same time, they have sought to reduce expenses by eliminating redundant administrative functions. Underlying these efforts is the need to establish strong internal controls and develop appropriate risk management systems.

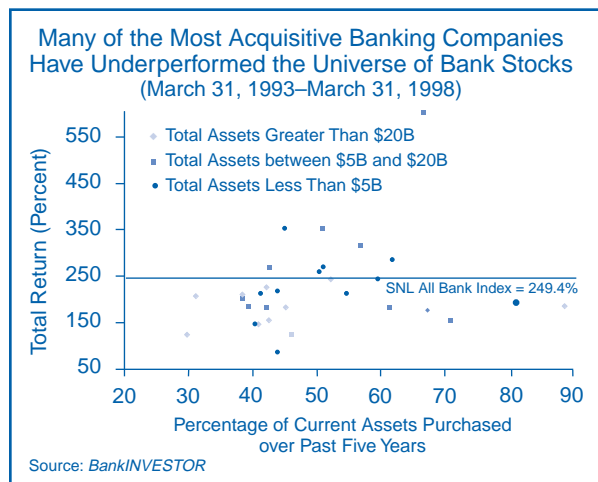
### Are Expectations Unreasonable?

As premiums paid to carry out M&A transactions have escalated, some industry analysts have viewed the assumptions regarding the expected earnings and strategic benefits as aggressive, raising uncertainty as to whether these benefits can be realized. Shares of banking organizations that have been active acquirers have not necessarily outperformed the universe of bank stocks, even before the recent market volatility. According to *BankINVESTOR*, for the five-year period ending March 31, 1998, most of the returns of the most acquisitive banking organizations across three separate size categories lagged the *SNL Bank Index* (Chart 1). This lag may be due to investor concerns about whether and to what extent the anticipated benefits of merger activity will be realized. For example, the assumed benefits related to economies of scale and diversification may be overoptimistic.

### Benefits of Scale

Economies of scale associated with greater size and capacity are commonly identified as a potential benefit of consolidation. Large banks make substantial capital investment in areas such as technology and delivery-system infrastructures; spreading these costs across a larger customer base may lead to greater efficiency. However, some observers question whether there is a limit to benefits of scale. Federal Reserve Board Chair-

CHART 1



man Alan Greenspan testified before the Senate Judiciary Committee in June 1998 that "there are no clear-cut findings that suggest bank mergers uniformly lead to efficiency gains. Returns could be muted by large company inefficiencies, and their customers may face bureaucratic inflexibility." Perhaps the increased complexity of larger institutions combined with their involvement in more nontraditional activities offset the advantages of larger scale.

### Benefits of Diversification

Another common goal of M&A activity is to promote diversification of revenue streams. The relaxation of regulatory restrictions on geographic expansion and permissible activities has made possible new combinations of revenue sources. However, the extent to which combining traditional banking with a broader range of activities will yield a diversified income stream is not yet clear. Industry analysts often point to the declining share of total revenues from net interest income as an example of improved diversification and potentially less volatile earnings. However, others argue that, like margin-related income, fee income from activities such as mutual fund sales, investment management, and brokerage operations is sensitive to both increasing interest rates and deteriorating economic conditions.

### Cost of Capital

Failure to meet performance expectations following a merger can lead to negative market assessments of earnings quality and stability. As creditors and investors view an institution's performance less favorably, they

require a higher rate of return on capital markets instruments. While cost of capital always has been important for institutions that rely significantly on capital markets as a funding source, changes in the competitive environment have made it a critical issue for all banking organizations. Technological advances and deregulation now permit low-cost competitors to enter previously insulated markets. (See *“Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale”* for a discussion of changes in the competitive environment.) Competitors with a lower cost of capital often can provide services at a lower price, or they can accept similar risks in exchange for a lower expected return. Such competition may lead higher-cost competitors to pursue higher-yielding but riskier investment alternatives.

### Economic Conditions

The M&A activity of the past few years has occurred in an environment of nearly ideal economic conditions. As a result, many of the new business combinations have yet to be tested by a downturn in the economy. Until these new entities experience a full business (and credit) cycle, the results of the M&A activity cannot be fully assessed.

Regardless of whether the long-term objectives of M&A activity are achievable, institutions that are transitioning to a new structure following a merger are likely to be especially vulnerable to deteriorating economic conditions. The experience of newly chartered institutions during the 1980s banking crisis is an example of deteriorating economic conditions interrupting this transition period. According to the FDIC’s recent study, *History of the Eighties—Lessons for the Future*, more than 16 percent of institutions chartered during the 1980s failed by 1994, compared with just 7.6 percent of preexisting institutions. The study attributed the high failure rate to a combination of “powerful competitive pressures to assume greater risk with relative inexperience in a demanding new environment.” The competitive pressures included incentives to “leverage high initial capital positions, increase earnings per share, and meet stockholder expectations.” Although recently merged institutions and newly chartered institutions are not identical, today’s merger participants face many of the same pressures.

The percentage of institutions that have recently experienced a structural change is higher today than at any

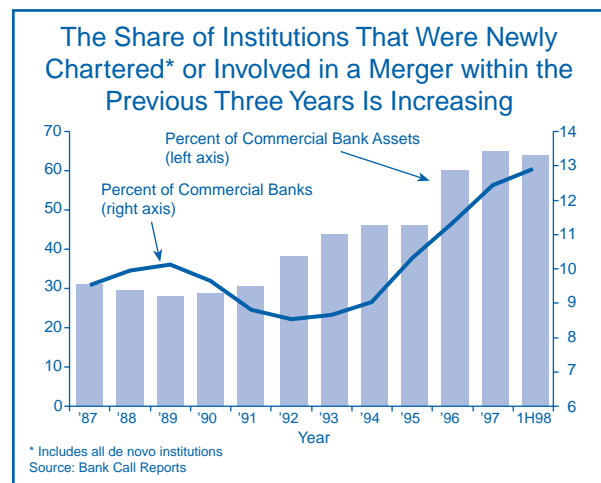
other time since the consolidation trend began. Institutions that were chartered or involved in a merger over the past three years represent nearly 13 percent of all commercial banks and 65 percent of commercial bank assets. (See *“Industry Consolidation Presents Unique Risks and Challenges for Community Banks”* for a discussion of the trend in newly chartered institutions.) As shown in Chart 2, these percentages have increased substantially in recent years. Much of the consolidation activity is occurring between institutions that have been part of the same holding company for extended periods; however, even these transactions present integration challenges that would be complicated by an economic downturn.

### Summary and Conclusions

While substantial benefits may be derived from bank M&A activity, mergers impose heavy demands on bank managers and present potential risks to banking organizations, bank investors, and the insurance funds. Bank managers face significant challenges associated with executing the merger, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. Additionally, uncertainty remains as to whether merger-related expectations can be fully realized. Finally, the process of integrating two institutions is complex and time-consuming. Should this process be interrupted by an economic downturn, these institutions may be especially vulnerable.

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CHART 2



## ***Industry Consolidation Presents Unique Risks and Challenges for Community Banks***

- **Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope.**
- **Some small banks that are not merging with or selling to competitors are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets.**
- **While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.**

Historically, commercial banking has been characterized by a large number of small institutions operating at the community level. Although the number of small, or community, banks (defined as those with total assets of \$500 million or less) has declined significantly since consolidation began in the 1980s, they continue to dominate the industry's demographics. At June 30, 1998, 92 percent (8,306) of FDIC-insured commercial banks held assets of \$500 million or less. Approximately 73 percent of these banks had no holding company or were subsidiaries of one-bank holding companies, and more than one-third operated only one office. The June 30, 1997, *Summary of Deposits* data present more evidence of the extent of community banking. On that date, two-thirds of all commercial banks operated offices exclusively within a one-county area.

In terms of demographics, the structure of commercial banking continues to reflect the time when state and interstate banking and branching restrictions tended to limit rivalry in many local markets. However, recent changes in the structure, regulation, and operating environment of the financial services sector have affected commercial banks, especially smaller community banks. Specifically, industry consolidation has created new challenges for small banks arising from heightened competition and accentuates traditional small bank obstacles related to size and scope of operations.

### ***Competitive Pressures***

In addition to intensifying competitive pressures from nonbanks, industry consolidation has heightened competition among commercial banks. According to the *Federal Reserve Board's Flow of Funds* data, for the seven-year period ending on March 31, 1998, commercial banks' share of total financial assets in the U.S. economy declined nearly 6 percentage points to just over 20 percent. At the same time that banks are capturing a smaller slice of the financial services pie, mergers, acquisitions, and consolidation have set the stage for increased competition within the industry. Larger banks operating across state lines and in multiple markets via branches, mailings, or technology now vie for community bank customers. Moreover, the rebound in new bank charters over the past four years, an outgrowth of the consolidation trend, has increased the number of small bank competitors in many markets. The inaugural *ABA Community Bank Competitiveness Survey*<sup>1</sup> in 1997 reported that small bankers considered other community banks their chief competitors for deposit gathering and all types of lending, and considered large banks formidable competitors in commercial and consumer lending and deposit gathering. While competition among small banks in common markets has existed for some time, the emergence of larger institutions as challengers results largely from many of the merger motivators and drivers discussed in "*Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale*" in this issue.

### ***New Chartering Activity***

A secondary effect of industry consolidation, and a potential source of increased competition for preexisting community banks, is the recent trend in new bank charters. From June 1994 to June 1998, more than 500 commercial banks were established in 48 states. Although rebounding, the annual level of new chartering activity remains well below the peaks of the previous three decades. Industry observers attribute the recent increase in new charters to many factors, including the availability of displaced banking talent, strong economic growth, potential niche opportunities in mar-

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<sup>1</sup> As presented in the *ABA Banking Journal*, April 1997, p. 55.

ket segments underserved by larger banks, and the loss of local decision making and perceived service gaps as local banks are acquired by larger banks or are consolidated into far-flung multibank companies.

New bank activity is not concentrated in one region of the country. However, at the state level there appears to be a relationship between new chartering activity and the number of institutions sold or consolidated in merger and acquisition transactions (see Chart 1). Forty percent of all banks sold or consolidated and 27 percent of new charters from June 1994 to June 1998 were in Texas, California, Florida, Illinois, and Georgia.

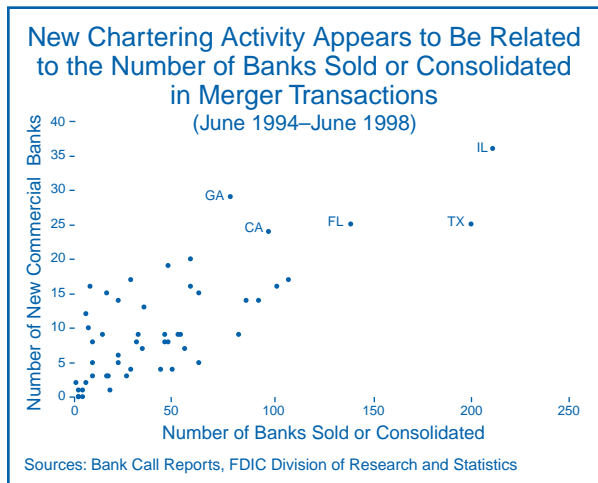
As shown in Map 1, ten states currently host a high percentage of recently established community banks. Many of these states have experienced strong economic growth during this expansion and have a large number of banking offices owned by out-of-state institutions. These concentrations are especially noteworthy since newly chartered institutions often pursue aggressive growth to improve profitability, which may influence pricing and terms for competitors within their markets. Reflecting the recent surge in new banks, 57 percent of the 402 unprofitable commercial banks through the first half of 1998 had been in business less than four years, up from 17 percent at year-end 1994 (see Chart 2). As would be expected, the ten states highlighted in Map 1 rank among the top in terms of the percentage of small banks that were unprofitable during the first half of 1998.

**Challenges of Scale and Scope**

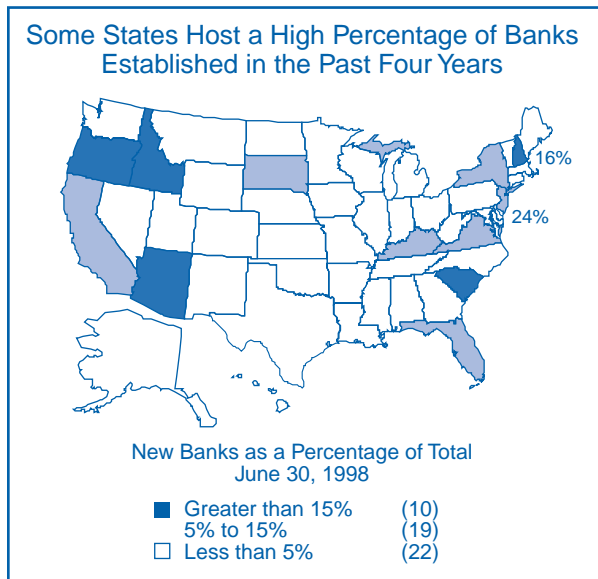
A by-product of industry consolidation is the emergence of larger institutions. By definition, community banks operate with relatively less scale than their regional, super-regional, and money-center counterparts. As a result, small banks have limited ability to spread the costs of new investments or operating expenses across a broad asset base. This characteristic has traditionally forced community banks to spend more to generate each dollar of revenue than the rest of the industry, as measured by efficiency ratios.<sup>2</sup> The inability of many community banks to fund large expenditures, such as investments in technology, alternative delivery systems, or new business lines, may cause

<sup>2</sup> The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.

**CHART 1**



**MAP 1**



**CHART 2**

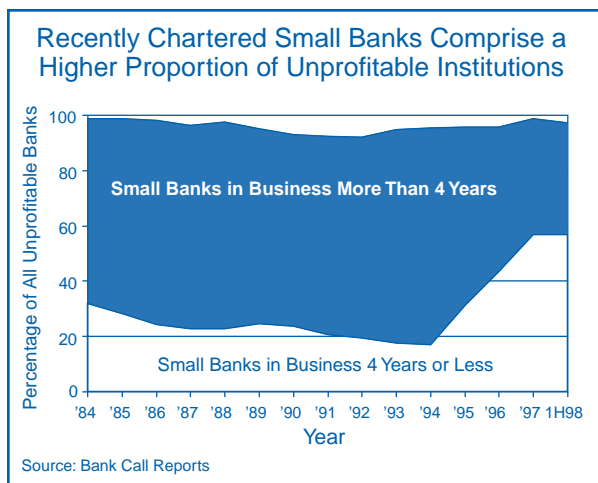
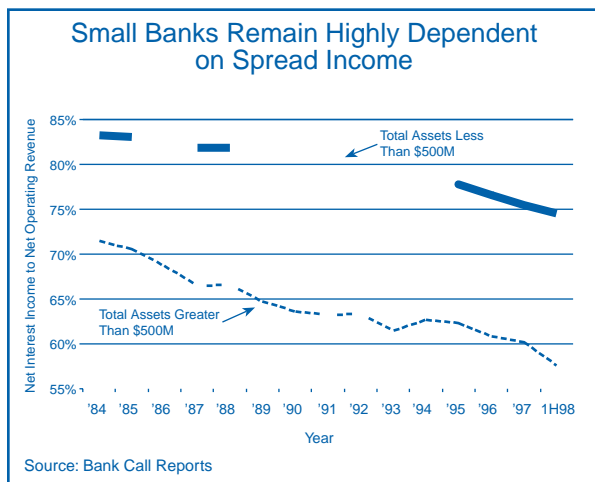


CHART 3



long-term competitive disadvantages. For example, *The Tower Group* estimates that 70 percent of 1997 information technology (IT) spending by banks was by the top 15 institutions.<sup>3</sup> Smaller institutions competing with larger banks that are investing in technology to improve operational efficiency, increase customer convenience, or to better identify customer profitability, pricing strategies, or cross-selling opportunities may find a diminished presence in the marketplace. Consequently, small banks may face increasing competition for customers who are attracted to sophisticated pricing, wider product arrays, and multiple delivery channels offered by competitors.

Closely related to scale is the issue of scope of operations, both business line and geographic. Community banks' scale may limit their ability to expand into new business lines or activities, thereby reducing the degree of revenue diversification and resulting in dependence on spread income. Since many noninterest sources of revenue require scale to economically justify investment, small banks tend to derive a greater percentage of net operating revenue from spread income, as shown in Chart 3. Also, the limited geographic scope of many community banks may result in less loan portfolio diversification and greater exposures to local economic downturns. From a portfolio management perspective, lenders with more diverse loan portfolios that can spread risks over a broader customer and economic base may gain pricing advantages over less diversified competitors.

<sup>3</sup> "How Much Do US Banks Spend On Information Technology?," The Tower Group Research Notes, www.towergroup.com.

### *How Are Community Banks Addressing Consolidation Challenges?*

In response to competitive pressures arising from industry consolidation, community banks, new and old, appear to be adapting to meet strategic challenges to their long-term viability. Indeed, this summer, Federal Reserve Board Chairman Alan Greenspan told the Charlotte, North Carolina, Chamber of Commerce that "well-managed smaller banks have little to fear from technology, deregulation, or consolidation." Recent surveys and anecdotes reveal that small banks that are not selling to or merging with competitors are adjusting business practices to cope with the aforementioned pressures and challenges. Their strategies include outsourcing business functions, expanding the use of non-deposit funding sources, partnering with other banks and nonbanks, emphasizing personalized service, and developing niches or specialties. However, as described below, while these approaches may help small banks meet the challenges of consolidation, they potentially complicate the operations and risk profiles of these institutions.

#### **Outsourcing**

A recent survey by *Electronic Data Systems Corporation* and *Bank Earnings International LLP*<sup>4</sup> found that community bankers are more concerned with controlling operating expenses than any other issue. This finding is not surprising given the cost savings expected from many recent mergers. The study also revealed that banks view IT as the most valuable tool for improving day-to-day performance—from controlling expenses to increasing fee income. Yet, according to *The Tower Group*, IT budgets as a percentage of total noninterest expenses for small banks are typically half of those for larger banks.<sup>5</sup> As a result, some small banks are turning to outside parties to maximize the utility of expenditures, IT and others.

*American Banker* recently reported on a trend among small banks to outsource the origination of consumer loans. *The Tower Group* noted that third parties handled 2.7 million noncard, nonmortgage loan applications (mostly from small institutions) in 1997, and annual outsourced volume growth is projected to average 40 percent through 2002.<sup>6</sup> Vendor networks designed to

<sup>4</sup> *American Banker*, July 22, 1998, p. 16.

<sup>5</sup> *Computerworld*, May 25, 1998, p. 20.

<sup>6</sup> "More Banks Handing Off Nitty-Gritty of Consumer Lending," *American Banker*, June 12, 1998, p. 1.

enable small banks to reduce hardware and personnel needs also have emerged and allow for more cost-efficient processing and cheaper access to customer information. Many small banks planning Internet-based or home banking also are turning to outside experts. Outsourcing certain business functions may allow for greater focus on profitable business lines, less risky access to state-of-the-art technology, cost savings, and more options for customers. However, these arrangements are not without risk. Indeed, FDIC-insured institutions have experienced difficulties in the past with indirect consumer lending, such as auto lending. Moreover, banks that outsource business functions may have less control over those functions and may become over-reliant on third-party providers.

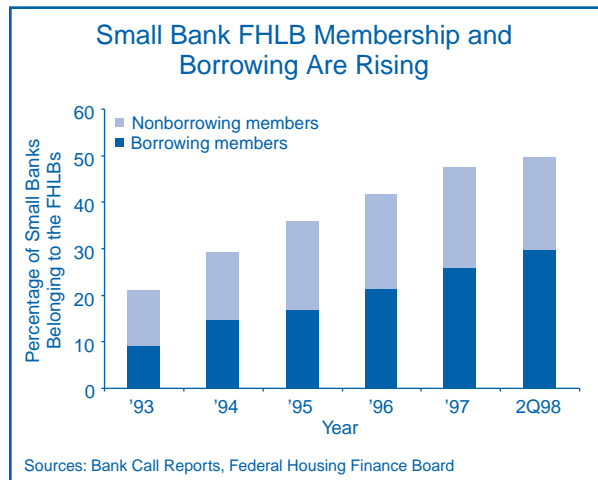
### Nondeposit Funding Sources

As noted above, increasing competition for deposits has left some small banks searching for alternative funding sources to meet loan demand. On average each year from 1993 to 1997, 64 percent of small commercial banks experienced loan growth in excess of deposit growth. Similarly, six in ten banks responding to the *1998 ABA Community Bank Competitiveness Survey*<sup>7</sup> reported that deposit levels were not keeping pace with loan demand. In response, small banks are increasingly turning to nondeposit funding sources. From 1993 through the second quarter of 1998, the percentage of small banks using borrowings of any type increased from 48 to 56 percent. Over the same period, the percentage of small banks funding with borrowings other than overnight funds (Federal funds and repurchase agreements) increased from 20 percent to 35 percent, and the percentage reporting brokered deposits rose from 7 percent to 12 percent.

The rising number of commercial banks joining the Federal Home Loan Bank (FHLB) System in recent years, as reflected in Chart 4, is likely a symptom of the aforementioned funding trend. At June 30, 1998, nearly half of all small banks were FHLB members, compared with 21 percent at year-end 1993. On the same date, 90 percent of FHLB commercial bank members and 87 percent of FHLB commercial bank borrowers were small banks. In addition to providing a backup source of liquidity, the FHLB is essentially acting as an intermediary to the capital markets for banks with limited access. The relatively limited nondeposit funding options available to many small banks may explain their

<sup>7</sup> *ABA Banking Journal*, February 1998, p. 47.

CHART 4



increasing reliance on FHLB advances. At June 30, 1998, approximately 80 percent of small banks' nonovernight borrowings were FHLB advances.

The increasing liquidity of loan portfolios is becoming another funding alternative. Many small banks have used participation arrangements to sell off portions of loans to correspondent banks or have turned to Fannie Mae or Freddie Mac to sell mortgages. The securitization of other loan types also may become increasingly appealing as funding shortages persist and market opportunities for small banks increase. For example, in July 1998, *American Banker* highlighted the creation of a new commercial mortgage conduit established specifically to buy loans originated by community banks.<sup>8</sup> The secondary market for the guaranteed portion of Small Business Administration loans also has been cited as a potential source of liquidity.

Although identifying and expanding the use of nondeposit funds may increase the flexibility of small banks, their use complicates asset-liability management. While net interest margins for small banks have yet to reveal significant compression, recent evidence suggests future declines. For example, a recent survey conducted by the *Federal Reserve Bank of Minneapolis* found that 57 percent of small bankers in the upper Midwest expect a shift away from deposit funding to decrease profitability.<sup>9</sup>

<sup>8</sup> "Commercial Real Estate: New Conduit Plans to Help Small Banks Enter," *American Banker*, July 21, 1998, p. 29.

<sup>9</sup> "Location Influences Community Bank Challenges," Fedgazette, Federal Reserve Bank of Minneapolis, July 1998, p. 2.



### **Partnering**

In an effort to expand revenue sources and attract and retain customers, smaller banks are expanding their spectrum of products and services through partnerships with other entities. The *1998 ABA Community Bank Competitiveness Survey* found that 10 percent of community banks partnered with other banks in 1997, while nearly twice as many have teamed up with nonbanks. Over two-thirds of the survey's respondents considered their partnering approach profitable. The leading types of arrangements with other banks include loan participations, title insurance, data processing, credit card programs, and mortgage lending. Nonbank partnering has been used to expand offerings to customers such as brokerage, insurance, and travel agency services. However, like outsourcing, partnering could result in less control and overreliance on third parties.

### **Service Orientation**

Small banks have long touted personalized service and local decision making as a competitive advantage. Influenced by the recent wave of merger and acquisition activity in the industry, community bankers cited service as an area with great opportunity in the *1998 ABA Community Bank Competitiveness Survey*. Indeed, many community bankers have publicly welcomed consolidation as a chance to establish new relationships and attract customers affected by integration problems and personnel shifting at larger acquiring or merging banks.

Establishing prudent relationships with smaller, underserved customers may present opportunities and profits for small banks. This may be especially true for small business customers, which may not fit more standardized lending models of larger banks yet remain acceptable credit risks. According to the Federal Reserve Board's second-quarter 1998 *Survey of Terms of Business Lending*, rates on small commercial and industrial loans earn the greatest spread of any size business



loans. Further, a recent survey by *PSI Global* of small business owners in south Florida, which has seen a great deal of merger and acquisition activity in recent years, found that nearly one-quarter of respondents would move their business if their bank was purchased, exemplifying the extent to which small banks may be able to use service to capitalize on consolidation activity.<sup>10</sup>

### **Developing Niches or Specialties**

Anecdotal evidence suggests that some small banks are specializing in narrow markets and niches. Some analysts and consultants have emphasized that community banks should not try to be what they are not, but should instead focus on a particular market segment or niche. By default, many small banks depend on their customers' local businesses and, through local expertise, may be better at serving specific industries than their larger competitors. However, a narrow focus may reduce portfolio diversification and could lead to greater exposures during an economic downturn.

### **Summary and Conclusions**

Small banks are facing heightened competitive pressures from larger, merged institutions and from new banks. Their ability to respond to these pressures is restricted by traditional scale and scope limitations. Community banks are addressing these challenges by outsourcing business functions, utilizing nondeposit funding sources, partnering with other banks and nonbanks to diversify revenues and widen customer options, capitalizing on personalized service, and developing niches or specialties. While these strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.

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<sup>10</sup> *South Florida Business Journal*, May 22, 1998, p. 6.

## *Regional Perspectives*

- **Job growth slowed during the first eight months of 1998, as the Region's economy began to feel the effects of slower global and national economic growth.**
- **The current pace of commercial real estate development is in line with vacancy and absorption rates for the various markets across the Region. Despite a large runup in planned office projects in greater Boston, constraints on nonbank capital sources may impede full development.**
- **The Region's banks report strong performance but are seeing some margin pressures. Asset quality is improving, according to the latest underwriting survey of FDIC-supervised banks in the Region.**
- **Reduced demand from Asia began to manifest itself through clear weakness in the Region's manufacturing sector in 1998. A slowdown in Canada's economy could aggravate the drag on the Region's economy in 1999.**

### *Region's Economic and Banking Conditions*

#### *Economic Overview*

Through the summer of 1998, the Region's economy continued to expand, although evidence mounted that the pace of job growth had slowed. The average monthly change in seasonally adjusted nonfarm employment across the Region rose more slowly during the first eight months of 1998 (1.3 percent) than during the same months in 1997 (2.2 percent). Measured on the same basis, manufacturing employment for the Region declined by 0.6 percent. The falloff was most evident in **New Hampshire, Maine, and Rhode Island**, with all three states posting average monthly declines of 3 to 4 percent (at annual rates). Much of the Region's weakness in manufacturing employment in 1998 can be traced to reduced export demand, increased import competition, reduced availability and rising cost of labor, and limits on pricing flexibility owing to slumping global economic growth. Despite the weakness in manufacturing employment, unemployment rates were all well below the prior year's levels and generally continued to decline through August 1998. The notable exceptions were Maine and Rhode Island, which experienced slight increases in unemployment rates during the summer months. The lack of qualified workers continues to constrain job growth in many parts of the Region.

#### **Office Vacancy Rates Continue to Decline, While Boston Pipeline Is Dominated by Office Projects**

In this space last year, the *Regional Outlook* examined trends in commercial real estate (CRE). Many of the trends observed then continued through the following

12 months. Most metropolitan markets are adding only modest amounts of industrial space, well in line with current vacancy rates. Also, much of the recent industrial development is occurring because many markets have properties that are outdated and functionally obsolete. These properties are either sitting vacant or being rehabilitated into retail or high-tech research and development space.

New retail development continues despite the closure of several major retailers in New England during 1997. In many cases, retail development reflects a shift from smaller, traditional retail formats toward power centers and "big box" formats. As a result, meaningful vacancy rate and demand trends are hard to pin down. For example, **Hartford's** recent increase in overall retail vacancy may reflect a shift in demand to different types of retail space (rendering older space obsolete, and thus vacant). Another cause for higher retail vacancy rates may lie in the conversion and marketing of obsolete industrial space for retail use. The high level of planned retail projects for the greater **Boston** area (see Chart 1, next page) also can be explained largely by a lack of suitable retail properties rather than a low overall vacancy rate.

Office properties are experiencing positive net absorption in most markets, with construction centered in the greater Boston area and Fairfield County, Connecticut. In general, vacancy rates for commercial office space continue to fall both in the largest market (greater Boston) and in many smaller metropolitan areas (see Table 1, next page).

TABLE 1

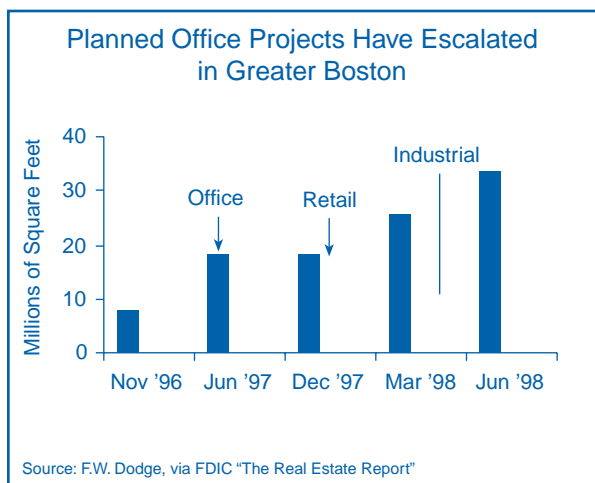
OFFICE MARKETS CONTINUE TO TIGHTEN (PERCENT OF CLASS A&B* OFFICE SPACE VACANT)			
	1997	1996	1989 TO 1997 (PEAK)
BOSTON, MA	6.2	8.9	18.2 ('91)
SPRINGFIELD, MA	7.8	9.9	28.5 ('90)
BRIDGEPORT, CT	13.2	14.2	25.8 ('92)
HARTFORD, CT	18.6	23.0	24.3 ('92)
STAMFORD, CT	12.0	15.2	30.7 ('89)
NEW HAVEN, CT	21.5	21.7	30.0 ('90)
NASHUA, NH	9.0	12.0	24.1 ('91)
PORTLAND, ME**	6.0	6.4	11.4 ('89)
PROVIDENCE, RI**	15.0	18.6	25.9 ('93)

\* BOSTON, HARTFORD, AND STAMFORD INCLUDE CLASS C SPACE  
 \*\* BASED ON INCOMPLETE DATA  
 SOURCES: SOCIETY OF INDUSTRIAL AND OFFICE REALTORS AND CB COMMERCIAL (BOSTON, HARTFORD, AND STAMFORD)

**Office Construction Is Escalating in Greater Boston**

The Region's largest commercial property market, greater Boston (the area inside Interstate 495), is seeing a significant increase in new properties proposed and under construction because of a strong local economy and limited available inventory. Chart 1 shows how planned new construction has escalated, particularly for the office market segment, which more than quadrupled in the 19 months through mid-1998 to almost 35 million square feet.

CHART 1



Commercial construction during the past few years has occurred largely in the suburbs of Boston. According to *F.W. Dodge*, greater Boston experienced an increase in commercial starts of about 9.5 million square feet in 1997—the highest annual total since 1989. Of that amount, 55 percent was in office properties. Still, this level of office construction (5.2 million square feet) pales in comparison with the 8.5 million square feet per year average between 1985 and 1989. The amount of new office property started in 1997 amounted to less than 5 percent of an inventory estimated at between 105 and 115 million square feet—half the average share seen in the mid- to late 1980s. Construction activity continued to accelerate in 1998, as the level of planned new projects rose to approximately one-third of existing inventory. A midyear report from *Cushman & Wakefield* placed greater Boston office construction during the second quarter of 1998 at 2.4 million square feet, versus 1.2 million for the same period in 1997.

Given the area's mid-single-digit average vacancy rate, space added in 1998 likely will not cause any appreciable drop in rental rates. If the current trend continues and the economy slows by mid-1999 or early 2000, then significant inventory could come on line just as demand begins to decline. However, most of the planned projects for greater Boston are in the early planning stages and could easily be shelved if an economic slowdown occurs. Also, the late-summer cooling of the equity market, which included a marked drop in real estate investment trust (REIT) share prices and a drying up of demand for commercial mortgage-backed securities, may stem commercial real estate development. In fact, sale prices nationally for commercial properties came under pressure in late summer, as certain REIT-led acquisitions were tabled owing to a sharp increase in capital costs. Much of this increase resulted from cautious lenders' insistence on higher interest rates and a pullback of investor demand for commercial mortgage-backed securities.

**Region's Insured Institutions Maintain Modest Exposure to Commercial Real Estate**

New England's insured institutions are somewhat exposed to this sector of the economy, although as a whole they have reduced their commercial real estate (CRE) lending in both absolute dollar terms and concentration levels relative to the late 1980s. Part of the reason may be regulators' warnings about the consequences of lax lending policies. Regulators have been

monitoring REIT lending especially and advising bankers to be aware of the risks associated with these types of loans. Apparently institutions, remembering the last banking and real estate bust, have proceeded cautiously during this expansion. Larger institutions (with assets over \$1 billion) have CRE loan concentrations, as well as total dollar exposure, well below the peak levels seen during the past 14 years. They have steadily reduced their CRE exposure over the past five years. These statistics were calculated on a merger-adjusted basis and represent only institutions that were strong enough to endure the last real estate downturn.

A different tale appears when smaller institutions (with assets under \$1 billion) are examined. Their CRE exposure has grown considerably, although from a low base. They have increased CRE, construction, and multifamily loans by 38, 27, and 73 percent, respectively, in the past five years. Still, concentration levels remain well below those of the late 1980s.

Why have smaller lenders increased CRE exposure, while larger players have curtailed their exposure? Quite simply, the smaller institutions have few other alternatives for loan growth. Higher CRE commitments help the Region's smaller players to diversify their consumer-dominated books of business. The recent high growth rates in CRE exposures reflect smaller institutions' low CRE exposure early in the decade. Also, most of the Region's commercial business is controlled by the large regional players and nonbank sources of funding. CRE offers smaller institutions a risk-return position somewhat more aggressive than their dominant consumer loan positions (particularly single-family mortgages). As long as they maintain careful

underwriting practices and obtain adequate pricing for the amount of risk taken, the increasing CRE exposure should not be an untoward risk for the Region's insured institutions.

### Banking Overview

The Boston Region's insured institutions reported healthy financial conditions through the second quarter of 1998 (see Table 2). For the six months ended June 30, 1998, the average return on assets (ROA) and return on equity (ROE) was lower than during the same period in 1997 but still above the national averages. The Region's average leverage capital ratio fell from 1997 levels but is in line with national averages. Delinquency and charge-off levels are falling and are below national levels.

Differences exist depending on institution size. Institutions with less than \$1 billion in assets reported an average ROA of 1.12 percent; those with assets between \$1 billion and \$25 billion reported an average ROA of 1.42 percent; and those with over \$25 billion in assets reported an ROA of 1.27 percent. Core earnings in the institutions with less than \$1 billion in assets are stable at just under 1 percent. Significant levels of security gains prop up income in the institutions with less than \$25 billion in assets, helping to maintain their levels of profitability. As of the second quarter of 1998, eight of the Region's insured institutions reported losses, compared with ten as of the second quarter of 1997. All the institutions reporting losses are in the group with less than \$1 billion in assets, and five have been open for less than two years.

TABLE 2

REGION'S INSURED INSTITUTIONS GENERALLY CONTINUE TO OUTPERFORM NATIONAL AVERAGES								
FINANCIAL INDICATORS (%)	BOSTON REGION INSTITUTIONS				NATIONAL TOTALS			
	6/30/98	6/30/97	6/30/96	6/30/95	6/30/98	6/30/97	6/30/96	6/30/95
RETURN ON ASSETS	1.27	1.31	1.18	1.04	1.22	1.19	1.15	1.05
NET INTEREST MARGIN	4.06	4.12	4.00	4.16	3.92	4.05	4.03	4.05
RETURN ON EQUITY	14.63	15.12	13.83	12.91	14.34	14.25	13.96	13.22
TIER 1 LEVERAGE	7.71	8.00	7.77	7.65	7.72	7.78	7.75	7.62
PAST-DUE LOANS	1.73	2.10	2.65	2.77	2.07	2.24	2.42	2.46

SOURCE: BANK AND THRIFT CALL REPORTS

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## Mergers Continue at a Strong Pace

### Consolidation Trends in the Region

The number of banks in the Boston Region has declined 40 percent, from 737 in 1988 to 439 as of June 1998. Part of the decline is due to strong merger and acquisition activity (including over 100 failures), and part is due to the change in interstate banking laws allowing banks within a single holding company to operate under one charter.

Several banks in the Region operate branches in more than one New England state, owing to the consolidation of multiple charters within holding companies as well as intraregional mergers or branch purchases. This trend is likely to continue. In 1998, acquisitions total-

ing almost \$7 billion had been completed by Boston Region institutions acquiring other regional institutions. During the same time frame, acquisitions involving \$1.3 billion in total assets had been completed by out-of-Region acquirers of Boston Region institutions. Organizations based in the Boston Region do not have a wide national presence, so most acquisition activity across boundaries in the Region has been of the latter type. Boston Region institutions have acquired few out-of-Region institutions with the exception of Fleet's acquisitions in New York, New Jersey, and Delaware. Few New England-based banks operate branches outside the Region, and banking subsidiaries controlled by New England-based organizations are mainly in contiguous states.

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## Underwriting Standards Show Improvement

Regulators continue to warn banks of the effects of making risky loans. The FDIC *Report on Underwriting Practices* shows that, nationwide, the percentage of FDIC-supervised banks loosening underwriting practices is slightly higher than the percentage tightening them. The report also states that 87 percent showed no material change in underwriting practices since their previous examination. Most of the higher-risk loans are CRE and construction loans. Also, banks are issuing credit cards to riskier customers and making high loan-to-value mortgage loans. If the economy weakens, such loans made to marginal borrowers may become delinquent and hurt banks' viability.

Subprime lending and high loan-to-value mortgage lending are tempting, as bankers see the opportunity to increase profits by lending in areas that in the past were dominated by the noninsured, finance-type companies. With competition heating up in the subprime market, spreads are narrowing, which may reduce returns to levels that do not adequately compensate an institution for the additional credit risk inherent in subprime loans. There is no evidence that insured institutions in the Boston Region have aggressively expanded into the subprime market. However, it is an area of emerging risk that bears watching, particularly because it is a rapidly growing market that has not been tested in an economic downturn.

Federal regulators are warning financial institutions against trying to compete with so-called "easy TV loans," which are often high loan-to-value loans that allow a borrower to borrow more than the current value of the home. These loans often are advertised as bill consolidation loans and are targeted at consumers who may be least able to afford the loan payments if there is a downturn in the economy. Also, the fear remains that borrowers will consolidate their loans into high loan-to-value equity loans and then once again incur substantial consumer debt. The Office of Thrift Supervision has warned savings and loans that they could face regulatory action if they fail to control the risks associated with such lending.

The news from the Boston Region is favorable. The *Report on Underwriting Practices* states that among the FDIC-supervised banks surveyed in the Boston Region, underwriting standards have tightened since the previous examination. Most deficiencies noted were listed as minor or moderate weaknesses rather than substantial weaknesses. While the news is favorable for the Boston Region, the sample examined in the first six months of 1998 included only 60 of the Region's 439 banks. Of the sample, about one-fourth showed a change in underwriting practices. The number of banks tightening underwriting standards was almost twice the number of banks loosening underwriting standards.

Credit standards in the Boston Region appear to be in line with the *Federal Reserve Senior Loan Officer Opinion Survey*. The survey, conducted in September, revealed a fairly widespread tightening of standards nationwide for commercial and industrial loans to large-

er firms. For domestic banks reporting, this tightening is a shift from previous surveys, but for foreign banks it is a continuation of a trend. The survey found minimal change in standards and terms for commercial and industrial loans to small firms.

## International Events Continue to Act as Drag on Region's Economy

### International Developments Are Hindering the Region's Economic Growth

As the economic slowdown in Asia developed fully during 1998, it became apparent that turmoil in that part of the world economy would continue to act as a drag on the nation's and the Region's growth into 1999. In addition, the fallout from weakened demand in Asia has had some indirect effects on other parts of the global economy that may have an impact on the Region.

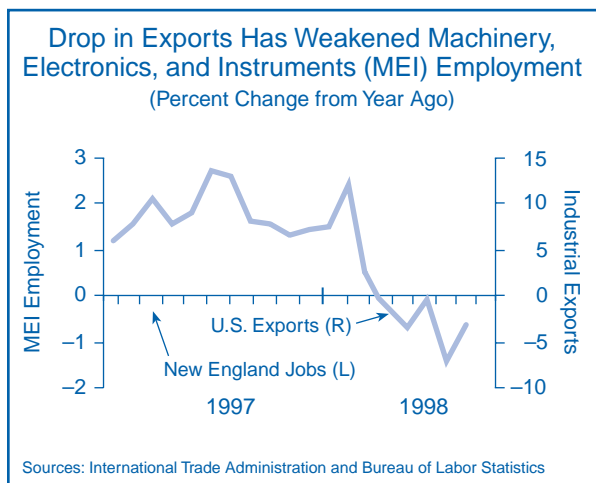
During the past year, the predominant effect from Asia's weakness has been a decline in exports, particularly industrial machinery, electronics and electronic equipment, and instruments. As a result of weakened sales abroad, several companies in the Region announced layoffs. The first firms to reduce employment were those that produce equipment used in the testing and manufacture of semiconductors. Declines in employment and investment in this part of the semiconductor industry typically precede declines among the suppliers of raw materials and the semiconductor makers themselves. By early October, more than 2,500 lost jobs in **Massachusetts'** technology manufacturing sector could be traced to weakness in Asia. Other firms involved in selling capital equipment to the weakened Asian nations have been similarly affected by reduced demand. In late September, Massachusetts-based Gillette announced planned layoffs due to the global economic turmoil—the first large consumer goods company in Massachusetts to take such action.

Chart 2 shows that U.S. exports of industrial supplies and materials went from an annual rate of growth of approximately 10 percent in early 1998 to an annual rate of decline of about 5 percent by summer. This drop helped to slow the rate of employment growth in the machinery (including computers), electronics, and instruments sectors. For the Region, the effect caused combined annual employment growth in these industries to fall from a rate of about 3 percent early in 1998 to no growth by August. A similar trend occurred nationally.

In the early August *Beige Book* from the Federal Reserve, Boston Region manufacturers responding to the survey indicated a decline in sales or orders of computers, semiconductors, and industrial machinery. Similarly, exporters reported that sales to Asia were down substantially during the summer from a year earlier, with some indicating that business with Korea and Indonesia had virtually disappeared. The survey stated that most exporters anticipated that weakness in Asia would continue to limit their sales in 1999.

A preliminary first-quarter look at exports by the *Alliance for the Commonwealth* indicated that Massachusetts saw exports fall 6 percent from the last quarter of 1997 to the first quarter of 1998. The drop in the state's exports was the most significant single-quarter decline since the Mexican peso devaluation earlier in the decade. Exports to Taiwan, South Korea, and Singapore were the hardest hit, but strong growth was seen in exports to Europe and China. The *Connecticut Economic Resource Center* reported a decline for that state of almost 9 percent between fourth-quarter 1997 and first-quarter 1998 (versus a national decline of about 4 percent). **Connecticut's** exports to Asia dropped 29 percent for the quarter, with the largest (dollar value)

CHART 2



declines in exports to Japan, South Korea, and Hong Kong.

### Canada May Join Asia as a Leading Risk to the Region's Expansion

Following on the heels of the Asian crisis in 1998, various emerging markets and nations with large resource industries were hit by adverse currency actions linked to the widespread weakening of global commodity prices and a general flight to quality vis-à-vis purchases of U.S. dollar-denominated assets. As a result of the collapse in demand from a once commodity-hungry Asia, speculation that Canadian producers of wood products, agricultural goods, crude oil and gas, and other commodities would see their demand plummet led to a drop in the Canadian dollar ("Loonie") to a new low against the U.S. dollar.

As is evident in Chart 3, the decline of the Loonie since 1997 has not been as pronounced as that of certain other foreign currencies. This is due to the fact that Canada's economy is only modestly dependent on the production of commodities and does not suffer from the economic mismanagement, excesses, and political instability seen in much of Asia, Latin America, and Russia. By late summer the low overall level of global commodity prices had done more to constrain output in Canada's oil and forest products industries than the weak Loonie had done to boost exports of these industries' products. However, persistent weakness in the Loonie might dampen economic activity in the Boston Region.

In addition to currency effects, the potential for a weakened Canadian economy is a risk for firms with cus-

tomers to the north, as well as the Boston Region's tourist areas. Emerging signs of a potential slowdown in Canada's economy in 1998 included a drop in midsummer retail sales, fewer housing permits issued between May and July, a decelerating rate of job growth through midyear, consecutive declines in monthly gross domestic product (at factor cost) between April and July, and an increase in the Bank of Canada's bank rate to 6 percent in an unsuccessful attempt to bolster the depressed Loonie.

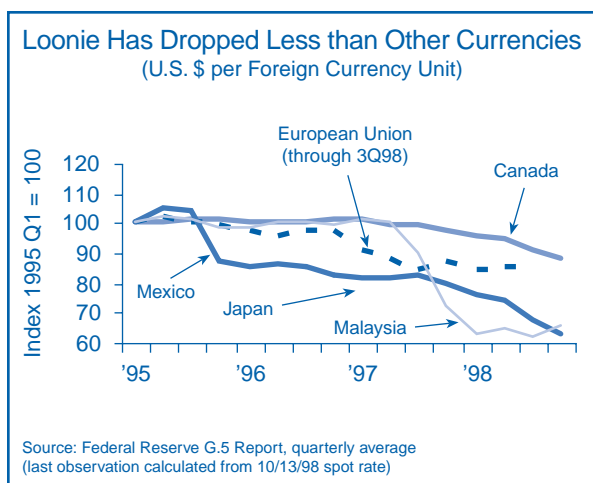
Note that some of Canada's apparent economic weakness in 1998 was due to several large strikes that curbed economic activity. Also, strong U.S. demand for Canadian exports and an increasing number of U.S. tourists should help offset expected weakness in Canada's economy in late 1998 and early 1999. After the Federal Reserve cut the federal funds rate by 25 basis points in late September and by another one-quarter percent in October, Canada followed with similar cuts of its own. Easier credit may further offset slow Canadian economic growth in 1999.

### Low Canadian and Asian Tourism Countered by Strong European and Domestic Volume

This summer there was some indication that the weaker Loonie had resulted in a drop in Canadian tourism in New England, and the volume of Asian tourists was also clearly lower. This weakness was more than offset, however, by strong European and domestic tourist volume. Anecdotal reports from areas such as **Old Orchard Beach, Maine** (dubbed the Canadian Riviera by some), indicated a marked decline in the number of Canadian tourists, as well as shorter stays and tighter wallets among those who did visit. However, Maine's overall summer season was expected to set some new records.

**Boston** tourism officials also reported a reduction in the number of Asian and Canadian tourists but indicated that overall, the season was strong. More remote areas, such as the Berkshires, reported an average year for summer tourism. **Vermont** tourism officials were predicting only 2 to 3 percent growth in the state's visitor count for the whole summer season, primarily because Canadian tourism had fallen off. This is not a recent trend. Since the early 1990s, the Loonie has been slowly losing value against the U.S. dollar (it stabilized between 1994 and 1997). As a result, the Canadian share of Vermont's tourist revenues has dropped from about 15 percent in the early 1990s to about 8 percent today.

CHART 3



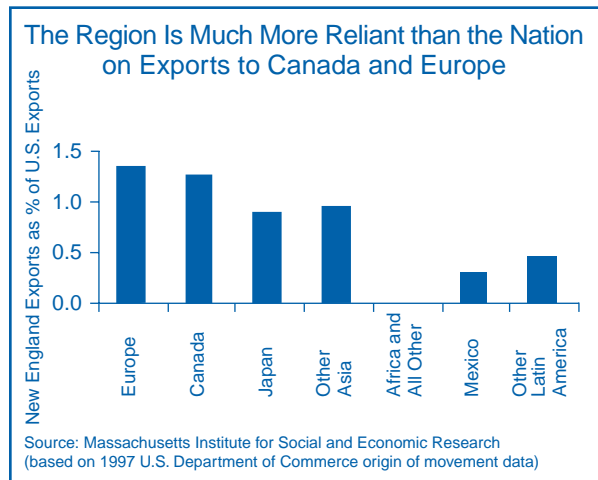
### A Weakened Canadian Economy Could Aggravate the Asian Effect on Region's Exporters

New England has significant merchandise export exposure to Canada, which is the largest single-country destination for its products. Chart 4 provides a breakdown of the shares of exports by destination for the Region's merchandise during 1997 relative to the national levels. This "location quotient" of merchandise exports highlights how Europe and Canada are more important to the Region's exporters than are the Asian nations, relative to the United States as a whole.

In 1997 the combined share of exports to Europe and Canada was 60 percent for the Region, versus 46 percent for the nation (Canada took 28 percent of the Region's exports, versus 22 percent of the nation's). Thus, weakness in exports to Europe and Canada would have a larger effect on the New England economy than on the nation as a whole. In 1997, exposure to Japan and other Asian countries was 32 percent of exports for the Region, versus 34 percent for the nation overall. The *Alliance for the Commonwealth* reported that Massachusetts' exports to Canada (its largest trading partner) dropped between the last quarter of 1997 and the first quarter of 1998.

If Canada's currency weakens further or if its economy falls into recession, New England companies that produce goods competing with Canadian imports could be at risk from lower-priced imports. The problem would likely be greatest for forest products firms that supply local mills or builders. Those consumers might substitute cheaper Canadian saw logs or lumber for those produced in the northern forests of Maine, **New Hampshire**, and Vermont. The Region's paper producers and some companies in agribusiness may also see some increased pricing pressure. Local paper producers sur-

CHART 4



veyed in the Federal Reserve's August *Beige Book* indicated that they were witnessing weak prices linked to increased domestic capacity and more low-cost imports.

Smaller community banks and large institutions with loan generation operations in northern New England may see forest products, agribusiness, and small retail/tourism clients experience some trouble in servicing their loans should the weakness in Canada's currency and its economy persist. Negative effects on earnings will be mitigated to the extent that these institutions have adequate geographic and product diversification. Through June 1998, banks in the northern counties of Maine, New Hampshire, and Vermont, which are the areas most likely affected by the Canadian economy, continued to show favorable trends.

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