
◆ Regional Outlook ◆

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In Focus This Quarter

◆ *The Asian Economic Crisis: Implications for the U.S. Economy*—The economic crisis in Asia is now more than one year old, yet its consequences are still reverberating throughout the global economy. There are growing indications that some sectors of the U.S. economy are beginning to experience slower growth directly attributable to problems in Asia. Consequently, lenders should be cognizant of their customers' exposure to global markets. Lending and strategic decisions predicated on an assumption of continued robust economic growth should be carefully scrutinized. *See page 3.*

By Paul C. Bishop

◆ *CLOs Lure Another Major Bank Asset off the Balance Sheet*—Securitization of corporate loans and bonds is in full swing, with 1997 issuance exceeding that of securities backed by credit card loans. Collateralized loan obligations (CLOs) and collateralized bond obligations, securities with deal- and issuer-specific risks, are potential bank investments that may grow in popularity if a current proposal to lower the risk weights for AAA-rated securities is enacted. Banks with an ample supply of low-margin commercial loans are expected to issue more CLOs to an increasingly demanding secondary commercial loan market. An institution's CLO strategy may have implications that should be considered when evaluating its capital adequacy trends. *See page 8.*

By Kathy Kalsner and Allen Puwalski

◆ *The Payment System: Emerging Issues*—The payment system is the heart of the U.S. economic infrastructure, moving value at the rate of 90 times the U.S. gross domestic product each year. The banking industry, although historically central to this movement, now faces a tangle of new technologies, new exposures, and new competitors that challenges its hold on the payments business. Its regulators face a different dilemma—that of how much intervention, if any, these changes warrant and how best to prevent the systemic exposures that increasingly large and rapid flows of money can create. Together, the issues they face frame a payment system that is fast becoming a technical and political contest. *See page 14.*

By Gary Ternullo

Regular Features

◆ *Regional Economy*—Several developments at midyear threatened the Chicago Region's economic vigor...growth in household and business incomes may come under downward pressure because of an inventory correction...lenders in communities where General Motors and its suppliers are a significant presence faced dampened activity...farm incomes could flatten or even weaken this year. *See page 20.*

By Chicago Region Staff

◆ *Regional Banking*—Most insured institutions in the Chicago Region continue to maintain strong capital and earnings positions...however, adverse weather, low commodity prices, and reduced government payments have raised interest in the financial trends of banks dependent on the farm sector...managers of those banks may want to review risk-control systems associated with the above trends, as well as recent changes in loan structures, funding sources, and loan loss reserves. *See page 24.*

By Chicago Region Staff

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The Asian Economic Crisis: Implications for the U.S. Economy

- **The impact of the Asian economic crisis on the U.S. economy has been increasingly evident, with some sectors experiencing slower growth as conditions in Asia continue to deteriorate.**
- **U.S. exports to Asia have decreased in recent months owing to falling demand for commodities, manufactured goods, and agricultural products.**
- **Slower U.S. growth resulting from reduced export sales and lower corporate profits could affect institutions throughout the nation.**
- **Reduced Export Competitiveness:** Most of the Asian economies had effectively pegged their currencies to the U.S. dollar. Between mid-1995 and early 1997, the U.S. dollar increased in value by more than 42 percent against the Japanese yen and by 23 percent against the German mark. This increase significantly worsened the international competitiveness of many Asian firms relative to Japanese or European competitors in export markets, since the value of their currencies and the price of their exports rose along with the U.S. dollar. By late 1995, export growth among the Southeast Asia economies was slowing, and by mid-1996 it was near zero.
- **Excess Production Capacity:** Although Asian savings rates were among the highest in the world, domestic saving was not sufficient to fund the desired levels of investment in factories, roads, housing, and telecommunications. The resulting inflow of foreign capital funded rapid capacity expansion in key sectors such as autos, chemicals, and microchips. For example, capital inflows to Thailand totaled \$1.9 billion in 1980 but rose to \$15.2 billion by 1996. The increase in production capacity put downward pressure on prices and reduced earnings growth in key export sectors.³
- **Rapid Asset Price Appreciation:** Real estate, land, and share prices on the region's stock markets soared during the 1980s and early 1990s. In Indonesia, for example, the Jakarta Composite stock index

The economic crisis in Asia is now more than one year old, yet the consequences of the unprecedented slide in currency values are still reverberating throughout the global economy. There are growing indications that some sectors of the U.S. economy are beginning to experience slower growth directly attributable to problems in the Asian economies. It is difficult to assess how significant and long-lasting the effects of the crisis will be, but it is clear that earlier views that the crisis would pass quickly and be followed by renewed growth were too optimistic. The consensus among economists and analysts now is that the recovery will be measured in years, not months.

Causes of the Crisis

Most economists agree that the Asian economies¹ are in the midst of a steep and severe recession. For example, Indonesia's gross domestic product fell by more than 12 percent in the first half of 1998, a decline second only to the drop in economic activity in the Soviet Union following its collapse in the early 1990s. While Indonesia may be the most startling example of economic deterioration in Asia, the other Asian nations also have experienced weakened stock markets, falling real estate values, rising corporate bankruptcies, and growing problem loan portfolios among financial institutions. It is generally agreed (with the benefit of hindsight) that the conditions that precipitated these events included the following²:

¹ Unless otherwise noted, "Asia" refers to the economies of China, Hong Kong, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand.

² A comprehensive survey of recent events and links to other information sources is available at the *Asia Crisis Home Page*, www.stern.nyu.edu/~nrubini/asia/AsiaHomepage.html.

³ A case in point is the growth of the auto industry. During the past several years, Korea invested heavily in new auto plants to satisfy both domestic and export demand. By 1999, Korean capacity is expected to reach 4.66 million light vehicles annually—2 million more than domestic demand. In Japan, excess capacity of 2.8 million vehicles is expected through 2002. Worldwide excess capacity in light vehicles is expected to reach more than 20 million units by 2002—more than the total 1997 production of General Motors, Ford, and Chrysler combined (*Wall Street Journal*, March 2, 1998). The result has been downward pressure on prices of domestically produced autos—down by 1.9 percent on the basis of the first-quarter 1998 producer price index—and imports, which have experienced price increases of less than 1 percent since mid-1996.

increased by nearly 53 percent in the two-year period ending in the first quarter of 1997.

- **Deteriorating Credit Quality:** Slower export growth and eroding competitiveness hampered Asian firms' ability to repay debt incurred to finance the growing levels of investment. Some Korean conglomerates were burdened with a debt load equal to 300 to 400 percent of equity. As much as two-thirds of this debt was short-term, with a maturity of less than 12 months. Additionally, the debt denominated in foreign currencies, such as the U.S. dollar, ballooned as local currency values dropped. With some firms struggling to repay mounting debt, banks began to experience a further deterioration in credit quality.

Some of the uncertainty about the strength and speed of the recovery in Asia is attributable to concerns about the faltering Japanese economy. As the second largest economy in the world and the engine of growth in the region, Japan must have a healthy economy if sustainable growth is to occur in the rest of Asia. With Japan currently in a deep recession and the outlook for its economy clouded by the halting pace of financial reform efforts, there is considerable uncertainty about how quickly economic and financial weaknesses throughout the rest of Asia can be repaired.

Impact on the U.S. Economy

The Asian financial crisis could affect the U.S. economy through several avenues. Some firms and industries



may be directly exposed, especially if they have operations in Asia. Banks may be exposed through changes in the financial condition of Asian borrowers. Other firms may be less directly exposed to economic conditions but will be affected by changes in relative prices and trade flows between the United States and Asia. The drop in Asian purchases of U.S. exports has hit agricultural products, commodities, and manufactured goods. As some recent corporate earnings announcements have shown, the crisis has been associated with profit growth that has failed to meet the market's expectations.

Banking

The U.S. banking industry has a smaller direct lending exposure to the Asian economies than either European or Japanese banks. As shown in Table 1, U.S. banks had outstanding loans of \$22 billion at the end of 1997, which accounted for 8.5 percent of all international lending to Indonesia, Malaysia, the Philippines, South Korea, and Thailand. To the extent that exposures exist, however, large banks and not smaller regional or community banks account for most of the lending. While the overall direct lending exposure of the U.S. banking industry may be relatively small, the indirect exposure resulting from changing economic conditions in the United States as a result of the crisis could potentially affect small and large institutions in all areas of the country.

Agriculture

Key to understanding the impact on agriculture is the fact that in world markets, agricultural commodities are priced and traded in terms of U.S. dollars. The steep decline in value of Asia's currencies means that the price of imported agricultural commodities has rapidly risen. Over a longer period, higher import prices tend to stimulate production in the importing countries that can displace demand for imports. Thailand, for example, is positioned to increase production of poultry and sugar. Other world producers, such as Australia, whose currency also has fallen in value, are now more competitive suppliers of some agricultural products to the Asian market than the United States.

On the basis of analysis performed by the U.S. Department of Agriculture's (USDA's) Economic Research Services,⁴ U.S. exports of red meat and poultry are expected to drop by 5 to 6 percent in fiscal 1998 and 1999 as a result of the Asian crisis. Exports of grains are projected to fall by at least 2 percent in fiscal 1999 as other world producers increase production in response to changing relative prices among major grain exporters. Overall, USDA expects agricultural exports to fall by 3 to 6 percent in fiscal 1998 and 1999, compared with the level of exports had the Asian crisis not occurred.

Commodities

Asian countries have become increasingly important commodity consumers in recent years. As a result, com-

⁴ "World Agriculture and Trade," *Agricultural Outlook*, pp. 10-11.

TABLE 1

| INTERNATIONAL CLAIMS BY NATIONALITY OF REPORTING BANK END DECEMBER 1997 | | | | | | | | | |
|--|----------------|---------------|------------|---------------|-------------|---------------|-------------|---------------|-------------|
| TOTAL INTERNATIONAL CLAIMS (MILLION U.S. \$) | | U.S. | | JAPAN | | EUROPE* | | OTHER | |
| | | CLAIMS | PERCENT | CLAIMS | PERCENT | CLAIMS | PERCENT | CLAIMS | PERCENT |
| INDONESIA | 58,388 | 4,898 | 8.4 | 22,018 | 37.7 | 15,044 | 25.8 | 16,428 | 28.1 |
| MALAYSIA | 27,528 | 1,786 | 6.5 | 8,551 | 31.1 | 12,997 | 47.2 | 4,194 | 15.2 |
| PHILIPPINES | 19,732 | 3,224 | 16.3 | 2,624 | 13.3 | 9,317 | 47.2 | 4,567 | 23.1 |
| SOUTH KOREA | 94,180 | 9,533 | 10.1 | 20,278 | 21.5 | 29,614 | 31.4 | 34,755 | 36.9 |
| THAILAND | 58,835 | 2,533 | 4.3 | 33,180 | 56.4 | 14,782 | 25.1 | 8,340 | 14.2 |
| TOTAL | 258,663 | 21,974 | 8.5 | 86,651 | 33.5 | 81,754 | 31.6 | 68,284 | 26.4 |

* INCLUDES FRANCE, GERMANY, NETHERLANDS, AND UNITED KINGDOM
SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS

modity markets have been affected by falling demand for basic materials and fuels in Asia. The abrupt halt of construction activity in the region has reduced Asian imports of metals and metal products. Consequently, world copper and nickel prices fell more than 36 percent during the year ending June 1998. Asian developing countries also had stepped up their demand for petroleum products, accounting for two-thirds of the increase in world petroleum consumption between 1992 and 1996. As economic activity in Asia slowed, oil demand softened and world inventories expanded, causing prices to tumble from \$20 per barrel in July 1997 to less than \$14 per barrel in June 1998. To the benefit of U.S. consumers, the drop in oil prices has reduced the prices of gasoline and other refined petroleum products, but it has cut into profits of oil producers. While there are few indications of widespread financial problems in the industry, smaller and less geographically diversified producers may be exposed to adverse price and inventory changes.

Manufacturing

Asia accounts for a large and growing share of U.S. trade in manufactured goods. Between 1990 and 1996, U.S. exports of manufactured goods to Asia increased from \$75 billion to more than \$140 billion, accounting for nearly one-third of the increase in total U.S. exports of manufactured goods. For the U.S. economy as a whole, machinery, food products, and chemicals are the most exposed to a drop in Asia's demand for U.S. exports. Together, these industries account for nearly 70 percent of U.S. exports to Asia.

Between 1990 and 1996, U.S. imports of manufactured goods from Asia rose from \$176 billion to more than \$285 billion. Increased imports from China accounted

for about one-third of the gain. U.S. imports from Asia are dominated by machinery and manufactured goods, including electronics and semiconductors, which together account for 93 percent of imports.

Asia's demand for U.S. exports will continue to weaken following the dramatic increase in import prices resulting from the drop in currency values. The latest trade data show that the dollar volume of U.S. goods exports to Asia (including both manufactured goods and other commodities) fell by 22.5 percent in May 1998 compared with one year earlier (Chart 1).

Changes in the volume of exports at the national level do not adequately describe the variation in the export exposure of different regions of the country. Chart 2 (next page) shows the percentage of state-level exports

CHART 1

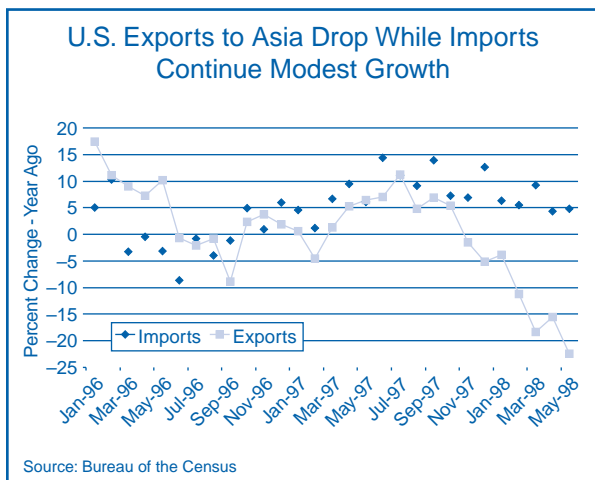
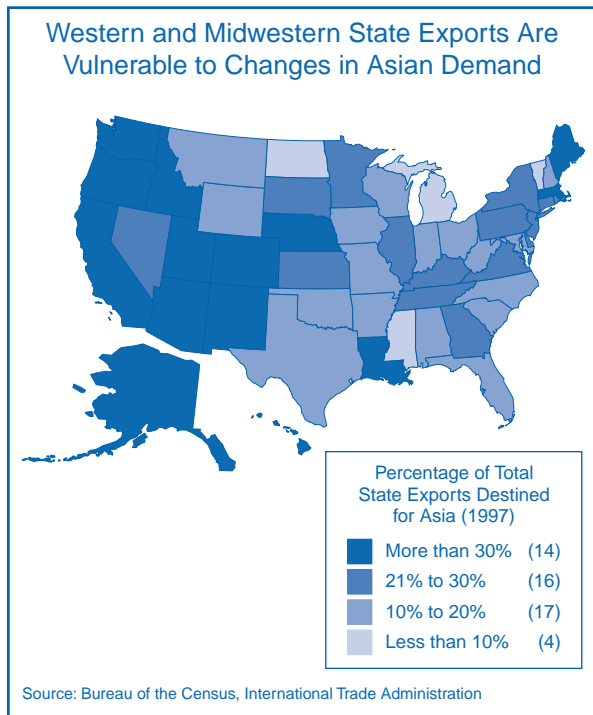


CHART 2



that are destined for Asia.⁵ Clearly, Western states are most exposed to changes in the demand for U.S. exports, especially electronics, transportation equipment, and industrial machinery. A significant share of exports from the Midwest also is destined for Asia, including chemicals and machinery such as construction equipment.⁶

In the initial stages of the crisis, the consensus view suggested that the United States would be overwhelmed by cheap imports from Asia, as Asian countries exported their way to economic recovery. Although there has been an increase in U.S. imports from Asia, the growth has been well below expectations. In May 1998, goods imports were up by just 4.8 percent over the previous year. The reason that U.S. imports of Asian goods have not been greater is due in part to the severity of the economic downturn and the weakness of Asia's financial institutions. Many Asian manufacturers are dependent

⁵ The state-level export data are from the Export Locator series published by the Bureau of the Census. These data tabulate the value of exports as determined by the location of the exporter, which may differ from the location of the producer. Although these data are an imperfect measure of state-level export performance, they are still of value in assessing regional exposures and remain the most complete data available.

⁶ A state-by-state analysis has been prepared by the U.S. Treasury and the U.S. Department of Commerce.

on components imported from neighboring countries or purchased on world markets. With the drop in currency values, all imported goods, including finished goods and intermediate goods that are used in the manufacturing sector, have become more costly. At the same time, Asia's weak financial systems have come under increasing pressure as the economic slump deepens. Many banks cannot, or will not, lend. Consequently, Asian firms cannot secure the capital to acquire imported inputs or to finance the sale of exports abroad. As the "credit crunch" abates, imports from Asia should rebound, placing greater pressure on U.S. manufacturers.

Corporate Profits

Profits of U.S. producers also will be affected by falling prices for import-competing goods and plummeting Asian demand for some U.S. exports. Although U.S. producers of import-competing goods will be under increasing competitive pressure, firms that use imported components from Asia will benefit from an effective reduction in costs. U.S. exporters may see disappointing Asian market profits offset by continuing strong sales in the U.S. and European markets. For these reasons, the impact of the crisis on corporate profits must be viewed in the context of gains and losses caused by changing relative prices of a firm's products and inputs.

A number of recent earnings announcements have failed to meet analysts' expectations. According to IBES International,⁷ the crisis has contributed to a reduction of profit growth, although most of the slowdown is attributable to both falling prices and weak demand for semiconductors and oil. Operating profits of all companies tracked in the Standard & Poor's 500 stock index increased by 4.4 percent in the first quarter of 1998, the smallest increase since 1991. Excluding the energy and technology sectors, profits of the S&P 500 firms increased by 8.6 percent in the first quarter. On the basis of these results, the impact of the crisis on corporate profits appears to be highly concentrated among firms in a few industries.

Summary and Implications

The consequences of the Asian economic crisis continue to unfold. The slowdown in growth in most Asian economies has already reduced U.S. export shipments and put downward pressure on prices of commodities and agricultural products. How long this trend will con-

⁷ As quoted in the *Wall Street Journal*, June 22, 1998, p. C1.

tinue is uncertain, but most analysts have dismissed the chances of a speedy recovery in Asia. Although most economists are not anticipating a recession in the United States in the foreseeable future, the indirect impact of the Asian crisis will be felt to some extent across most regions of the country.

Lenders should be cognizant of their customers' exposure to a continued drop in demand for exports or to further deterioration in the pricing environment. More generally, slower U.S. growth could affect even those



borrowers that have little or no direct exposure to export markets. What is clear for insured institutions is that at this stage of the economic expansion and with a number of uncertainties about the global economic outlook, lending and strategic decisions predicated on an assumption of

continued robust economic growth should be carefully scrutinized.

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Paul C. Bishop, Economist

TABLE 2

| CHICAGO REGION: MERCHANDISE EXPORTS TO ASIA—1997 | | | | |
|--|-----------------------------|------------------------------|--|----------------------------------|
| INCLUDES CHINA, HONG KONG, INDONESIA, JAPAN, MALAYSIA, THE PHILIPPINES, SINGAPORE, SOUTH KOREA, TAIWAN, AND THAILAND | | | | |
| INDUSTRY SECTOR | VOLUME (\$ MILLIONS) | EXPORT GROWTH 1993-97 | PERCENT OF EXPORTS TO ASIA BY INDUSTRY* | EXPORT EXPOSURE TO ASIA** |
| TOTAL EXPORTS TO ASIA | 18,619.1 | 64% | 100% | 15% |
| TOP FIVE EXPORT INDUSTRIES | | | | |
| INDUSTRIAL MACHINERY & COMPUTERS | 3,844.7 | 78% | 21% | 15% |
| ELECTRIC & ELECTRONIC EQUIPMENT | 3,526.2 | 84% | 19% | 24% |
| CHEMICAL PRODUCTS | 2,748.8 | 35% | 15% | 23% |
| TRANSPORTATION EQUIPMENT | 1,848.5 | 41% | 10% | 6% |
| SCIENTIFIC & MEASURING INSTRUMENTS | 1,272.2 | 54% | 7% | 23% |
| TOTAL OF TOP FIVE EXPORT INDUSTRIES | 13,240.3 | 62% | 71% | 14% |

* PERCENT OF REGION'S TOTAL EXPORTS TO ASIA FROM EACH OF THE TOP FIVE EXPORT INDUSTRIES.
 ** PERCENT OF REGION'S TOTAL WORLD EXPORTS FOR EACH INDUSTRY DESTINED FOR ASIA.
 SOURCE: INTERNATIONAL TRADE ADMINISTRATION

CLOs Lure Another Major Bank Asset off the Balance Sheet

- Securitization of corporate loans and bonds is in full swing, with 1997 issuance exceeding that of securities backed by credit card loans.
- Collateralized loan obligation (CLO) and collateralized bond obligation (CBO) issuance has grown dramatically since 1996. Both CLOs and CBOs are potential bank investments that may grow in popularity if a current proposal to lower the risk weights for AAA-rated securities is enacted.
- These bonds may offer a higher yield than other AAA-rated securities, but they also may carry both deal- and issuer-specific risks that warrant closer scrutiny.
- Banks with an ample supply of low-margin commercial loans are expected to issue more CLOs to an increasingly demanding secondary commercial loan market.
- Securitizing investment-grade commercial loans has implications for capital adequacy.

CBOs and CLOs are fixed-income securities that share many similarities with other asset-backed securities. In a CLO or CBO, commercial loans or bonds are pooled and securitized, and participation certificates in the underlying assets are sold to investors. The first CLO and CBO transactions occurred in the late 1980s, but issuance was slow until last year. During 1997, the estimated volume of corporate bonds and commercial loans securitized was \$54 billion, more than double the amount securitized in 1996. In fact, the combined issuance of CBOs and CLOs in 1997 was more than the amount of credit card loans securitized during the year. The amount of securitized commercial loans and corporate bonds is expected to continue to grow this year, with an increasing number of deals backed by commercial loans¹ (see Chart 1).

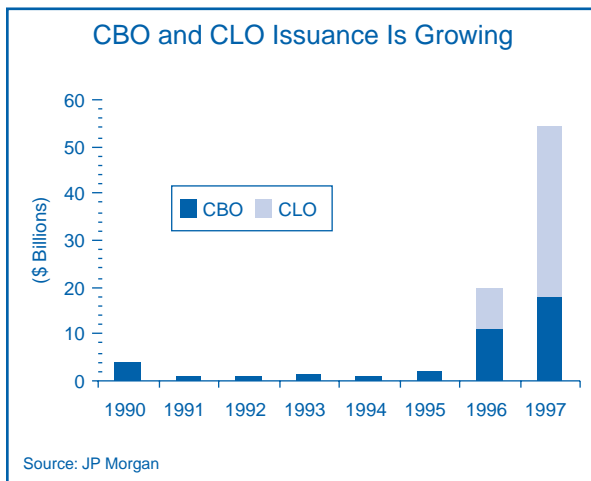
¹ CBOs/CLOs: An Expanding Securitization Product, p. 1, JP Morgan, September 1997.

CBOs and CLOs: A Natural Development in the Asset-Backed Securities (ABS) Market

The growth of the CLO market can be explained by several supply and demand factors. On the demand side, strong investor appetite for ABS has produced tremendous growth in the securitization of consumer loan segments such as credit card, auto, and home equity loans. The increasing comfort level of the capital markets with these asset classes and the various structures used to securitize them has facilitated the ABS market's expansion into nonconsumer loans, including corporate debt obligations and bank commercial loans. CBO and CLO structures represent a natural progression from the securitization of a pool of consumer loans to the securitization of a diversified package of corporate bonds or bank loans.

Increased standardization of terms among commercial lenders and more information flow on returns, defaults, and recoveries also have made commercial loans and corporate debt more desirable to institutional investors and an asset class viable for securitization. In addition, CLOs provide a way for investors, including banks, to own a credit-enhanced interest in a diversified pool of loans without directly owning the individual loans. Investors are increasingly considering collateralized bond and loan products as higher yielding alternatives to other ABS.

CHART 1



Foreign and, to a lesser extent, domestic banks have been large purchasers of CLOs and CBOs. Bank investment in CLOs and CBOs primarily has been in the most senior, highest investment-rated tranches. Together, foreign and domestic banks are estimated to have purchased almost one-half of the highest rated classes of CLO and CBO securities issued in 1997. Insurance companies dominated the purchase of the middle or mezzanine class of CLOs and CBOs.²

Last year the Federal Financial Institutions Examination Council proposed lowering the risk weighting for AAA-rated ABS from 100 percent to 20 percent. Bank investment in AAA-rated ABS products, including CLOs and CBOs, could increase substantially if the proposal is approved.

Lower Capital Requirements, Higher Return Ratios Attract Banks to CLO Market

On the supply side, issuers of CLOs backed by *investment-grade* loans are motivated by regulatory capital treatment, return on capital, and relationship management. While the CLOs originated in the late 1980s were designed to purge the lender's balance sheet of lower quality commercial loans, the recent bank-issued CLOs have been secured by higher credit quality, lower margin commercial and industrial loans.

A bank that is capital constrained may view the CLO structure as an alternative to issuing additional equity. But more often, banks are motivated to securitize investment-grade commercial loans because by doing so they effectively subject themselves to the market's capital requirements for such loans instead of their regulator's. Tight competition has compressed the margin that banks earn on investment-grade loans to the point that more institutions are considering investment-grade lending to be an inefficient use of capital. As margins have declined, the CLO market has helped relationship managers rationalize lower pricing from the perspective of return on capital. *Since investment-grade and non-*

investment-grade-performing commercial loans have the same risk weightings for regulatory capital purposes, removing the higher quality, lower yielding assets from the balance sheet tends to leave existing bank capital supporting higher return activities.³ In this way, a bank can improve certain profitability measures, but possibly with a higher risk profile.

Table 1 (next page) illustrates the effects of a CLO on a bank's capital and return ratios. In order to compare the on- and off-balance sheet transactions, the costs of the CLO and the associated reserve requirement are analogized to the on-balance sheet funding costs and capital requirement if the assets remained on the balance sheet. The assumptions reflect the spreads and reserve requirement of a typical transaction. While the execution of the CLO costs more than the on-balance sheet financing of the loans, the risk-adjusted return on capital (RAROC) is greater with the CLO. The reserve requirement is minimized by the tiering of tranches in the securitization, which provides credit enhancement to the senior classes. The reserve fund, if retained by the issuing bank, represents recourse to the bank from the sold assets and requires capital at 100 percent under "low-level" recourse.

CLOs also may be used to facilitate corporate borrowing relationships. For example, banks that want to maintain relationships with corporate borrowers but are restrained by concentration limitations, either by borrower or by industry, may use CLOs to alleviate concentrations without disrupting borrower relationships.

Large commercial banks with significant holdings of investment-quality commercial loans are likely candidates to issue CLOs. CLO issuance by investment banks could grow as these institutions secure a stronger foothold in the commercial loan market. In 1997, foreign banks were the primary issuers of CLOs, but more U.S. banks are expected to issue CLOs in the future. Japanese and Asian banks may increase their CLO activity as they come under pressure to improve capital ratios and remove distressed loans from their balance sheets.

² *CBOs & CLOs—An Attractive Investment Class*, p. 5, Merrill Lynch & Co., Inc., December 1997.

³ Pursuant to the Basle Accord, commercial loans generally receive a 100 percent risk weighting regardless of the credit rating of the loan. Proponents of CLOs have argued that banks can improve their risk-adjusted return on capital by removing the higher quality, lower earning commercial loans from the balance sheet.

TABLE 1

| CLOS CAN FACILITATE A HIGHER RAROC ON INVESTMENT-GRADE ASSETS | |
|---|---|
| ASSUMPTIONS: | |
| AMOUNT OF LOANS IN CLO: | \$1 BILLION |
| LOAN PORTFOLIO YIELD: | LIBOR + 50 BPTS |
| BANK FUNDING COSTS: | LIBOR - 10 BPTS |
| CLO FUNDING COSTS: | LIBOR + 24 BPTS |
| BANK RETAINS 1% RESERVE FUND: | \$10 MILLION |
| BEFORE CLO | |
| YIELD LESS FUNDING COST | (L+50) LESS (L-10) = 60 BASIS POINTS |
| NET SPREAD EARNED | .006 × \$1 BILLION = \$6 MILLION |
| RISK-BASED CAPITAL REQUIREMENT | (8% ON \$1 BILLION) = \$80 MILLION |
| RAROC | \$6 MILLION/\$80 MILLION = <u>7.5%</u> |
| AFTER CLO | |
| YIELD LESS FUNDING COST | (L+50) LESS (L+24) = 26 BASIS POINTS |
| NET SPREAD EARNED | .0026 × \$1 BILLION = \$2.6 MILLION |
| RISK-BASED CAPITAL REQUIREMENT | (100% OF RESERVE FUND) = \$10 MILLION |
| RAROC | \$2.6 MILLION/\$10 MILLION = <u>26%</u> |
| SOURCE: BEAR, STEARNS & CO. INC. | |

Arbitrage Opportunities Motivate Most Securitization of Subinvestment-Grade Debt

Issuance of CLOs backed by *subinvestment*-grade loans and most CBOs, which commonly are backed by a mixture of bonds with a subinvestment-grade weighted average, typically is motivated by the potential to capitalize on wide spreads between investment and subinvestment-grade debt. The securities backed by subinvestment-grade collateral, often referred to as “arbitrage” CLOs and CBOs, contain higher yielding, riskier securities such as high-yield debt, distressed bonds, highly leveraged loans, and emerging market debt. By assembling a diversified pool of higher yielding investments, asset managers can limit aggregate event risk and create a security with a lower required yield than the underlying collateral. Securitizations can include a combination of loans and bonds and are sometimes referred to as collateralized debt obligations or CDOs.

A Closer Look at CLO Structures

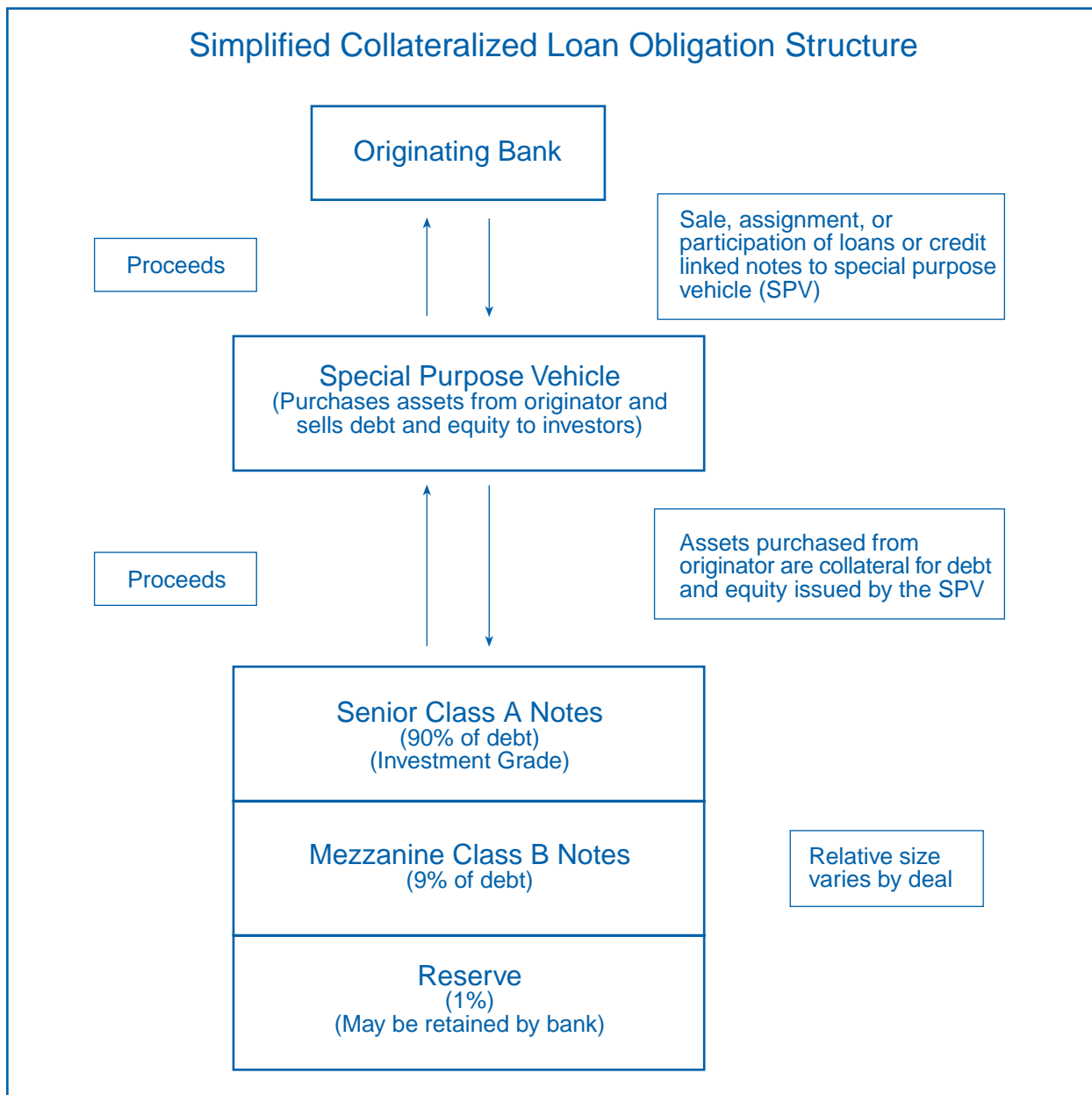
While the structures of CLOs and CBOs are similar, banks’ involvement as issuers of CLOs, and the forces driving this issuance, elevate the importance of considering CLO structures. Chart 2 presents the basic structure of a CLO. Although specifics may vary, most CLOs

use a stand-alone special purpose vehicle (SPV) or trust to purchase a diversified pool of assets from a bank originator or issuer. The purchase of the assets by the SPV is funded through the sale of debt securities to investors. The structure of the SPV may include one or more tranches of debt that are secured by the pool of assets owned by the SPV. The classes of debt are distinguished by their priority of claims on the cash flow from the collateral, with the most subordinated pieces functioning as an equity investment in the pool.

The senior tranche is usually the largest, has the greatest amount of credit protection, and earns the highest credit ratings in the CLO structure. *The rating of the senior class typically is higher than the average rating of the underlying pool of assets due to the tiering of claims among the debt classes and credit enhancement in the CLO.* The junior tranches of debt may be below investment grade or not rated. The reserve or “equity” portion may be retained by the issuing entity as a form of credit enhancement or sold to third-party investors who want a potentially higher return investment.

CLO collateral has included both funded and unfunded loan commitments, loan participations, and different types of credit default swaps. Loan assignments also may be transferred through a CLO but are less commonly included because of bank issuers’ desire to main-

CHART 2



tain borrower relationships. The issuer may transfer the actual loan, the cash flow from the loan, or the default risk to investors.

CLOs typically rely on an asset manager or servicer to “manage” or protect the investors’ interest in the collateral. The investment style or role of the asset manager may change depending on the purpose of the CLO. Securitizations that use an asset manager to actively manage the performance and market value of the collateral are referred to as “market arbitrage” or “market value” transactions. In these deals, the asset

manager can trade assets into and out of the securitized pool in order to maximize the market value of the securitized portfolio. In contrast, most bank-issued CLOs are designed as “cash flow” transactions, in which the asset manager’s role is more as a servicer than as a portfolio trader. These structures rely primarily on the ability of the collateral to make stable cash flow payments over a predetermined period and emphasize the credit quality of the collateral and the predictability of interest and principal payments rather than liquidity and market performance, as in market value transactions.

An Introduction to Delinked and Linked CLO Structures

The variables in structuring a CLO are many. The relative size of the senior and subordinated tranches, the form of credit enhancement, the ability of the asset manager or servicer to adjust the asset pool, and the method and degree to which ownership of the underlying loans is conveyed to investors vary among CLOs. Despite the variations, two basic structures have emerged: “delinked” structures and “linked” structures. The primary difference between these two is the extent to which the SPV “owns” the securitized assets. An issuer may consider many factors when determining the type of structure to use, including the ability or desire of the issuer to transfer the loans without notifying the borrower, the credit quality of the loans, the investment rating of the bank issuer, and the desired capital treatment of the securitized loan.

In a delinked structure, the collateral is transferred from the issuer to the SPV. Delinked structures are generally treated as “true sales” for accounting purposes, and the loans in the CLO are removed from the issuer’s balance sheet. Delinked CLOs are structured to insulate the investor from the credit quality problems or insolvency of the issuer. Ratings on delinked CLOs are predicated on the projected performance of the collateral and the credit enhancement structure rather than the credit quality of the issuer. Some delinked CLOs are similar to structures used in credit card securitizations that capitalize on the flexibility of a revolving master trust. The master trust structure is advantageous because it allows for the securitization of different types of assets, such as fixed or floating rate or revolving or term loans.

In linked transactions, also known as credit linked notes, the issuer retains ownership of the underlying collateral, and the *cash flow generated by the collateral pool* is conveyed or sold to the SPV. All or part of the credit risk from the underlying assets is transferred to the CLO investor using credit derivatives. As in delinked CLO structures, credit protection is provided through the layering or tranching of the debt sold and other credit enhancements.

Investors in linked CLOs are not completely insulated from the credit risk of the issuer. Because the issuer retains ownership of the underlying loans, a default or bankruptcy by the issuer could affect the transmission of cash flow to the CLO investors. As a result, investors

in linked CLOs bear both the credit risk of the securitized loan pool and, to some degree, the risk that the issuer may become insolvent. *Because of this dual exposure, ratings on linked structures are typically capped by the credit rating of the issuer.*

The accounting and regulatory capital treatments of delinked and linked CLOs also differ. Linked structures generally do not qualify for sale treatment under generally accepted accounting principles because the assets remain under the control of the issuer. Issuers of linked CLOs may be granted some regulatory capital relief under the Basle Accord if the cash received from the securitization is assigned as collateral for the underlying loans. The Basle Accord, which governs capital adequacy requirements for Bank for International Settlements member countries, reduces the risk weighting on commercial loans that are secured by cash or certain types of risk-free marketable securities such as Treasury bills.⁴ While linked CLOs may provide some form of capital incentive for foreign banks under the Basle Accord, linked structures offer little relief to U.S. banks because U.S. banks must maintain minimum leverage capital ratios in addition to risk-based capital ratios. Since the securitized loans count as assets of the bank issuer in a linked structure, the leverage ratio (roughly, book equity to book assets) is not reduced. Consequently, the linked CLO structure has been more popular among foreign banks.



The Role of Investment Rating Agencies

Although the approach may vary among rating agencies, the criteria used to determine the investment rating for CLOs are similar. Rating agencies evaluate the ability of the securitization vehicle to make interest and principal payments to holders of the debt. This analysis requires an evaluation of the credit quality of the underlying collateral pool, including the projected cash flow

⁴ Under the Basle Accord and the U.S. risk-based capital guidelines, assets collateralized by cash or Treasury securities generally receive a preferential risk-weighting that may range from 0 to 20 percent. For background information regarding the risk weightings for collateralized transactions applicable to federally regulated institutions, see Federal Deposit Insurance Corporation Financial Institution Letter number 64-96 dated August 22, 1996.

generated by the pool, the credit enhancement, and any additional protection provided to the investors based on the structure of the securitization. The rating agencies set limits on the amount of industry and borrower concentration in a pool and statistically evaluate the effect of diversification among loans when estimating potential defaults and losses from the securitized assets over the life of the transaction. If the underlying collateral is not already rated—most commercial loans are not—the rating agency will grade the underlying loans and assign a rating to the security on the basis of the credit quality of the loans and the underwriting criteria used by the lender. Estimates of default probabilities, timing of default, and recoveries in the event of default are assigned to the loans and vary by collateral type and credit grade. These estimates are generally based on historical default studies authored by the various rating agencies.

Implications for Insured Institutions

The advent of CLOs poses new opportunities and risks to banks. The ability to transfer all or part of a commercial loan's credit risk to investors may have several consequences. When issuers of CLOs securitize their

highest grade assets, they are effectively lowering the weighted average credit quality of their retained assets. An institution's loan loss reserving policies and capital adequacy should take into account the implications of its CLO strategy.

While the issuance of CLOs may be confined to larger banks that have considerable commercial loan portfolios, smaller banks or other types of institutions that desire a greater exposure to this type of lending may consider investing in CLOs. These instruments offer banks the opportunity to invest in a diversified pool of commercial loans. Because of credit enhancement features and diversification advantages, the most senior debt issued by the CLOs can earn a higher investment rating than the average rating on individual loans in the pool. Despite the investment rating, banks that invest in CLOs should be aware that CLO structures are less standardized than other ABS investments, and therefore, performance and underlying risk will be both issuer and deal specific.

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The Payment System: Emerging Issues

- **Essential to the transfer of value in the U.S. economy, the once-arcaic and bank-centered payment system is undergoing considerable change as new technologies bring new opportunities, new exposures, and new competitors into the payments business.**
- **For most banks, the major issues lie in small-value payments, where they struggle for advantage in adapting new technologies into new products and services while protecting their traditional payments business from technologically adept nonbank competitors.**
- **For regulators and a handful of the largest banks, large-value payments present the most serious challenges, as technology has enabled increasing payment velocity and volume but also has created the potential for systemic failures.**

The payment system is the heart of the U.S. economic infrastructure, moving an estimated \$670 trillion annually among consumers, businesses, financial institutions, and governments.¹ Despite this volume—an amount equal to roughly 90 times the U.S. gross domestic product—the payment system remains transparent to most users because of its dependability in moving value safely. Historically, banks have been essential to this movement, reaping, according to the *Bank Administration Institute*, an estimated \$117 billion each year in revenues both as payment agents and as the holders of the funds from which those payments are made.

Broadly speaking, the payment system encompasses the numerous payment products, players, and the infrastructure that together transmit value throughout the economy. More specifically, it can be defined as a collection of individual systems constructed around specific payment products. Credit cards, for example, represent a payment system. So do debit cards, checks, foreign exchange, and even cash. This product-based definition is a relevant one for many bankers, since it centers on the products and services that generate revenue rather than on the less glamorous “back office” functions that are measured instead by their cost. A

second definition segments the payment system by payment size. Using this definition, the payments world is divided into systems that carry *small-value* or *retail* payments and those that carry *large-value* or *interbank* payments. This latter classification is oriented more toward infrastructure than product but is convenient from a regulatory perspective because the seriousness of the risk posed varies considerably by payment size.

However defined, the payment system today is a source of new opportunities and exposures—a result of a host of new technologies that the “information revolution” has spawned. These technologies create different issues for banks and regulators. For banks, the issues involve adapting the technologies into new products and services while protecting their payments business from nontraditional competitors that specialize in its creation and use. For regulators, the issues involve managing the risks—principally systemic risk—that accompany the large increases in payment volume and velocity enabled by technology. Taken together, these issues frame a payment system that can be both a political and a technological battleground, with significant incentives for participants to shape payment products and channels in a way that favors their own objectives.

Small-Value Payments: A Technological Brawl

Nowhere has the battle to shape the payment system been more contentious than in the small-value segment, where emerging information technology can best be leveraged into new fee-based retail products. There are two battles here. The first involves *maintaining the monopoly over the payments infrastructure* that connects each bank with the Federal Reserve and, by extension, with every other depository institution in the United States.² While this infrastructure is interbank—that is, it is dedicated to settling accounts between institutions and does not directly extend to their customers—the ability to aggregate and settle individual retail payments through it has enabled the banking industry to maintain its centrality to the nation’s monetary flows.

¹ Estimate for 1996 from the National Automated Clearing House Association; www.nacha.org/resources/marketing/direct-payment/us-payments-96.gif.

² Depository institutions were granted exclusive access to this infrastructure upon its creation by the Federal Reserve Act of 1913.

The second battle involves exploiting new technologies either to attract new customers or to serve existing ones more profitably. This battle is both highly visible and highly technical and underscores the potential of the passing of information to eclipse the passing of value as the most critical profit opportunity in payments. The best example of this potential is *bill presentment*, the process of posting vendor invoices—such as credit card or utility statements—on the Internet to facilitate electronic payment. The crucial question concerns where the customer transaction data will lie. If they lie on vendors' sites or on the sites of nonbanks that concentrate such data, those entities will effectively "own" the customer by owning the information needed to cross-sell or otherwise add value during the billing process. Owners of customer-specific data also can tailor new services—a process that can develop loyalty as well as related sales. Losing this battle would be doubly costly for banks because, regardless of where the data reside, electronic payments will eliminate most of the float in the payment process, to the benefit of vendors and largely at the expense of banks.

Another battle is building between banks and nonbanks with respect to *digital cash* and *stored value* applications. These applications are directed at the micropayment sector—that is, payments that are normally considered too small for credit cards. Whether they reside on a computer or a smart card, these applications substitute electronic data for actual cash, with the amount stored on each card covered dollar for dollar by balances on account with an issuer. The struggle is for the right to issue this value, and the *American Bankers Association* has contended that regulated depository institutions alone should be permitted to do so.³ The battle here is for more than just fees, for the interest on the balances that back this electronic value could provide issuers with substantial new sources of income.

With some new payment technologies, the distinction between opportunity and risk can blur. As the Internet enables the distance between shopper and shopkeeper to increase, the need to authenticate unseen customers, merchants, and banks increases as well. At the same time, the open nature of the Internet requires that the privacy and integrity of transaction information be protected. The building blocks to accomplish this are neither simple nor easily interwoven—successfully combining cryptographic protocols, specialized security hardware, and existing information systems is a dif-

³ *The Role of Banks in the Payments System of the Future*, www.aba.com.

Emerging Issues in Small-Value Payments

Maintaining the payment system monopoly. Access to Federal Reserve payment services has historically been limited to depository institutions. Maintaining that monopoly—and thus maintaining its centrality to current and future payment products and services—is an important issue to the banking industry.

Electronic bill presentment is the process of presenting bills and receiving payments electronically. Internet bill presentment may be one of the most hotly contested services, because the owner of the site where invoices are posted could cross-sell to customers as well.

Digital cash and stored value are applications in which electronic data substitute for cash. Such applications can run on either smart cards or personal computers. An important issue is who holds the balances that back electronic value, because, unlike with paper cash, issuers may be able to earn interest on the digital balances held by consumers.

Securing online transactions. Ensuring the integrity, privacy, and authenticity of electronic transactions is widely desired by those engaged in electronic commerce. With larger payments, desirability will become necessity. Current implementations use combinations of encryption algorithms and specialized hardware.

Banks as certificate authorities (CAs). Authenticating Internet payers and payees may require a complex public key infrastructure in which trusted organizations supply decryption keys to authenticate the counterparties to a transaction. Some banks are already acting as CAs. Others are weighing the benefits and largely uncertain exposures of providing such a service.

Electronic Funds Transfer '99 (EFT '99). On January 2, 1999, the U.S. government will be required to make benefit and vendor payments electronically. This mandate raises issues of how to provide service to the "unbanked," how to provide service internationally, and for vendors, how to integrate remittance data with the payment itself.

Development of financial electronic data interchange (EDI) standards. For bank commercial customers to benefit from electronic payments, banks must be able to handle remittance information—information that accompanies payments and identifies sender and transaction detail. Standardizing such data is an important step in enabling banks to receive them and pass them on to their customers.

Point of sale check truncation. Checks are costly to handle and time-consuming to collect. Check truncation reduces cost and eliminates float by converting the check into an electronic transaction at the point of sale. Although banks will have fewer checks to handle under check truncation, they will lose float and the return on investment in check-handling equipment.

difficult matter in itself if the whole is not to be weaker than the individual parts.

The VISA and MasterCard Secure Electronic Transaction (SET) protocols, designed to protect Internet credit card transactions, illustrate the complexity that banks and their customers will need to navigate in *securing online transactions*. Under SET, all banks and merchants will use digital certificates to authenticate themselves to consumers and each other for each Internet transaction.⁴ These certificates are electronic messages that contain a decryption key for the sender that is itself authenticated by a trusted third party. The infrastructure for storing, distributing, and vouching for these keys, known as a Public Key Infrastructure (PKI), will contain several tiers of certificate authorities (CAs) and will be difficult and costly to implement. Banks not only will use these certificates, but many are considering becoming—or have already become—CAs themselves. While *banks acting as certificate authorities* may represent a logical progression in banking services, there is little evidence of a homogeneous legal infrastructure or legal precedent sufficient to guide digital signature disputes. These voids leave unanswered the question of whether the expected gains from providing such services will compensate for the potentially long-tailed liability from doing so.

A major stimulus for electronic payments could come on January 2, 1999, when the U.S. government is required by law to convert its vendor and benefit payments from paper checks to electronic transfers—the so-called *Electronic Funds Transfer '99 (EFT 99)* program. Three separate challenges arise from this mandate. The first is that the “unbanked”—those segments of the population that are socially, economically, or geographically distanced from a financially bank-centric world—must eventually be provided with a cost-effective means to receive, store, and spend their electronic value.⁵ The second challenge is that the EFT mandate applies internationally as well as domestically. Given the need for each international payment to settle in two currencies and countries, the ability to provide efficient cross-border EFT will vary considerably from country to country.⁶

⁴ Depending upon card brand and SET version, consumer certificates may be required as well.

⁵ Because of resistance from bankers and benefit recipients, compliance waivers are envisioned that will make the program largely voluntary until the details of the special electronic transfer accounts (ETA) are worked out.

⁶ www.fms.treas.gov/eft.

Perhaps more challenging to many financial institutions is that electronic payments to vendors, unlike those to individuals, will require electronic remittance data to accompany the payment itself. This information goes beyond simple routing instructions and includes the information—such as purchase order or invoice numbers—necessary for the vendor to apply the payment correctly. According to a study by *Booz-Allen & Hamilton*, only slightly more than 5 percent of financial institutions were able to receive and forward such remittance information as of early 1997.⁷ Developing this capacity will therefore be an industrywide challenge. Once again, there is an opportunity disguised as a cost. The development and implementation of *financial electronic data interchange (financial EDI)* standards will enable financial institutions to retain control of—and add value to—business-to-business transactions when commercial payments migrate to the Internet.

The U.S. government is not alone in seeking an end to costly paper-based payments. Vendors too are pressing for the elimination of the slow check presentment process wherein checks must physically be moved from vendor to vendor bank to issuer bank before funds can be transferred. *Point of sale check truncation* shortens this process by converting the check into an electronic payment at the point of sale, leaving the customer with an executed check and the vendor with a transaction that will settle like a debit card—and in doing so eliminates much of the potential for check fraud. While this process is beginning to displace physical presentment, the outlook for banks is mixed. As the volume of checks that must be physically handled decreases, so too will the income from float and the returns from past investments in check-handling capacity.

Large-Value Payments: Making the World a 'Good and Final' Place

Unlike small-value payments, the issues surrounding large-value payments are not strategic ones for banks, and less technological wizardry pervades them. Instead, the common factor is the systemic risk posed by payment failures. For this reason, regulators—particularly the Federal Reserve and the world's other central banks—take very seriously the payments “plumbing” that is otherwise obscure even to many bankers. In an

⁷ *Remittance Data Study*, Booz-Allen & Hamilton; www.fms.treas.gov/eft/remit.html.

electronic and intangible world where a bank's accumulated exposures can routinely exceed its equity, the overriding objective for payment system designers, users, and regulators is "good and final" payment—a term referring to funds that are both irreversible and fully collected.

Recognition is building concerning the payment system's *vulnerability* and just how critical it is to the U.S. economy. An October 1997 report issued by the *President's Commission on Critical Infrastructure Protection (PCCIP)* warned that "the nation's core payment systems...seem to present a serious physical vulnerability within the financial system."⁸ The source of that vulnerability, in the eyes of the commission, stemmed not so much from a lack of security as from the critical importance of those systems to settling financial transactions throughout the economy and the lack of available alternatives if they failed. As such, it was feared that the payment infrastructure provides an enticing target for cyber-terrorists and information warriors and that such threats will only grow in the future.

Concentration refers to the fact that while banks are central to payments and all enjoy equal access to Federal Reserve payment services, some banks are clearly more central than others. According to March 1998 Call Report data, a mere 25 banks hold nearly two-thirds of the U.S. banking industry's transaction accounts.⁹ Should one of these large banks suddenly fail, its inability to fund settlements could result in a loss of payment system liquidity and disruption of domestic and foreign financial systems alike. While this concentration is not new, what *is* new is the considerable increase in concentration that the new megamergers promise.¹⁰ How and whether to inoculate the payment system from the weight of these super-institutions will become an issue for the regulatory community.

The criticality of a nation's payment system is not confined within its own borders. Because of globalization and the increasing velocity of payments, threats to one

⁸ www.pccip.gov/report_index.html, p. A39.

⁹ Transaction accounts, in essence, are those accounts from which third-party payments can be made. The data used here are based only on transaction accounts held on behalf of other public and private financial institutions here and abroad—accounts from which interbank transfers are made.

¹⁰ As of March 31, 1998, the top three U.S. bank holding companies held approximately 25 percent of all reported interbank transaction deposits. The mergers announced through June 30, 1998, would increase that concentration to over 34 percent.

Emerging Issues in Large-Value Payments

Payment system vulnerability. According to the PCCIP, the nation's core payment systems may present a serious physical vulnerability within the financial system.

Payments concentration. Payment services are concentrated in a relatively few large banks, and that concentration is growing as megamergers are creating a smaller number of superbanks.

Y2K. The Year 2000 problem threatens to disrupt payments by transmitting computer problems via the payment system from banks that have not fixed the problem to banks that have.

The Euro. Bank and interbank systems in Europe and abroad must be modified to accept the Euro. In addition, the resources required to implement the Euro must be diverted from resolving Y2K problems.

Foreign exchange settlement risk. Foreign exchange transaction exposures can be many times a bank's capital. The failure of a major creditor to pay could drain essential liquidity from international markets.

Achieving finality in gross payment systems. Making a given country's domestic payments irrevocable and immediate is a major step in avoiding the international spillover of internal financial crises.

Collateralizing net payment systems. According to the BIS, systems that do not permit immediate final settlement must be collateralized to ensure the eventual satisfaction of member positions in the event of a participant's failure. Like finality, collateralizing helps prevent the internationalization of a domestic failure.

country's system become threats to those of other countries as well. There are a number of these emerging cross-border concerns. The most immediate and visible is the *Year 2000* or *Y2K problem*. Because banks and the payment networks that join them are heavily computerized, the latent points of vulnerability to software and hardware failures have grown factorially with the number of interconnected internal and external systems. In this context, the concern is that any banks that have failed to correct their Y2K exposures will transmit that failure via the payment system to other institutions throughout the world, delaying or even arresting settlements in the process. This concern is heightened because, in both Asia and Europe, bank resources needed to fix Y2K are being consumed instead by more immediate problems. In Asia, it is surviving the decay in currencies and credits. In Europe, it is *the Euro*, which rates as an issue in itself—demanding the modification

of bank and interbank payment systems throughout the world in anticipation of that currency's January 1, 1999, launch.

Although less well known to the general public, *foreign exchange settlement risk* remains of considerable concern to the Bank for International Settlements (BIS) and its member central banks. This exposure arises because cross-border payments, unlike domestic payments, have no single central bank to guarantee settlement, leaving U.S. banks exposed to their foreign counterparties and correspondents—sometimes for several days—for more than \$244 billion in daily trades.¹¹ Potential solutions to this problem include netting—offsetting risks so that only the differences are due—and simultaneous settlement. An ongoing effort by several of the world's largest banks to provide simultaneous cross-border settlement, a project known as the Continuous Linked Settlement Bank, will require considerable international cooperation since it will effectively span the central banks in each country whose currency it settles.

Efforts by individual countries to solidify their payments infrastructure are ongoing as well. *Achieving finality* in payments—a term meaning that a completed payment is irrevocable—is the most prevalent, and recognizes that payments must be irreversible to establish the liquidity for those that follow. One way of speeding up finality is with real time gross settlement (RTGS) systems. “Real time” means that there is no delay in settlement. “Gross settlement” means that transactions are settled in the full amount for which the original payment instructions were entered. FedWire, the U.S. Federal Reserve's large-value payment system, is an RTGS system. Many other countries also have them, and still more are developing or planning them. Complementary to RTGS systems are net or provisional settlement systems, which total up the accumulated debits and credits for each participant over the course of some period—usually one day, offset them against each other, and settle at the end of the period. The New York Clearing House's Clearing House Interbank Payment System is one such system. Although their use leads to smaller, or *netted*, settlement amounts for each participant and substantially lower liquidity demands on the payment system as a whole, payments in such systems are not final until the last creditor pays. Thus, there is a daily threat of recalculation and a potentially fatal change in mem-

¹¹ *Settlement Risk in Foreign Exchange Transactions*, March 1996, and *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, May 1996; Bank for International Settlements; www.bis.org/publ.

Sources of Additional Payment System Information

Electronic Bill Presentment

Checkfree www.checkfree.com/ebill
Microsoft-First Data
Corp www.msfdc.com

Digital Cash and Stored Value

Cybercash www.cybercash.com
Digicash www.digicash.com
Mondex www.mondex.com
VISACash www.visa.com

Securing Online Transactions

Certicom www.certicom.com
Entrust www.entrust.com
RSA www.rsa.com
SETCO www.setco.org

Certificate Authorities

Certco www.certco.com
Digital Signature Trust . . . www.digsigtrust.com
GTE Cybertrust www.cybertrust.gte.com
Verisign www.verisign.com

Electronic Funds Transfer '99, Financial EDI, and POS Check Truncation

National Automated
Clearing House
Association www.nacha.org
U.S. Treasury Financial
Management Service . . www.fms.treas.gov/efit

Payment System Vulnerability

President's Commission on
Critical Infrastructure
Protection www.pccip.gov

The Euro, Foreign Exchange Settlement Risk, Payments Finality, and Collateralization

Bank for International
Settlements (BIS) . . . www.bis.org/publ
Federal Reserve Board
of Governors www.ny.frb.org
New York Clearing
House Association . . . www.chips.org
U.S. Federal Reserve . . . www.bog.frb.fed.us

bers' liquidity positions if a major creditor bank fails. For such systems, the BIS is encouraging member *collateralization* levels sufficient to cover at least one, and preferably two, of each system's largest net creditor banks at any one time.¹² While these are not new issues in developed nations, the increasing extent to which financially underdeveloped and underregulated countries are involved in global payments confers new importance on the development of finality and collateralization in payment systems worldwide.

Differing Perceptions, Common Threat

Banks are united neither in their perceptions of these issues nor in their desire for regulation to address them. With respect to small-value payments, large and small banks have disagreed over whether the Federal Reserve should withdraw from providing retail payment services—a debate that ended in favor of the small bank faction earlier this year when the Fed announced that it would remain an active and, according to some large banks at least, a subsidized competitor in clearing and

settlement. There also has been disagreement, again along lines of size, over whether the issuance of new products such as stored value cards should be limited to regulated depository institutions. In large-value payments, the differences are due more to relevancy than competition. Few small banks will feel compelled to address foreign exchange exposures or the vulnerabilities of the national and international payments infrastructure.

Whatever their individual perceptions of the issues surrounding the payment system, all banks are susceptible to its interruption. Likewise, they are strategically vulnerable—individually and as an industry—if they fail to preserve their role as a trusted gateway for the settlement of their customers' obligations. This is perhaps the most critical of all payments issues facing banks, for while their daily operations may depend on their continued success in maintaining the payment system's dependability, nothing short of their payments franchise may rest on their ability to market this success to their customers as a feature essential to the entire range of current—and future—payment services.

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¹² *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (Lamfalussy report), November 1990; BIS; www.bis.org/publ.

Inventory Accumulation, Strike at General Motors, and Falling Crop Prices Are Areas of Interest

- For over a year, *Regional Outlook* has reported that economic conditions in the Chicago Region were healthy, albeit also vulnerable to a slowdown.
- At midyear 1998, high—and perhaps excess—inventory stocks appear to have accumulated in parts of the economy. Incomes of households and businesses may come under downward pressure as steps are taken to reduce surplus inventories.
- Repercussions from a labor dispute between General Motors (GM) and the United Auto Workers Union also threatened the Region's economic vigor. Lenders to households and small businesses may be affected through year-end, especially in communities where GM and its suppliers are a significant presence.
- Forecasts of lower crop prices, along with reduced federal payments, heighten the prospect that farm sector incomes will flatten or even weaken this year. A first-quarter survey of credit conditions at agricultural banks found that requests for renewals or extensions of farm loans were higher than they were a year earlier.

Manufacturing Sector: Inventory Accumulation Bears Watching while Strikes' Impact Is Felt

Recent developments suggest that many of the Region's manufacturers face intensifying challenges as 1998 unfolds and leads up to 1999. Against the background of a long-lived cyclical expansion and the impact of Asian developments (see recent editions of *Regional Outlook*), this article discusses two of the more recent challenges:

- a significant amount of the inventory buildup since late 1997 likely was unplanned; and
- possible repercussions from the United Auto Worker (UAW) union's strikes against GM.

Either situation could significantly threaten the manufacturing sector's vigor in the Region.

Inventory Correction Ahead?

Excess inventory accumulation is one imbalance that often occurs in aging expansions. It arises because growth in demand moderates or falls short of expectations, but firms are slow to recognize this development and to trim their production schedules. For over a year now, output (as measured by real gross domestic prod-

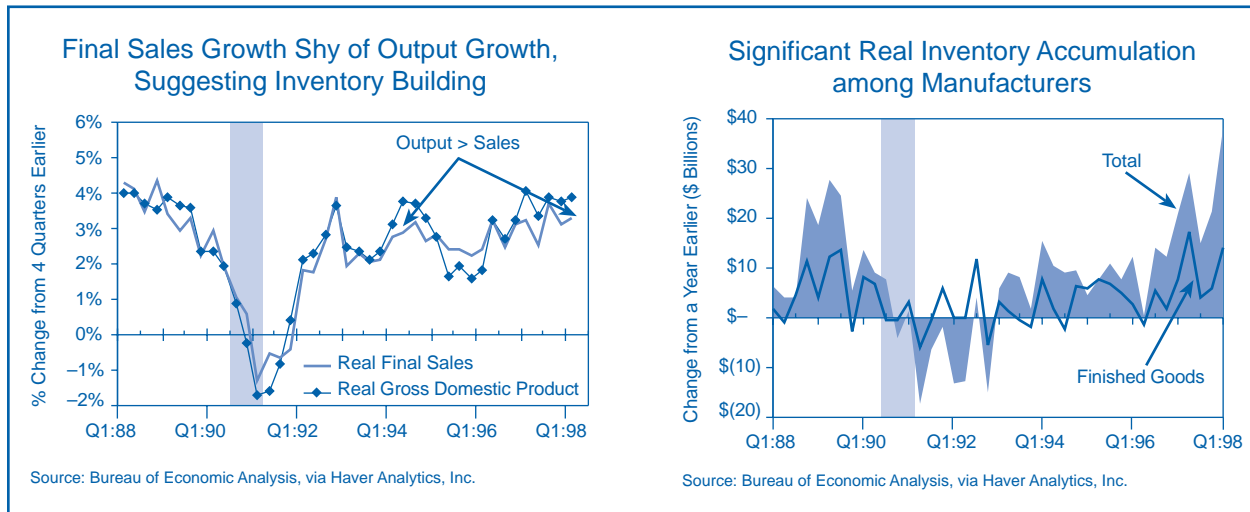
uct, or GDP) has been rising faster than sales (see Chart 1, left panel). In fact, over one-third of the increase in real GDP in the fourth quarter of 1997 and first quarter of 1998 went to nonfarm inventories rather than to end users.

Available data do not distinguish whether or not the recently rapid inventory accumulation was planned. However, because the economy's short-term capacity for robust growth is limited, it is reasonable to assume that recent stockpiling was not purposely done in anticipation of a sustainable burst of economic growth. To some extent, the falloff in demand from Asian countries and increased competitiveness of goods made there may have contributed to the current increase in inventories.

The inventory buildup appears to be fairly widespread among manufacturers, wholesalers, and retailers. In the manufacturing sector, one-third of the recent stockpiling involves finished goods (see Chart 1, right panel), suggesting that producers face difficulties in quickly moving goods out the door in return for payment. Manufacturers' stockpiles of production inputs and of semi-finished products also are rising fairly rapidly. Unless final demand strengthens, fabrication of these stocks will produce more finished goods, which could exacerbate any existing excess.

To minimize further accumulation, various businesses trimmed their orders in the first quarter, thus contribut-

CHART 1



ing to a 3.2 percent drop (at an annual rate) in manufacturers' new orders, exclusive of defense. Other typical responses currently taking place include reducing overtime work, shortening employees' workweeks, or even laying off employees. These developments underlie many economists' expectations of an inventory correction and slower GDP growth this year. In light of the Chicago Region's heavy reliance on manufacturing, the impact of an inventory correction likely will be heavier here than in much of the nation.

UAW Strikes' Impact Could Intensify Any Inventory-Related Slowdown

The effect of two early-June strikes against GM by local UAW unions in Flint, Michigan, have negative implications for the economy as a whole and for many communities in this Region in particular. The 115,000-plus U.S. workers laid off by GM because of shortages of parts greatly exceed the 9,200 people on strike. About 42 percent of the idled GM workers in the U.S. are in Michigan; 19 percent are in Ohio; and 8 percent are in Indiana. Idled GM facilities are indicated by stars on Chart 2 (next page), where the graduated shading reflects the importance of the motor vehicles and parts industry in general to individual counties.

Repercussions along the supply chain for the motor vehicle industry quickly spread beyond GM facilities to other firms such as those making wiper blades, car seats, dashboard components, and similar products.

A rough rule of thumb is that one to two jobs in related industries are affected for every production-line job at GM.

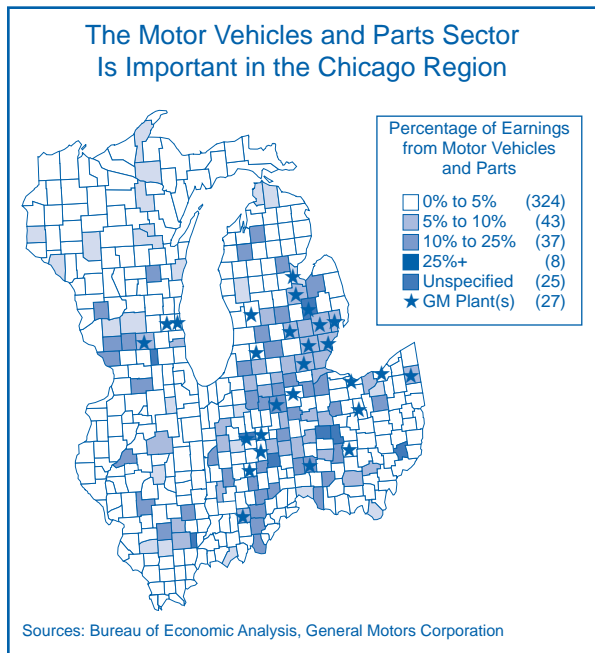
Analysts' studies of previous strikes suggest that about half of the production and income losses experienced during the strike will be made up in following quarters as GM and supplier firms ramp up production and fill their distribution lines again.¹ For local businesses outside the vehicle industry but dependent on it, any post-strike catch-up may be limited, especially if the business sells services (e.g., restaurants, vacation rentals, entertainment, and travel) rather than goods.

The longer the strikes and associated layoffs last, however, the more significant will be the adverse effects not only on GM and its suppliers but also on household incomes and local business activity. For a hypothetical UAW household earning \$52,000 a year on GM's production line, a six-week layoff would trim annual income by about 8 percent (or \$4,200), even if maximum unemployment benefits were received. Even if workers make up some of their lost income after the strike, their financial cushions may be strained during the strike period.

Lingering in the background is the possibility of additional strikes later this year at other GM facilities. Should they occur and again temporarily shut down

¹ Keith Bradsher, "Money and Other Hardening Positions in Strikes at G.M.," *The New York Times*, June 27, 1998.

CHART 2



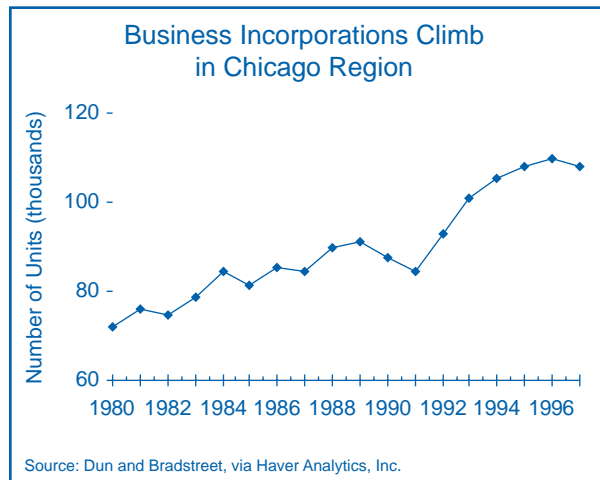
much of GM, strains on the repayment abilities of some households and small businesses would be intensified.

Implications: During an inventory correction, manufacturers, wholesalers, and retailers may resort to price discounting to eliminate excess stocks, thus pressuring their profit margins. Meanwhile, some entities whose repayment ability is stressed by slower revenue growth may increasingly draw on their operating lines with banks to fund excess inventories. Such situations likely will test bankers' ability to balance the needs of business customers against the need to maintain adequate overall credit quality.

The GM-UAW situation raises additional concerns, which include:

- The ability of laid-off and striking workers to make timely payments on mortgage, home equity, vehicle, and other loans may be challenged.
- Small businesses in communities with a heavy exposure to GM, its suppliers, or both also may face difficulties repaying loans.
- Households and small businesses could increasingly use credit card lines to finance their spending until the strike is over and incomes rebound. While increased lending may be viewed positively in the

CHART 3



short term, bankers should consider the possibility that small business and personal bankruptcy filings in affected communities might increase if the strike is prolonged.

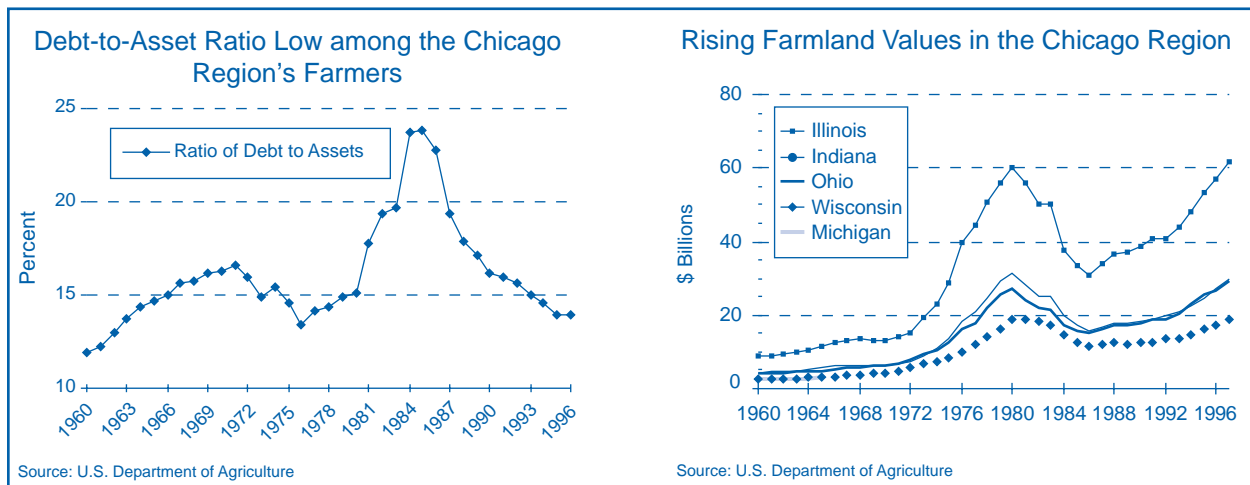
In addition, any significant slump in the Region's economic health caused by either situation could trigger some fallout among the 625,000 businesses incorporated in the Region since 1991 (see Chart 3). They represent a pool of borrowers that have never weathered an economic downturn. Many may be smaller establishments, which may not have considerable cash flow or equity cushions with which to ride out a downturn.

Crop Farmers Deal with Adverse Weather and Lower Prices

Considering that corn and soybeans generate about 46 percent of agricultural cash receipts in this Region, several areas deserve monitoring as the crop year unfolds.

- A late-June *progress report* by the U.S. Department of Agriculture (USDA) indicates that smaller shares of the corn and soybean crops in Illinois, Indiana, and Michigan were rated good or excellent than shares among the major planting states as a whole. Illinois appears to lag the most, with 52 percent of the state's corn crops in late June rated good or excellent, down from 79 percent a year ago. Only 49 percent of its soybean crops were rated good or excellent, compared with 68 percent last year.
- Even so, *prices* may remain under downward pressure, partly because of falling demand from Asia and

CHART 4



existing carry-over stocks. From April to June, Central Illinois cash prices for soybeans were 25 percent lower than a year earlier, and corn prices were 14.5 percent lower. For each crop, USDA projections call for even lower prices ahead, with soybean prices perhaps heading to the lowest level in more than a decade.

- Per-unit *production costs* for soybeans are predicted to edge upward for a typical Central Corn Belt producer this year.²
- *Cash payments* to farmers continue to be reduced under terms of the 1996 Farm Bill.

Another cautionary note comes from the Chicago Federal Reserve Bank's recent survey of credit conditions during the January–March quarter. It found that, among agricultural banks in the Federal Reserve's Seventh (Chicago) District, requests for renewals or extensions of farm loans (excluding real estate loans) were higher than they were a year earlier. Although some analysts suggest that changes in farmers' marketing strategies may explain why farmers are holding crop inventories and perhaps repaying loans more slowly, any such strategies would bear monitoring if prices are more likely to fall than rise in coming months.

² Doane's Agricultural Report, June 12, 1998.

Implications: Currently, farmers' repayment capacity and collateral in farmland appear to be positive, as illustrated in Chart 4. Farmland values rose by 7.5 to 10 percent in the Region last year, to all-time highs in several states. This appreciation contributed to the improved asset coverage of debt loads (see Chart 4, left panel).

Historical experience, however, suggests that high values on a limited number of farmland transactions can lead to inflated estimates of land values and unrealistically low estimates of debt-to-asset ratios. Thus, lenders need to guard against over reliance on land collateral values and to continue careful evaluation of current cash flows and income projections.

Chicago Region Staff

Update on UAW-GM Situation

Striking UAW workers in Flint, Michigan, ratified a settlement with GM in late July, and full operation of all parts and assembly plants is estimated to be reached by mid-August. Although overtime hours associated with catch-up production may temporarily boost workers' paychecks, at least some households will need this boost in income to repay loans taken out during the shutdown or to meet postponed debt payments.

Trends to Watch: Banks Dependent on the Farm Sector

- Most insured institutions in the Chicago Region continue to maintain strong capital and earnings positions.
- A combination of adverse weather, low commodity prices, and reduced government payments has raised interest in the financial trends of banks dependent on the farm sector.
- Managers of banks dependent on the farm sector may want to review risk control systems associated with the above trends, as well as recent changes in loan structures, funding sources, and loan loss reserves.

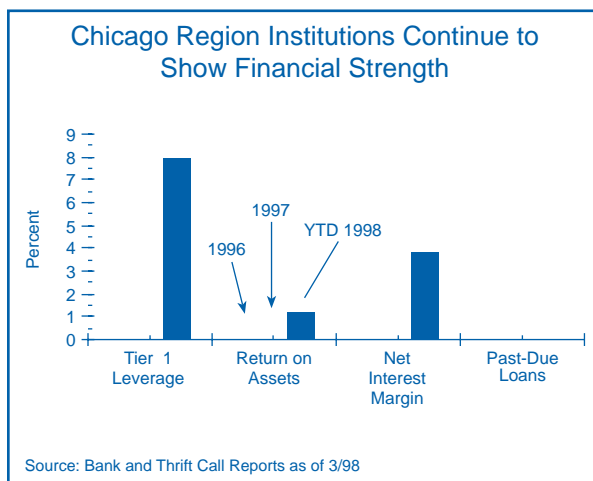
Overview

Insured institutions in the Chicago Region continue to adapt to a rapidly changing environment. For example, the trend of fewer but larger institutions continued during the first quarter of 1998. The first three months of the year saw a net reduction of 27 insured institutions operating in the five-state area, but the Region's total assets increased by over \$12 billion to \$933 billion.

Banks and thrifts in the Region have generally been able to manage such changes and maintain relatively strong capital and earnings positions (see Chart 1). Thus far in 1998, the Chicago Region's institutions have:

- increased aggregate leverage capital to 8.0 percent of average assets;
- recorded a solid aggregate return-on-assets (ROA) of 1.26 percent; and
- maintained good overall asset quality.

CHART 1



The financial strength described above continues to provide significant flexibility to meet emerging risks. This flexibility is important in an environment where institutions have to address concerns resulting from the Year 2000 computer problem and continuing reports of aggressive loan underwriting standards.

Having sufficient flexibility to deal with potential problems and changing conditions is always important, but even more so when an institution concentrates a good portion of its business in one or two sectors of the economy. In that regard, a combination of factors has recently raised interest in the trends of banks dependent on the farm sector.

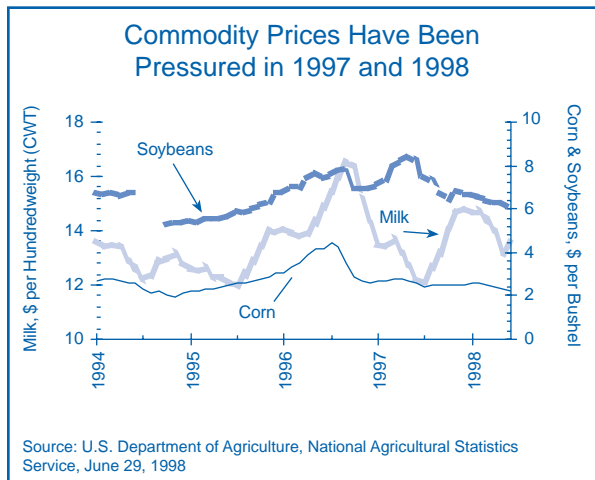
Concerns over Farming Vary

Previous articles in this publication have noted rapid consolidation in some hog and dairy operations and more volatile pricing in associated commodities. Additional potential problems, which are discussed in more depth in the *Regional Economy* section of this edition, include:

- Adverse weather conditions during the spring and early summer that may affect crop yields this year.
- Reduced Asian demand, along with high world production and carryover stocks, has resulted in lower corn and soybean prices, and there are forecasts of continued pressure on these prices (see Chart 2).
- Reduced government payments, which at least one study¹ indicates may lead to declining farmland values in the Midwest.

¹Charles H. Barnard, Gerald Whittaker, David Westenbarger, and Mary Ahearn, "Evidence of Capitalization of Direct Government Payments into U.S. Cropland Values," *American Journal of Agricultural Economics*, November 5, 1997, pp. 1642-1650.

CHART 2



The amount of concern over these conditions varies. From an individual bank's standpoint, much depends on whether the farmers who borrow from it have financial cushions that are substantial enough to absorb reduced cash flows and still allow for prompt repayment of outstanding debt.

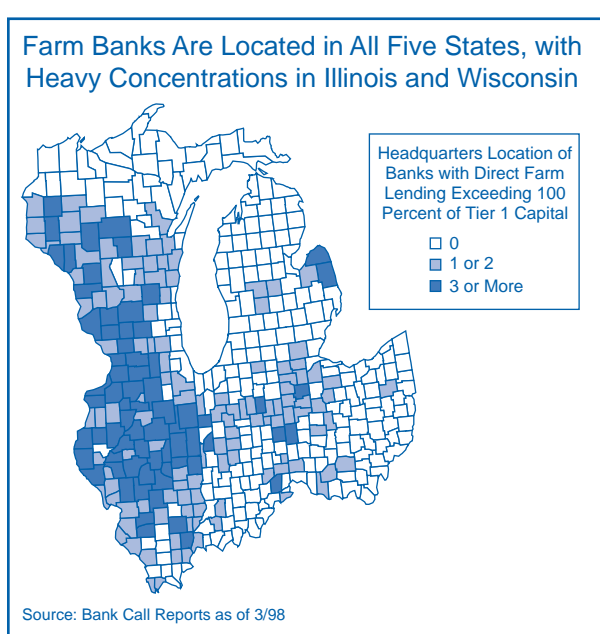
Many banks that directly service this sector of the Region's economy are undergoing some structural changes themselves, adding further potential stress to adverse agricultural conditions. These changes include consolidations of institutions, loan portfolio structure and funding changes, and declines in loan loss reserve levels. The remainder of this article defines "farm banks" and identifies where they are located. It also looks at the structural changes noted above with the intent of identifying where they may cause stress for risk-control systems.

Identification of Banks with Significant Exposure to Farming

Communities that depend on the farm sector of the economy are located throughout the Region. Types of farming activity are diverse and vary depending on geographic location. For example, in **Illinois, Indiana, and Ohio**, corn and soybeans are the primary products, while in **Wisconsin and Michigan**, dairy farming tends to be the most important.

Some banks that service these businesses are easy to identify because they hold a substantial volume of farm loans in their portfolios. In addition, many other institutions do not make a significant volume of direct loans

CHART 3



to farmers but are still vulnerable to this sector because they are in communities where agriculture is a substantial component of overall earnings.

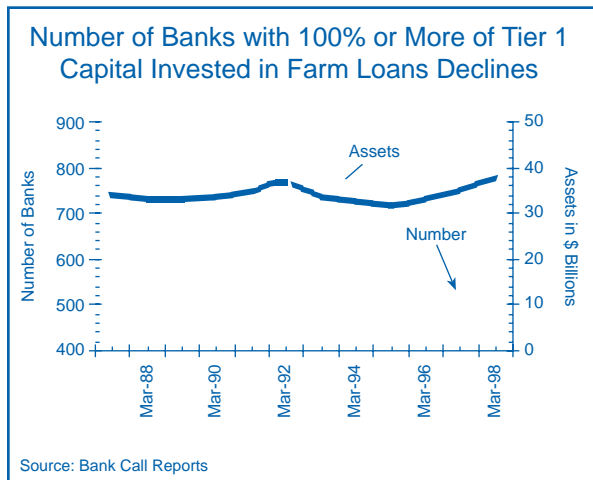
Both types of institution will be significantly affected by changes in the economic conditions of farmers. However, given the limitations of available economic and bank data, we have, for the purposes of this analysis, defined "farm banks" as institutions with direct farm-loan exposures exceeding Tier 1 risk-based capital. Although this definition excludes many institutions with high indirect exposures, it still captures over 500 banks as of March 31, 1998. These banks are located in each of the five states of the Chicago Region, with the heaviest concentrations in Illinois and Wisconsin (see Chart 3).

Number of Banks with Significant Direct Exposure to Farm Loans Continues to Decline

The number of institutions with direct agriculture loan exposures of over 100 percent of Tier 1 capital has steadily declined throughout the decade (see Chart 4). Some of the reasons for the reduced numbers include:

- Some multibank holding companies have simplified their structures by consolidating several banks into one unit.

CHART 4



- Institutions have merged to take advantage of potential growth opportunities or perceived efficiencies.
- Owners sell when they, or key personnel, are ready to retire.
- Urbanization of some agricultural areas has reduced the number of farms and changed the customer base that these banks serve.

Over the past several years, the trends noted above have occurred during relatively prosperous times for Midwest farmers. These prosperous times have helped many of the remaining farm banks to manage such changes and maintain good operating performance.

Financial Conditions of Most Farm Banks Are Favorable, but Some Show Weaknesses

On an aggregate basis, the Region's farm banks appear healthy. As of March 31, 1998, their aggregate:

- Tier 1 leverage capital ratio of 9.2 percent exceeded the overall average of all institutions in the Region;
- ROA was slightly below the Region's overall average, at about 1.2 percent, but was stable; and
- asset quality also remains adequate, though there has been a modest increase recently in past due loan levels.

While measures of aggregate farm bank performance remain good, a small but growing number of individual

institutions (64) in this group have elevated (over 5 percent of total loans) past-due loan levels. In addition, approximately 65 institutions reported substantially (more than 50 basis points) lower than average earnings during the first quarter. Banks exhibiting these characteristics may need to be especially cautious, given the potential added stress their farm customers may experience in the current environment.

Even institutions not exhibiting weaknesses may need to closely review their risk-control systems, especially in cases where increased competition has led them to change loan portfolio structures and funding sources.

Increased Competition Is One Factor Changing Loan Portfolio Structures

Increased competition from several fronts is trimming banks' share of farm debt. Among the contributing factors are:

- Equipment manufacturers, seed companies, and other agricultural vendors are more active in offering credit to farmers.
- A rising number of crop farmers are leasing equipment through manufacturers instead of using traditional credit.
- The Farm Credit System has recently become more active.

These competitive factors and the strong financial health of some farmers have resulted in only moderate growth in direct farm loans at farm banks. For much of the 1990s, direct farm loan growth, measured from March to March of each year, has been at 3 percent or lower. While growth improved in 1998, with almost 10 percent growth in direct farm lending noted, there is some concern that part of this increase may be explained by reports of more farmers delaying repayment of loans in the Midwest (see ***Regional Economy: Inventory Accumulation, Strike at General Motors, and Falling Crop Prices Are Areas of Interest***).

Competition and urbanization also have resulted in changes in the types of loans made. For example, many farm banks in the Region have greatly increased residential and commercial real estate lending since 1990 (see Table 1). As a result, 1- to 4-family mortgage loans now exceed total farm debt at over half of the Region's

TABLE 1

| COMMERCIAL REAL ESTATE AND RESIDENTIAL LOANS BECOME MORE IMPORTANT TO FARM BANKS* IN THE CHICAGO REGION | | | | |
|---|--------------------------------|---------|---|---------|
| LOAN CATEGORY | DOLLARS INVESTED (IN BILLIONS) | | DOLLARS INVESTED AS A % OF TIER 1 CAPITAL | |
| | MAR. 90 | MAR. 98 | MAR. 90 | MAR. 98 |
| 1- TO 4-FAMILY RESIDENTIAL | 4.9 | 7.5 | 168.5 | 214.1 |
| FARM | 5.0 | 6.3 | 171.6 | 181.0 |
| COMMERCIAL REAL ESTATE | 2.1 | 3.9 | 71.0 | 112.0 |
| COMMERCIAL | 2.9 | 3.4 | 101.1 | 98.4 |
| INDIVIDUALS | 3.3 | 2.9 | 112.5 | 83.2 |
| ALL OTHER | 0.5 | 0.7 | 17.3 | 18.9 |

* DIRECT FARM LOANS EXCEED TIER 1 CAPITAL
SOURCE: BANK CALL REPORTS

farm banks. In addition, over 31 percent of farm banks have commercial real estate loan exposures exceeding 100 percent of Tier 1 capital.

The activities described above may require some institutions to reassess how they monitor the risk contained in their loan portfolios. Obviously, the need for a strong review of direct farm loans remains important—especially an appropriate assessment of the adequacy of cash flows and collateral values. In addition, some institutions may need to enhance their reviews of credit risk related to commercial real estate, while others need to assess how increases in mortgage lending may have altered their interest rate risk profile.

Allowance for Loan and Lease Losses Coverage of Gross Loans Is Declining

These risk reviews are all the more important given a steady reduction in the ratio of allowance for loan and lease losses (ALLL) to gross loans for farm banks in this Region since 1993. On an aggregate basis, the ALLL as a percentage of gross loans has declined from 1.57 percent at year-end 1993 to its present level of 1.29 percent (see Chart 5). This decline was a common occurrence, as about 230 of 503 farm banks now operating saw their reserve ratios drop by over 20 basis points over the same time frame. In addition, 38 of these institutions experienced a decline of over 100 basis points.

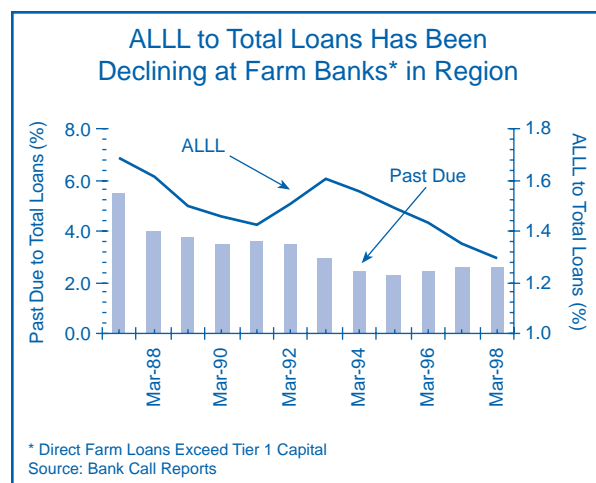
The trend of a declining ALLL ratio is somewhat expected, given current modest levels of past-due and problem loans. However, this ALLL trend may not con-

tinue, as the Region already has approximately 115 farm banks that had loan reserve levels of less than 1 percent of their total outstanding loan portfolios as of March 31, 1998. It is also interesting to note that 49 of these same institutions reported year-to-date return-on-assets of less than 1 percent. While these institutions do not show signs of loan problems on an aggregate basis, modest ALLL coverage and earnings may make them more vulnerable during any downturn or localized problems in the agricultural economy.

Changes in Funding Structure May Make Earnings More Volatile in the Future

Another area of change is how farm banks are funding growth. Of interest is that aggregate loan growth has outpaced deposit growth for the past several years. This

CHART 5



development, widespread among banks, has increased the loan-to-deposit ratio for farm banks from 62 percent as of March 31, 1990, to almost 77 percent at the end of the first quarter this year. As of March 31, 1998, over 40 percent of these institutions had loan-to-deposit ratios exceeding 75 percent, in contrast with only 10 percent in 1990.

Weak core deposit growth appears to be due, in part, to stiff competition. Large banks, credit unions, and non-bank entities are expanding into rural areas, increasing competition for consumer deposits. As a result, farm banks have had to alter their funding strategies. For

example, during this decade, Chicago Region farm banks have quadrupled their use of borrowed funds, from 1.2 percent of total assets at year-end 1990 to 4.9 percent at the end of the first quarter this year.

Two risks emerge with these funding shifts. First, liquidity risk increases because these funds may be more interest-rate sensitive and therefore less stable than core deposits. Second, this increased interest-rate sensitivity may make earnings more volatile in the future.

Chicago Region Staff

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