In Focus This Quarter

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

By Steven E. Cunningham, John F. Sherman

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

By John F. Sherman

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

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Regional Perspectives

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◆ Commercial Real Estate Trends in the Dallas Region—Fueled by rapid growth in commercial real estate lending, four major markets in the Dallas Region continue to widen the gap between the nation’s and Region’s levels of commercial real estate activity. See page 21.

By Alan C. Bush, Adrian R. Sanchez, Jeffrey A. Ayres
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Sincerely,

George French
Executive Editor

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

• The size and value of recent mergers and acquisitions in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers.

• Deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among the important drivers of bank merger and acquisition activity.

• By identifying the rationale and incentives for bank merger and acquisition activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.

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

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

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

Why Are Banks Merging?

Deregulation

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

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

**Increasing Competition**

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

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

Competition in a mature industry often intensifies as competitors focus on sustaining market share as revenue growth rates slow. In banking, recent changes in the operating environment have stimulated a dramatic increase in competition. Specifically, barriers to entry into the industry have fallen: Capital is plentiful, experienced managerial talent is available (as a result of the many mergers), and regulatory restrictions have been relaxed. Technological and financial innovations also are influencing how banks compete by enabling them to manage disparate operations with broader product arrays more efficiently. Moreover, as a result of intensifying nonbank competition and continuing evolution in distribution systems, some banking services have come to resemble commodities. Consequently, brand loyalty appears to be declining and banks are experiencing reduced influence over pricing.

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

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

Year

Note: Negative 285 percent rate in 1987 shown as zero.
Source: FDIC Historical Statistics on Banking

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

The third capital management alternative, M&A, offers potential benefits to both parties to the transaction. M&A may permit acquirers to deploy excess capital while improving earnings through operating and financial economies, diversification of revenues and geographic exposures, and greater management expertise. M&A also can provide access to new products—a common objective of competitors in mature industries. For institutions acquired through a purchase transaction in which ownership rights are relinquished, mergers provide a means of returning capital to shareholders rather than attempt-

ing to remain independent in an increasingly competitive environment.

Market Valuations

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

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

*(As reported by the Wall Street Journal, April 16, 1998, p. C1.)

As Market Valuations Have Increased, Cash Usage in Bank Mergers Has Declined

Percentage of Cash Used in All Bank M&A

SNL Bank Index Price-Earnings Ratio

Year

* Price-Earnings Ratio = stock price of index members to previous 12 months’ earnings weighted by market capitalization.
Source: SNL Securities
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earnings ratio) both absolutely and relative to the S&P 500. For example, according to the price-earnings ratio for the SNL Bank Index, at year-end 1994, investors paid $9.76 per dollar of bank earnings; on June 30, 1998, investors paid $22.88 per dollar of earnings. Over the same period, the price-earnings ratio of the SNL Bank Index relative to the S&P 500 increased from 65 percent to 79 percent.

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

Following the strong performance through the first half of 1998, the SNL Bank Index lost 21 percent of its value during the third quarter of 1998 (all during the month of August) because of concerns about corporate earnings, international exposures, the flat yield curve, and the ability of banking companies to expand market-sensitive revenues. Over the same period, the S&P 500 declined only 10 percent. Likely in response to relatively poor stock market conditions, only 75 bank mergers were announced during the third quarter of 1998— a 30 percent decline from the second quarter—with over half announced during July. According to SNL Securities, only 32 bank mergers were announced in August and September 1998, the lowest number for any two-month period since March and April 1997, when 31 mergers were announced. The August 1998 decline in the SNL Bank Index was the largest monthly decline since a 7 percent drop in March 1997. In addition, the average price-earnings ratio for the index relative to the S&P 500 during third-quarter 1998 was the lowest in eight quarters. Consistent with the aforementioned relationship between bank stock valuations and the level of cash committed to bank M&A activity, the amount of cash committed to mergers in September increased significantly.

Synergistic Opportunities

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

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

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Chart 5

Bank Stock Values Relative to the Broader Market
Reflect Ability to Generate Equity Returns in Excess of Costs

Return on Equity Less Estimated Cost of Equity (right axis)

Bank Price-Earnings Ratio Relative to S&P 500 (left axis)

Source: Credit Suisse/First Boston

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

Whereas mergers in overlapping markets provide opportunities for cost cutting, value creation from revenue enhancements is more likely to materialize in M&A transactions across markets and industries. Such mergers can be expected to lead to increased diversification of revenues and geographic exposures. These expectations may be driving the recent trend in acquisitions of investment banking units and brokerage houses by banking companies. As traditional interest-spread income has stagnated, many institutions have focused on expanding noninterest sources of revenue. At June 30, 1998, noninterest income made up 40 percent of net operating revenue (net interest income plus noninterest income) for all commercial banks, compared with only 25 percent in 1984. Similarly, geographic expansion can reduce a firm’s dependency on local, undiversified economies. Supporting this notion, a May 1998 working paper by the Federal Reserve Bank of Philadelphia found that economic benefits are strongest for banks engaged in interstate expansion, especially for mergers that diversify macroeconomic exposures.5

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

Differences in the ability of managers to operate institutions efficiently may also provide impetus for acquisitions. As Federal Reserve Board Chairman Alan Greenspan noted in recent testimony, “there are considerable differences in the cost efficiencies of banks within all bank classes, implying that there is substantial potential for many banks to improve efficiency of their operations, perhaps through mergers.”6 Thus, managers of more efficient banks may acquire less efficient competitors in an attempt to increase the latter’s value through improved management. As shown in Chart 7 (next page), the efficiency ratios7 of bank holding companies improved significantly from 1987 to 1997. However, continued disparities in efficiency among companies, as reflected by the upward slope of the lines in Chart 7, may offer additional opportunities for M&A activity.

Technology and Globalization

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

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2 Testimony before the Committee on the Judiciary, U.S. Senate, June 16, 1998.
3 The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.
Bank Efficiency Has Improved, but Differences among Institutions May Provide Merger Incentives

Bank Holding Companies Continuously Operating from 1987 to 1997

**Management Incentives**

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

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

**Summary and Conclusions**

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

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Risks and Challenges for Consolidating Institutions

- Bank merger and acquisition (M&A) activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies.

- As premiums paid in M&A transactions have escalated, some industry observers have raised concerns over whether the assumptions concerning potential earnings and strategic benefits can be realized.

- Institutions in the process of integrating an acquired entity are likely to be especially vulnerable to a downturn in the economy.

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

Execution Risk

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

Management

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

Technology

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

Diversification

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

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

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

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

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

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

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

Cost of Capital
Failure to meet performance expectations following a merger can lead to negative market assessments of earnings quality and stability. As creditors and investors view an institution’s performance less favorably, they
require a higher rate of return on capital markets instruments. While cost of capital always has been important for institutions that rely significantly on capital markets as a funding source, changes in the competitive environment have made it a critical issue for all banking organizations. Technological advances and deregulation now permit low-cost competitors to enter previously insulated markets. (See “Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale” for a discussion of changes in the competitive environment.) Competitors with a lower cost of capital often can provide services at a lower price, or they can accept similar risks in exchange for a lower expected return. Such competition may lead higher-cost competitors to pursue higher-yielding but riskier investment alternatives.

Economic Conditions

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

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

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

Summary and Conclusions

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

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Chart 2

The Share of Institutions That Were Newly Chartered* or Involved in a Merger within the Previous Three Years Is Increasing

* Includes all de novo institutions
Source: Bank Call Reports
Industry Consolidation Presents Unique Risks and Challenges for Community Banks

- Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope.

- Some small banks that are not merging with or selling to competitors are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets.

- While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.

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

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

Competitive Pressures

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

New Chartering Activity

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

1 As presented in the ABA Banking Journal, April 1997, p. 55.
In Focus This Quarter

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

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

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

Challenges of Scale and Scope

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

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1 The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.
long-term competitive disadvantages. For example, The Tower Group estimates that 70 percent of 1997 information technology (IT) spending by banks was by the top 15 institutions.3 Smaller institutions competing with larger banks that are investing in technology to improve operational efficiency, increase customer convenience, or to better identify customer profitability, pricing strategies, or cross-selling opportunities may find a diminished presence in the marketplace. Consequently, small banks may face increasing competition for customers who are attracted to sophisticated pricing, wider product arrays, and multiple delivery channels offered by competitors.

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

### How Are Community Banks Addressing Consolidation Challenges?

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

### Outsourcing

A recent survey by Electronic Data Systems Corporation and Bank Earnings International LLP4 found that community bankers are more concerned with controlling operating expenses than any other issue. This finding is not surprising given the cost savings expected from many recent mergers. The study also revealed that banks view IT as the most valuable tool for improving day-to-day performance—from controlling expenses to increasing fee income. Yet, according to The Tower Group, IT budgets as a percentage of total noninterest expenses for small banks are typically half of those for larger banks.5 As a result, some small banks are turning to outside parties to maximize the utility of expenditures, IT and others.

American Banker recently reported on a trend among small banks to outsource the origination of consumer loans. The Tower Group noted that third parties handled 2.7 million noncard, nonmortgage loan applications (mostly from small institutions) in 1997, and annual outsourced volume growth is projected to average 40 percent through 2002.6 Vendor networks designed to

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

**Nondeposit Funding Sources**

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

The rising number of commercial banks joining the Federal Home Loan Bank (FHLB) System in recent years, as reflected in Chart 4, is likely a symptom of the aforementioned funding trend. At June 30, 1998, nearly half of all small banks were FHLB members, compared with 21 percent at year-end 1993. On the same date, 90 percent of FHLB commercial bank members and 87 percent of FHLB commercial bank borrowers were small banks. In addition to providing a backup source of liquidity, the FHLB is essentially acting as an intermediary to the capital markets for banks with limited access. The relatively limited nondeposit funding options available to many small banks may explain their increasing reliance on FHLB advances. At June 30, 1998, approximately 80 percent of small banks’ nonovernight borrowings were FHLB advances.

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

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

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

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

Establishing prudent relationships with smaller, underserved customers may present opportunities and profits for small banks. This may be especially true for small business customers, which may not fit more standardized lending models of larger banks yet remain acceptable credit risks. According to the Federal Reserve Board’s second-quarter 1998 Survey of Terms of Business Lending, rates on small commercial and industrial loans earn the greatest spread of any size business loans. Further, a recent survey by PSI Global of small business owners in south Florida, which has seen a great deal of merger and acquisition activity in recent years, found that nearly one-quarter of respondents would move their business if their bank was purchased, exemplifying the extent to which small banks may be able to use service to capitalize on consolidation activity.¹⁰

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

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

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Regional Perspectives

• Regional job growth slowed dramatically in July 1998 from the same month a year ago. The confluence of the Asian economic crisis, this summer’s drought, and ongoing weaknesses in the energy and high-technology industries have contributed to this slowdown.

• Although office construction in many areas of the Region is at or near its previous cyclical peak, construction and absorption rates for new office buildings continue to remain high. However, projected slower office employment growth may result in some weakness for this market segment in 1999.

• Fueled by rapid growth in commercial real estate lending, four major markets in the Region continue to widen the gap between the nation’s and Region’s levels of commercial real estate activity. Although banks with significant exposure to commercial real estate are performing well, this recent rapid growth bears close monitoring.

Region’s Economic and Banking Conditions

At mid-year 1998, job growth in the Dallas Region was continuing to outpace that of the nation. The differential in growth rates between the two, however, has narrowed substantially as the Region’s economy faces problems in agriculture, energy, and high technology. As of July 1998, total nonfarm employment growth in the Region (year to year) was 3.0 percent, compared with 2.5 percent for the nation. Just a year before, employment growth in the Region was 4.2 percent, versus the national growth rate of 2.6 percent.

Much of the economic slowing in the Dallas Region is attributable to the Asian crisis. The economic fallout from the crisis has manifested itself in several ways. Weaker demand for agricultural and manufactured products has dampened exports to Asia. Agriculture, manufacturing, and wholesale trade in particular have suffered. Moreover, weak industrial production in Asia has resulted in a lower demand for oil, which, coupled with a worldwide oil glut, has pushed oil prices down significantly (see Chart 1).

Not all the news has been bad, however. Two sectors of the Region’s economy doing particularly well are communications and construction. The explosion in cellular technology combined with the rapid growth in Internet use has benefited the communication sector, while low interest rates, corporate relocations, employment growth, and population growth have contributed to the construction sector’s strong performance (see Chart 2).

Chart 1

Oil Prices Have Plummeted 37 Percent since October 1997

$/barrel

Source: The Wall Street Journal

Chart 2

Employment Growth Is Strongest in the Sectors of Construction and Transportation, Communications, and Utilities

Source: U.S. Bureau of Labor Statistics
Most financial institutions in the Region continue to report strong profitability and credit quality thanks to a robust economy and low interest rates. However, not all banks are sharing in the good times; 71 banks with combined assets of $7 billion reported negative return on assets for the second quarter of 1998. As of June 30, 1998, there were 1,487 banks and thrifts in the Dallas Region, down 8 percent from two years earlier. This decrease is largely the result of mergers and consolidations. During the same two years, assets fell 11.5 percent, to $320 billion, primarily because of the consolidation of NationsBank of Texas.

In May 1998 the United States District Court for the Northern District of Texas ruled with the Office of the Comptroller of the Currency in a merger application filed by NationsBank of North Carolina and NationsBank of Texas. The ruling effectively removed the prohibition against interstate branch banking in the state of Texas. Previously, only Texas and Montana had elected to opt out of interstate branch banking in 1995 as part of the Riegel-Neal Act.

Beginning June 30, 1998, the former NationsBank of Texas will report call report data as a branch of the parent bank in North Carolina and therefore will no longer be included in the Dallas Region’s banking data. This change will remove almost $63 billion in assets from the aggregate call report data and will affect the comparability of several of the Region’s and particularly Texas’s aggregate bank performance ratios. NationsBank of Texas, like many other large financial institutions today, generated relatively high revenues through noninterest income and was less dependent on the interest margin for core earnings. Consequently, its departure will have the effect of increasing the average net interest margin for the Region while lowering its noninterest income as a share of earning assets.

Whether other large banks with out-of-state holding companies will follow NationsBank’s lead is unknown; however, Texas Banking Commissioner Catherine Ghiglieri announced in a May 13, 1998, press release that all state banks would be allowed to engage in interstate branch banking. One consequence of the trend in bank consolidations is the reduction in taxes paid to the state of Texas. The Texas State Department of Banking estimates that NationsBank of Texas alone paid over $10 million in franchise taxes in 1997.

As evidenced by Chart 3, key measures at insured institutions in the Dallas Region remain positive:

- As measured by the return on asset ratio, the Dallas Region’s insured institutions reported profitability similar to that reported by the nation. While the Region enjoys a higher net interest margin than the nation (43 basis points), noninterest income as a percentage of earning assets continues to be almost 80 basis points lower. This fact may simply reflect the relatively small number of large banks headquartered in the Region.

- Net charge-offs increased from 0.32 percent as of June 30, 1997, to 0.42 percent as of June 30, 1998, although charge-offs in the Region were still 14 basis points below the national figure during the latter reporting period.

- Dallas Region banks and thrifts continue to report more equity than their national counterparts. As of June 30, 1998, they reported a leverage ratio of 8.05 percent, 34 basis points higher than the national ratio.
Commercial Real Estate Trends in the Dallas Region

Commercial real estate construction activity is heating up in many of the Region’s markets. There are 534 banks in the Dallas Region designated as commercial real estate (CRE) banks, defined here as banks with CRE, multifamily, and construction loans exceeding either 25 percent of total loans or 200 percent of tier 1 capital. As of June 30, 1998, these banks held almost $30 billion in CRE loans outstanding and $149 billion in assets, or 47 percent of the Region’s banking assets.

On average, these banks held over 34.5 percent of their loans in CRE; 78 institutions reported more than 50 percent of their loans in CRE. The return on equity for CRE banks was 15.74 percent, much higher than that of other banks in the Region. Moreover, CRE banks tended to be more “loaned up” than other banks in the Region (as measured by a loan-to-asset ratio of 59 percent versus 56 percent for the Region as a whole, but still below the national average of 61 percent). CRE banks were in line with the nation in leverage (7.88 percent versus 7.71 percent), past-due rates, and charge-offs.

Many banks in the Region have rapidly expanded their CRE portfolios as a result of the Region’s strong economic growth over the past several years. Table 1 shows that CRE banks with under $1 billion in assets in selected Dallas Region markets have increased their exposures to commercial real estate. With the exception of Dallas, each of the selected markets’ CRE loan growth is significantly greater than it was three years ago and more than the current national average for all CRE banks headquartered in metropolitan markets. Dallas CRE loan growth is still well above the national average but is below that recorded in June 1995. Rapid growth in any market segment heightens concerns over the increased risks taken on by lenders. Although banks with significant exposure to CRE are currently performing well, the recent rapid growth in CRE lending warrants close monitoring of these exposures, especially as signs of a softening economy are emerging.

Office Construction Remained Strong in 1998 but Is Questionable in 1999

For many, the real estate-related banking crisis of the 1980s is still a painful memory. Although the economy has returned to vibrancy and commercial office construction has resumed its rapid growth, some analysts are cautioning against what they believe to be the early signs of overbuilding in some of the Region’s major markets.

Austin. The Austin economy is one of the fastest growing in the nation. Although housing construction has cooled off in the past year, commercial construction remains robust. During the past two years, the supply of available office space increased by about 1 million square feet while absorption totaled approximately 2 million square feet. As a result, Austin’s metropolitan office vacancy rate has fallen from 9.8 percent in June 1996 to 5.2 percent in June 1998—among the lowest in the nation.

<table>
<thead>
<tr>
<th>CRE Banks for Selected Dallas Region MSAs*</th>
<th>Austin</th>
<th>Dallas</th>
<th>Denver</th>
<th>Houston</th>
<th>CRE Banks in all U.S. MSAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Banks under $1 Billion)</td>
<td>JUNE '98</td>
<td>JUNE '95</td>
<td>JUNE '98</td>
<td>JUNE '95</td>
<td>JUNE '98</td>
</tr>
<tr>
<td>Number of Banks</td>
<td>16</td>
<td>19</td>
<td>59</td>
<td>62</td>
<td>31</td>
</tr>
<tr>
<td>CRE Loans/Total Loans</td>
<td>48.5%</td>
<td>42.9%</td>
<td>44.7%</td>
<td>33.7%</td>
<td>43.6%</td>
</tr>
<tr>
<td>CRE Growth over Prior Year**</td>
<td>27.8%</td>
<td>15.1%</td>
<td>26.4%</td>
<td>33.6%</td>
<td>36.7%</td>
</tr>
<tr>
<td>Total Loan Growth over Prior Year**</td>
<td>10.6%</td>
<td>14.5%</td>
<td>20.8%</td>
<td>29.1%</td>
<td>26.2%</td>
</tr>
</tbody>
</table>

* MSA = Metropolitan Statistical Area
** Analysis limited to institutions identified as CRE banks as of 6-30-98; growth measures reflect year-ending calculations as of 6-30-98
Source: Bank and Thrift Call Reports
Currently, 6.6 million square feet of office space is in various planning stages in Austin. However, the recent turmoil in Asia, with its negative impact on the area’s semiconductor industry, is likely to lead to a slowdown in other sectors of Austin’s economy. The recent turbulence in the stock market also could have negative repercussions. High-tech stocks are particularly vulnerable to swings in the market, and many high-tech firms rely on their share prices to pursue further research and development as well as reward their employees with stock options.

Although long-term prospects look good for the Austin economy, some analysts expect substantially slower job growth in 1999 and 2000 caused by problems overseas and weakness in the semiconductor industry. In the short term, office absorption and office completions are expected to weaken, with office vacancy rates rising slightly over the next year or two.

**Dallas.** According to Cushman & Wakefield, office construction activity in the Dallas area accelerated in early 1998, with approximately 10 million square feet of office space under construction. Four to five million square feet is expected to be completed this year. The demand for office space in the Dallas market is expected to remain strong throughout 1998, thanks to corporate relocations and robust job growth.

However, most analysts expect growth in the Dallas economy to slow in 1999. Indeed, the metropolitan office vacancy rate in Dallas is beginning to rise— from 14.6 percent as of March 31, 1998, to 15.4 percent just three months later (see Chart 4). Account-

**Houston.** Houston is experiencing one of its strongest years of job growth in this decade. Despite the recent woes in energy, Houston employment in the first five months of 1998 grew at a rate of 4.8 percent. As a result, demand for office space is strong. Nearly 6 million square feet of office space was absorbed in the Houston office market in 1997 (see Chart 5), and absorption is expected to remain strong in 1998. Downtown office rents have reportedly increased by more than 15 percent as a result of the strong growth in employment and the relocation and expansion of various companies.

With oil prices so weak, however, Houston is unlikely to maintain its current rate of employment growth into the second half of 1998. Houston’s dependence on energy is still great, and later this year its economy is likely to feel the effects of the steep drop in oil prices. Moreover, merger activity in the energy, high-tech, and utilities industries is expected to result in job losses, curbing the demand for office space somewhat. Most analysts expect job growth in Houston to slow further in 1999.

**Denver.** Denver’s economy continued its rapid growth in the first half of 1998, with employment expanding at
a rate of almost 5 percent. Construction is booming and several major office projects are under way. Absorption of office space remains strong, forcing up rental rates and pushing the office vacancy rate down to 7.9 percent by the end of June 1998. With office vacancies so low and job growth strong, new office construction is expected to continue its strong pace for some time.

Denver’s buoyant economy and rapidly growing telecommunications and financial services industries will likely contribute to the growing demand for office space in the near term. Absorption rates appear to be keeping pace with the amount of office space completed. Still, more than half of Denver’s office space under construction was labeled speculative in the first quarter by Grubb & Ellis.

**Continued Rapid Growth in Demand for Office Space Questionable in 1999.** Demand for office space in all four major markets in the Dallas Region likely will exceed supply in 1998, pushing office vacancy rates down and rental rates up. Office construction, however, is approaching previous cyclical peaks in these markets.

Two major trends have contributed to the recent boom in office construction. The first was the lack of net new supply of office space added during the first half of the 1990s. Approximately 58 percent more net new office space was added to these four markets in 1996–97 than in the previous six years combined. The recent office construction boom is an attempt on the part of developers to make up for the lack of office construction earlier this decade.

Second, office employment growth during this expansion, which has actually exceeded total nonfarm employment growth, is fueling the demand for new office space (see Chart 6). In particular, the Region’s financial services and business services sectors have recorded exceptional job growth rates.

These two factors have resulted in declining office vacancy rates and rising rental prices throughout much of the Region. However, the demand for office space is expected to slacken next year as problems in the energy and high-technology sectors cause office job growth to slow.

**Construction Lending in Key Dallas Region MSAs Is Twice the National Average**

Construction lending as broadly defined in Bank and Thrift Call Reports includes construction lending for offices, warehouses, multifamily units, and residential structures. Chart 7 (next page) shows the trend in construction loans divided by total assets for the Austin, Dallas, Denver, and Houston metropolitan statistical areas (MSAs) compared with a standard of twice the national average. Only banks with under $1 billion in assets headquartered in the Dallas Region are included in this analysis, as they are more likely to underwrite loans in their immediate area. As evidenced by Chart 7, the selected MSAs in the Dallas Region exceed the standard by a wide margin, in some cases by as much as 3 percentage points. Even though the metropolitan economies in the Dallas Region are enjoying unprecedented growth and strength, the growth in the construction sector and construction lending has been quite dramatic. While a high construction loan-to-asset ratio does not necessarily mean that banks are at risk, it does indicate a need for caution.

**Implications:** The U.S. economy remains strong as it enters its eighth year of economic expansion. As long as absorption continues at its current levels, the existing rate of office construction can be maintained. However, some of the Region’s key economic drivers that influence demand for office space—such as oil and high

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**Chart 6**

*Office Employment Grew More Rapidly than Total Employment from July 1993 to July 1998*

- Office employment consists of the finance, insurance, and real estate sectors; business services; legal services; and professional services.
- Total employment is nonfarm employment less office employment.
- Source: Bureau of Labor Statistics
technology—are under pressure from oversupply, decreased Asian demand, and rapid consolidation. Continued weakness in these sectors may put the present pace of absorption at risk. A more general slowdown in economic activity could further reduce absorption rates.

Local lenders face increasing competition for financing from nonbanks, real estate investment trusts, and money center banks. Competition often reduces net interest income spreads and may lead to falling underwriting standards as bankers seek to maintain, or grow, market share. Evidence of falling standards seems to be mounting: The FDIC’s March 1998 *Report on Underwriting Practices* is consistent with other regulatory assessments and anecdotal reports of loosening underwriting standards in construction lending. Bankers must always maintain prudent credit underwriting standards. After seven years of economic prosperity, however, they may also need to consider asset valuations and repayment sources under an alternative economic scenario that might include slower economic growth.

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