Regional Outlook

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In Focus This Quarter

■ ***Will Credit Scoring Transform the Market for Small-Business Lending? -*** **In an effort to reduce the cost of small-business lending, some institutions are using credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios, in some cases venturing into markets well beyond their local economies. The ramifications could be significant. An overreliance on credit scoring models could expose lenders to increased credit risks. Over time, the traditional niche enjoyed by small banks in small-business lending could come under considerable pressure.** *See page 3.*

■ ***Banking on the Internet: New Technologies, New Opportunities, New Risks -*** **Internet banking promises a wide range of new benefits. It also offers a host of new problems and some new twists on old ones. The tradeoff is one that depository institutions and regulators alike must grapple with as they stake out their positions in cyberspace.** *See page 7.*

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Will Credit Scoring Transform the Market for Small-Business Lending?

- **Small-business lending, traditionally a segment in which small banks have enjoyed comparative advantages, is receiving greater focus from larger banks and nonbank financial companies.**

- **Some insured institutions are beginning to rethink traditional approaches to small-business loan underwriting to include the use of credit scoring models.**

- **The use of small-business lending credit scoring models, while providing banks opportunities for underwriting and servicing efficiencies, carries with it a number of potential risks.**

Background

As of 1994, there were more than 22 million small businesses in the U.S., making this a very attractive potential market for lenders. Small-business lending has been a line of business in which small banks have been very successful given their traditional strong niche in relationship banking. Small-business lending traditionally has been a relatively cost-intensive lending segment, since origination costs are spread over smaller loan balances. Some institutions are now beginning to use credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios. A number of larger banks, especially, appear to be looking to the efficiencies of credit scoring to help provide quick loan approvals and more competitive loan rates. With the aid of this technology, some institutions are rapidly expanding their loan portfolios, in some cases venturing into markets well beyond their local economies.

Commercial bank small-business lending exposures in the New York Region considerable. (For purposes of this article, small-business lending refers to loans categorized as commercial and industrial loans with original amounts of $1 million or less reported on the June Call Reports.) At midyear 1996, commercial banks in this Region reported $29 billion of small-business loans, amounting to 13 percent of all commercial and industrial loans. As shown in Table 1, there are 103 banks in the Region with small-business loan exposure exceeding 100 percent of equity and 23 banks with exposure exceeding 200 percent of equity. Given the level of lending exposures, increased usage of new credit scoring technology could have a significant effect on small-business lending in the Region.

In the New York Region, as well as the nation, many large banking companies have announced nationwide

Table 1

Banks With Concentrations in Small-Business Loans

	Exposure Greater than 100 Percent of Equity		Exposure Greater Than 200 Percent of Equity	
	Number of Banks	Combined Total Assets ($Millions)	Number of Banks	Combined Total Assets ($ Millions)
Washington, D.C.	5	$660	2	$447
Delaware	1	59	0	0
Maryland	16	1,925	7	605
New Jersey	21	3,124	2	283
New York	30	6,494	6	565
Pennsylvania	25	4,763	5	668
Puerto Rico	5	1,884	1	199
Totals	103	$18,809	23	$2,768

Source: Bank Call Reports

programs to increase their share of small-business lending. These programs may have been prompted by the new credit scoring technology. Several of these companies reportedly are offering pre-qualified and pre-approved lines of credit to small businesses through the use of credit scoring technology.

The Growing Importance of Credit Scoring

While credit scoring technology is not new, until recently it typically has been associated with consumer lending, particularly with credit card lending. Primarily using credit bureau information, credit scoring provides lenders with a tool to rank risks or probabilities of default, assigning statistically derived numerical ratings or scores based upon a borrower's past experience with paying debt. Based upon the enormous volume of historical information on consumers contained in credit bureaus, model developers link incidences of good and bad credit performance with borrower characteristics. Applicants then are compared to these credit performance indicators in order to make credit extension decisions. While credit scoring has helped consumer lenders reduce origination costs and to grow receivables at rapid rates, the recent rise in credit card charge-offs has raised concerns about the effectiveness of such models, or at least about how the models are being used.

Small-business credit scoring is a relatively new concept in scoring technology, but is gaining more attention from lenders. *Small-business credit scoring models are similar to consumer credit scoring models in one significant aspect -- the most important indicator of credit performance is the credit profile of the principals of the business derived from consumer credit bureau information.* Other business information from companies such as Dun and Bradstreet Corporation and Experian (formerly TRW) also is used in the scoring process.

A primary vendor of these scoring models has cited analysis purporting to show that business financial statement information did not prove a useful indicator of credit performance for small-business loans. The reasons for this result may be due to inconsistency in financial statement quality and the difficulty in separating business entity cashflow information from the business owners' activities. Also, the relative importance of principals' credit history and financial statement information in predicting credit performance was found to change somewhat with the size of the business -- the larger the business the more important financial statements become in assessing performance.

Many institutions cite the potential cost savings involved in the underwriting process as one of the most significant characteristics of credit scoring. In many cases, with scoring technology, loan application processes have been streamlined to one page forms for loans up to $50,000, not dissimilar to that of consumer loan applications. In some cases, financial statements are not required at all. Reducing paperwork helps to reduce both processing time and costs. Table 2 illustrates how scoring has changed underwriting practices, as reported by one large bank at a recent conference on credit scoring. While it is impossible to know whether the information presented in Table 2 is representative of the way most institutions are using credit scoring models, it is clear that credit scoring may represent a significant departure from traditional underwriting methods.

Part of the reduction in underwriting costs may come from improvements in the allocation of underwriting resources. It has been argued that credit scoring allows banks to more easily identify those applicants which are clearly either approvals or denials. This process would enable banks to reallocate their underwriting resources more efficiently to those loans which pose intermediate risks and require closer attention. Other advantages of credit scoring systems that often are cited are greater consistency in underwriting, better measures for pricing strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

Table 2

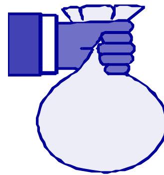
Small Business Lending: Credit Scoring versus Traditional Loan Underwriting

	1993	1996	1997
Percent of loans requiring annual financial statements	100%	20%	--
Percent of lines reviewed annually	100%	0 - 5%	--
Processing time for loans of $50,000 - $250,000	3 days	1 day	1 hour

Source: Reported by a Large Bank at a Recent Conference on Credit Scoring.

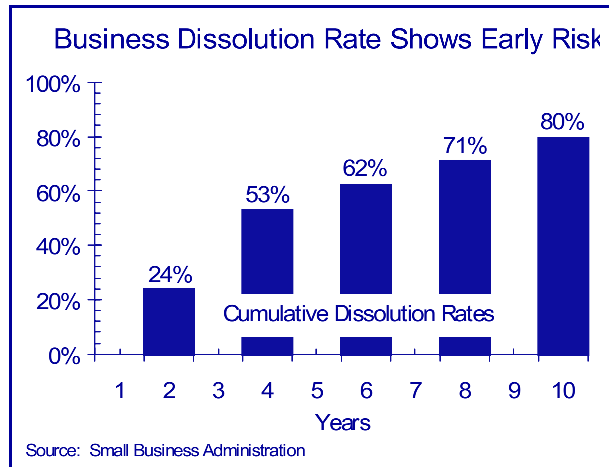
Small-business lending has historically been a profitable area of bank lending. This situation is most likely attributable to lenders thoroughly analyzing potential customers, persistently monitoring their performance, and building solid lending relationships. Credit scoring for small-business lending raises the possibility that some banks will forgo the traditional underwriting concepts of relationship lending in favor of a more mass-marketing approach, in a manner similar to credit card lending. To the extent that credit scoring is used to rapidly gain new customers by either targeting out-of-territory customers, or customers with less business experience, the risk profile of an institution's small-business lending portfolio may change. Any such change in profile may be significant due to the risks associated with newer borrowers. For example, new firms tend to fail at an extremely high rate, with 53 percent of new businesses failing within the first four years of inception (see Chart 1). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

There are potential dangers associated with placing undue reliance on credit scoring models. *The predictive value of any credit scoring system may be substantially diminished if the model is used for unintended purposes or customer types*. Therefore, misuse of a scoring system could expose an institution to considerable losses. Since only the largest banks have small-business loan portfolios large enough to create statistically valid scoring models customized for their own customer base, smaller companies should be especially aware of potential misuse. This risk takes on added meaning when one considers that a $1 million small-business loan represents substantially more capital to a $100 million bank than to a $10 billion bank. Adding further uncertainty, small-business credit scoring has been implemented during a period of relatively strong performance by businesses, with commercial and industrial loan delinquency ratios near historical lows. How well these models perform during an economic downturn remains to be seen.



Depending on the manner in which it is implemented, credit scoring for small-business lending may represent a fundamental shift in underwriting philosophy -- *viewing a small-business loan as more of a high-end consumer loan and, thus, granting credit more on the strength of the principals' personal credit history and less on the financial strength of the business itself.* While this may be appropriate in some cases, it is important to remember that the income from small businesses remains the primary source of repayment of most loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

Chart 1



Competitive pressures in small-business lending are increasing not only because of large banks' efforts to expand their lending but also because of greater participation in the market by nonbank financial companies. Several large firms, such as American Express, AT&T, the Money Store, and GE Capital Services, are expanding their business lines to service the needs of small businesses. These companies are offering small-business credit cards, innovative new types of credit, and other services such as consulting, accounting and investment services. Some observers have suggested that the cost advantages of credit scoring may cause small-business lending in the future to be dominated by 12 to 15 large banks or financial firms. Faced with stiff competition, there may be strong motivation for some banks to increase the dollar threshold on low documentation loans, streamline the process for larger loans, or lower credit scoring thresholds for loan approvals.

The most recent ***FDIC Survey of Underwriting Practices*** and the ***Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices*** both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth goals were seen as the main reasons for easing in these cases. With regard to small-business credit scoring techniques, the Federal Reserve survey pointed out that banks were most commonly using credit scores for automatic acceptance or rejection of loans up to $50,000.

Summary

Credit scoring has the potential to transform the market for small-business lending. The traditional niche enjoyed by small banks in this area may come under tremendous pressure from larger banks and nonbank companies employing this new technology. Credit scoring at a number of institutions is driving dramatic changes in underwriting methods for small-business lending. These changes may facilitate short-term revenue generation as business can be expanded rapidly and underwriting costs can be slashed. It is extremely important, however, that banks understand and control the potential risks inherent in such a strategy. The application of credit scoring to small-business lending merits the close attention of both bankers and their supervisors.

Andrea W. Bazemore, Banking Analyst

Banking on the Internet

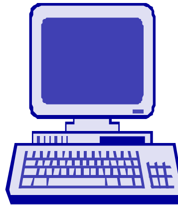
New Technologies, New Opportunities, New Risks

- **Despite the potential for lower transaction costs, increased efficiency, and greater asset diversification, few banks do business through the Internet.**

- **Although *competitive risks* are pushing banks to create an Internet presence, *operational risks* remain an obstacle to actually using those sites for moving information or money.**

- **The FDIC's Division of Supervision recently released examiner guidance on Internet banking and is developing training programs for its examiners.**

The Allure of Cyberbanking

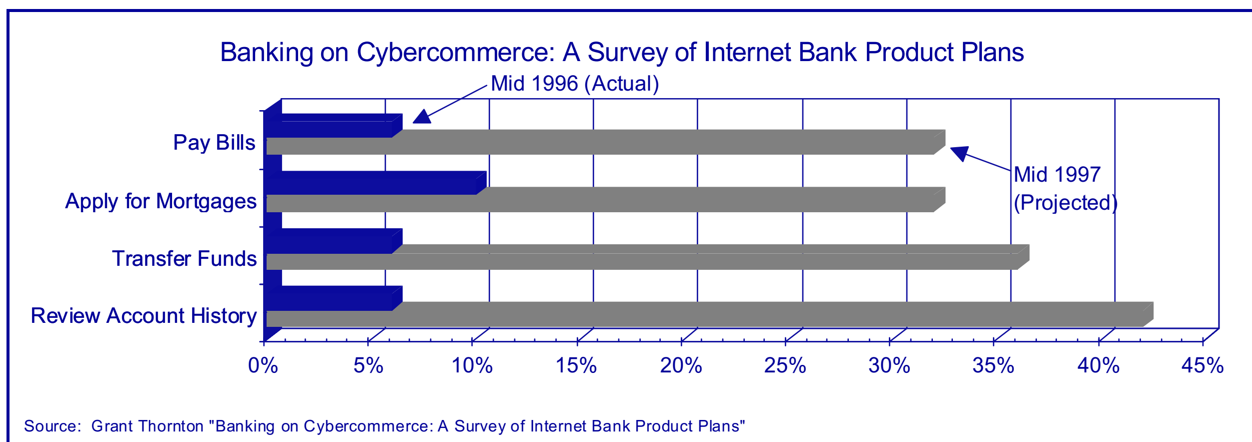


On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking,* is of particular interest to banks because it exploits an existing and geographically extensive public network infrastructure and promises a range of new operating and marketing benefits. One such benefit is the ability for an institution to expand its trade area to include other cities, states, regions -- or even countries -- without a commensurate expansion of its branch structure. This greater geographic reach can do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. A March 1996, study by ***Booz, Allen & Hamilton Inc.*** estimated an average Internet transaction cost of $0.01 compared to $0.27 for an ATM, $0.54 for a telephone, and $1.07 for a full-service branch.

Slow Migration to the Future

Another 1996 study, this one by ***Grant Thornton*** in July (see Chart 1), found that despite these potential benefits, most banks established an Internet presence for appearance's sake -- being perceived as a leader, advertising bank services or staying abreast of competitors -- rather than with an intent to grow deposits or capture the transaction economies that cyberbanking could provide. Of the 44 Internet institutions surveyed, only one in three expressed intentions to begin offering bill payment or funds transfer over the Internet by the end of the second quarter of this year. Even this subdued enthusiasm now appears optimistic. Despite the perceived benefits and the scarcity of competition, few banks have to date ventured into this area in a meaningful way. According to the ***Bankweb*** world-wide web site, only 800 or so banks -- less than 1 percent of the industry -- have an Internet site and only 18 of those permit transactions. In the New York Region, 114 institutions have an Internet presence but only three allow customers to pay bills or

Chart 1



transfer funds. A major question, then, is why so few institutions have chosen to exploit this medium?

Risk

The reason is risk. Banks are familiar with the control of exposures found in proprietary or private payment channels, but they are less comfortable with the new risks attendant to a public network. On one hand, there are *operational* exposures that convincingly argue against rushing headlong into cyberspace. On the other hand, there are *competitive* risks. Nonbank competitors with strong foundations in cybertechnology pose a budding threat to the banks' historical payment-services monopoly and argue with equal authority for an immediate Internet presence to gain or preserve market share. These opposing forces help explain the large numbers of banks establishing web sites that stop short of actually moving information or money.

Of these two types, operational risks are the most immediate and command the most attention. They derive from the formative state of both the technology supporting on-line commerce, and the legal and regulatory structure governing its use. These risks include theft or misappropriation of internal data or external transmissions, transaction fraud, errors in underwriting virtual transactions, liquidity shortfalls, changing technical standards, inadequate or geographically inconsistent regulatory and legal infrastructure, noncompliance with existing laws or regulations that were not designed for an on-line world, and damage to an institution's reputation from the realization of any or all of these risks (see ***Some Concerns or the CyberBanker,*** right).

Systemic Threats and a New Payments Model

In addition to bank-specific risks there are the systemic threats that a public domain payments model could bring. One of the key features of the Internet is redundancy. Any one of a large number of possible paths can be used for a given transaction and therefore the failure of any one path or node will not affect the functionality of the network as a whole. This feature presents a multitude of new and -- from a banker's perspective -- previously unconsidered points of vulnerability to technologically-sophisticated miscreants. In a cyberworld of small value transactions, the effects of an attack may not be much more severe than those which accompany credit card crime. However, there is good reason to expect that Internet transaction sizes will continue to grow. According to one software vendor,

Some Concerns or the CyberBanker

Internal Data Security. The Internet cannot distinguish between customers and criminals. Invasive attacks can range from simple vandalism to theft or destruction of proprietary operating or customer data. Firewall software, data encryption, specialized hardware configurations and commercial insurance can limit such exposures.

External Transmission Security. Because the Internet is an open network, transaction messages are completely exposed, rendering them vulnerable to theft or tampering. Message encryption is a common response, but hardware or implementation flaws can circumvent it. This threat will increase greatly if large value or interbank transactions migrate to the Internet.

Transaction Fraud. Fraud takes two forms: misrepresentation during a transaction or repudiation following it. This problem takes new dimensions in cyberspace because no physical relationship with a customer exists. Encryption protocols which include digital signatures are one response. Biometric authentication schemes, the most commonly proposed being fingerprint or retinal verification, are another.

Difficulties with Virtual Underwriting. Even if your cyberborrowers are who they claim to be, there remain difficulties in establishing their creditworthiness. The lack of a personal relationship is one factor. The limited knowledge of local employers and credit grantors that appear on applications is another. Such difficulties could hasten and heighten dependency upon credit scoring models.

Liquidity Risks. Internet transaction volume and velocity are expected to increase rapidly, potentially creating transactions which occur so rapidly as to exceed immediate bank liquidity. Denial of service attacks, where a site is intentionally deluged with transactions in order to shut it down, also can affect liquidity if affected customers decide to close their accounts.

Lack of Technical Standards. An institution building an early presence on the Internet is making a financial bet as to which standards will endure.

Lack of Regulatory and Legal Infrastructure. Regulators are waiting and observing. Future promulgated "best practices" may not be those which an institution has already adopted. Similarly, a lack of legal precedent hinders criminal and civil prosecution of cybercriminals. Even where precedent exists, it is frequently inconsistent across jurisdictions.

Reputation Risk. An image of solidity is a cornerstone of banking. Internet banking confronts banks with more exposure and potentially greater publicity about losses.

Competitive Risks. Unlike the operational risks discussed above, competitive risks accrue to institutions not securing an Internet foothold. They involve the threat of lost market share or payment system position to more aggressive peers and nonbank competitors.

inter*branch* payments on the Internet are likely to begin in 1997 with inter*bank* activity to follow a year or so later. This development would be a significant evolution because wholesale transactions are generally large relative to bank liquidity. An attack or disruption of the Internet payments mechanism for a single large transaction could conceivably pass liquidity shocks to other banks in the same way that bad weather at a major airport can disrupt air traffic throughout the country.

New Technologies, Old Reporting

The advent of fully transactional web sites also could heat up bank competition for low cost deposits and frustrate regulatory oversight in the process. One possibility is a "deposit arbitrageur," a hybrid of brokered deposits and program trading in which a computer program could search the Internet for the highest deposit rates and immediately reallocate deposits accordingly. In the long run, such activities could harmonize local interest rates. In the short run, however, this rapid turnover could mean substantial liquidity drains on institutions accustomed to local deposit monopolies. From the regulatory perspective, this transaction velocity -- and its potential to rapidly alter bank balance sheets -- could present new challenges in a world of quarterly Call Reports and examination intervals that can exceed one year.

FDIC -- the CyberRegulator

New risks demand new supervision techniques and the FDIC's Division of Supervision (DOS) has responded with their recently-released electronic banking safety and soundness examination guidance. Under that guidance, institutions having Internet sites are placed into one of three tiers based upon the "maturity" of their site. Safety and soundness examination procedures focus on bank policies, procedures and planning. The examination procedures are cumulative -- meaning that each successive tier adds an additional level of scrutiny to the tiers below -- and do not require a technical knowledge of Internet systems. "Information Specialist" involvement also varies by tier (see Table 1). A DOS training program for all safety and soundness examiners already has begun, and technical training for information systems specialists is being developed. A new specialty, the electronic banking Subject Matter Expert, also is being established.

Measured Steps in a New Environment

Banks increasingly are becoming distributors of commodity-like products. As such, profitability may become dependent upon both cost efficiencies and high volume -- a combination sometimes argued as inconsistent with high-cost branch structures. Internet banking offers institutions a means to compete in this new environment. It also offers new risks. Recognizing this tradeoff, many banks have entered this realm with measured steps. Those who have not face risk of a different sort. They face instead the risk that their competitive position will pass to more innovative competitors -- competitors with new technologies and the drive to accomplish old business in thoroughly new ways.

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Table 1

The Division of Supervision Classifications for Internet Banks

	Level 1	*Level 2*	*Level 3*
Description	An information-only site	A site permitting electronic submission of loan or deposit applications	Transactional site offering electronic bill payment or funds transfer services
Specialist Examination Requirement (in addition to Safety and Soundness Exam)	Information Specialist review required only if site is tied into internal bank systems.	Consultation with Information Specialist required to determine if further review is warranted.	Concurrent Information Specialist Examination required.

For More In ormation:

Division o Supervision

DOS currently is implementing examination guidance for safety and soundness examiners and developing training for technical specialists.

Cynthia Bonnette, Examiner
Chairman, New Banking Technologies Task Force
(202) 898-6583

Stephen White, Information Systems Review Examiner
Chairman, Information Systems Subcommittee
Federal Financial Institutions Examination Council Task Force on Supervision
(202) 898-6923

Division o Compliance and Consumer A airs

DCA is reviewing new banking technologies from a consumer protection, fair lending and CRA perspective to provide guidance on compliance matters. DCA also is coordinating outreach efforts with consumer community groups.

John Jackwood, Special Assistant to the Director
(202) 942-3854

Regional O ice Contacts

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John Soffronoff, Review Examiner
Division of Compliance and Consumer Affairs
New York Regional Office
(212) 704-1405

O ice of Policy Development

OPD provides leadership in developing FDIC policies, including those addressing new banking technologies. The office coordinates several interdivisional electronic banking efforts and represents the FDIC on the interagency U. S. Treasury Consumer Electronic Payments Task Force.

Sharon Powers Sivertsen, Director
(202) 898-8710

Related Web Sites

FDIC	http://www.fdic.gov
FFIEC	http://www.ffiec.gov
NETBanker	http://www.netbanker.com
Bankweb	http://www.bankweb.com
National Computer Security Assoc.	http://www.ncsa.com
RSA Data Security Inc.	http://www.rsa.com
Smart Card Resource Center	http://www.smart-card.com
American Bankers Association	http://www.aba.com

Economic Recovery Continues in the New York Region

- **The New York Region is slowly recovering from the early 1990s recession, although growth rates throughout the Region are uneven.**
- **The Region has added a large number of jobs since the last recession. Despite the employment growth, the New York Region continues to lag the nation in job creation.**

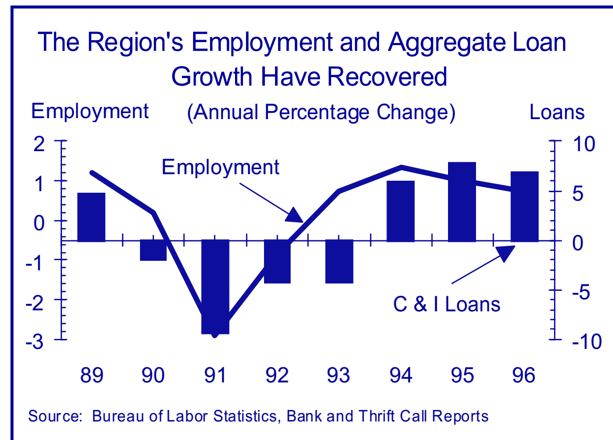
Economic trends indicate that the New York Region has recovered from the last recession and is expanding moderately. Commercial and industrial (C&I) loan growth in insured institutions in the Region also has rebounded modestly, signaling that the climate for banks has improved somewhat. However, while certain areas of the Region are strengthening, other parts are growing less rapidly. Upstate New York, in particular, is showing signs of weakness.

Region Continues Along Road to Recovery

Since the end of the 1990-1991 recession, the New York Region has added over 830,000 new jobs to its employment base, representing growth of 4.2 percent. After four consecutive years of negative growth, aggregate C&I loan growth has bounced back into the positive. Chart 1 relates aggregate growth in Region's C&I loans to employment growth in the Region. Both measures show a recovery and expansion from the early 1990s recession.

However, job growth within the Region has been uneven. The smaller states and jurisdictions such as Delaware and Puerto Rico have performed the best. Both have added more than 10 percent to their employment bases over the period 1991 to 1996. For example, employment in the **Wilmington** area has risen by over 11 percent. Delaware has benefited from favorable tax policies that have attracted out-of-state banks and financial corporations. **Puerto Rico's** economy has been helped by a 23 percent increase in service jobs and a 19 percent increase in trade jobs. However, despite the improved employment growth, Puerto Rico's economic performance remains inconsistent. A large percentage of the population still receives some form of public assistance.

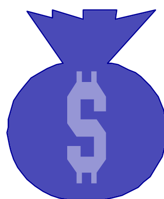
CHART 1



The larger states have lagged in job creation, with employment rising only 2 percent in New York and 4.4 percent in Pennsylvania over the same five year period. New Jersey and Maryland did slightly better and recorded about 5.5 percent growth. Much of the slower growth in jobs can be traced to the severity of the last recession in the major East Coast urban centers of **New York City, Baltimore, Philadelphia** and **Newark**. In **Baltimore**, employment rose just 3 percent, while **New York City**, after suffering the sharpest job loss in more than two decades, added only about 2 percent to its workforce. In **Newark**, employment has been essentially flat, while in **Philadelphia**, employment has declined by over 4 percent since 1991.

Retail sales are another indicator of a Region's economic health. Rising retail sales point to a generally strengthening business climate. Again, growth has been uneven. In **Pennsylvania,** retail sales were up 5.4 percent in December 1996 compared to a year earlier. In comparison, retail sales throughout the nation rose 4.8 percent over the same period. In **New York**, retail sales nearly matched the national rate of growth with an increase of 4.4 percent over the prior year end. How-

ever, retail sales growth in **New Jersey**, **Maryland** and **Delaware** were mostly flat.



A more recent and interesting development regarding growth in consumer prices is taking place in **New York City** and **Baltimore**. Although consumer prices remain generally higher in the Region than elsewhere, growth rates are moderating in those cities. For example, between December 1995 and December 1996, the U.S. consumer price index rose 3.3 percent. In **New York City**, the change in prices was just 2.9 percent. In **Baltimore**, consumer prices rose only 2.6 percent. If the trend continues, lower consumer prices will help make the Region more competitive for business development and jobs.

Implications: The Region continues along the long road to recovery from the national recession of the early 1990s. The strengthening economy in the New York Region has promoted growth in existing businesses and stimulated new business formation. *For the banking industry, this development has been good news for loan demand and profitability.*

Compared to the Nation, Jobs Growth Still Remains Slow

Despite these economic gains, the Region continues to lag the nation in employment growth. The nation's payrolls have grown three times faster than the Region's since the last recession. This lagging relationship is consistent with long-term trends. Chart 2 shows that the Region's slower job growth relative to the nation has existed for about 15 years. The reasons for these lags are complex and reflect a number of factors which discourage job creation. These factors include:

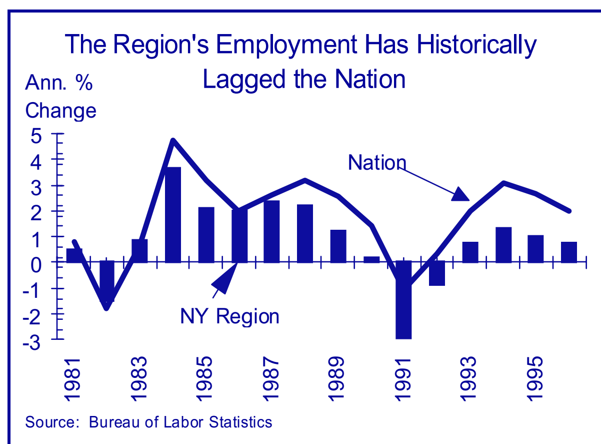
- In general, the Region's population has been growing more slowly than other parts of the nation, such as the southwestern or southeastern parts of the U.S.
- Most of the Region is a "mature economy." Industries and infrastructure are already in place. Land is expensive and the potential for physical expansion is limited compared to other regions of the U.S.
- In general, the Region has higher taxes, energy and living costs than other parts of the nation.
- There is a perception that some parts of the Region, particularly the heavily populated urban areas, offer a lower quality of life compared to other parts of the nation.

Upstate New York Remains an Area to Watch

Upstate New York is generally defined as the area north of the New York City metropolitan area. This area essentially mirrors the territory encompassed by the FDIC's **Syracuse** field office. Originally, upstate New York was a leader in the manufacture of electrical equipment, photographic equipment, paper products and machinery. However, beginning in the 1970s, large numbers of manufacturing jobs were shed to other parts of the nation and the world. More recently, large numbers of service and trade jobs, as well as additional manufacturing jobs, were lost during the last recession. These job losses were caused by a wave of corporate restructurings and downsizings.

Upstate New York continues to exhibit very little economic growth. Since the end of the last recession, the economy of the Region has not benefited from the national economic expansion. For example, housing prices, which are already among the lowest in the Region, are either falling or are flat. In the **Rochester** area, housing prices have risen about 4 percent, but remain well below the average 19 percent rise in the U.S. over the five-year period.
Since 1991, housing prices in the **Albany** area have dropped 5 percent. In the **Syracuse** and **Buffalo** areas, housing prices have moved very little. *To the extent that this continues, mortgage loan demand can be*

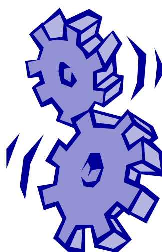
CHART 2



expected to remain flat and banks' collateral positions may weaken.

Employment in the upstate New York area also has shown little growth. In the **Albany-Schenectady-Troy** area, job growth has declined as a result of layoffs in state government. In 1996, Albany lost 4,000 jobs, a loss of about 1 percent of its job base. Economic growth in the Albany area has been weakened by a nominal population growth. With the New York State government continuing to seek reductions in its workforce over the next few years, the outlook for faster employment growth appears limited.

The **Syracuse** area has been hurt by a slowly eroding manufacturing base. The area also has seen slowdowns in trade and construction. Its high utility and corporate tax rates further limit economic growth. Although Syracuse posted a small 3,000 job gain in 1996, less than 1 percent of its employment base, there has been practically no employment growth since the last recession.



Despite a gain of 2,000 jobs in 1996, less than 1 percent of its employment base, the **Rochester** area has a poor record for job creation. Rochester was particularly hard hit by the last recession with large job losses in manufacturing, including extensive downsizing by Xerox and Eastman Kodak. Restructuring in manufacturing industries will limit near term growth. *Rochester's dependence on only a few companies for employment and income also is a source of instability.*

The **Buffalo** area also has exhibited a decline in its employment base. In 1996, Buffalo lost 2,000 jobs, representing less than 1 percent of its jobs base. Its nonseasonally adjusted unemployment rate as of December 1996 stood at 7.1 percent, compared to a U.S. rate of 5.0 percent for the same month. Comments from ***Data Resources, Inc.*** characterize the slowdown as broad based and trace the decline to weakness in the Canadian economy. Trade with Canada is a major component of the Buffalo economy. Overall, Buffalo is dependent on a declining automotive and heavy-machinery manufacturing base that may limit its future economic growth.

Implications: *The upstate New York area has benefited less from the national economic expansion than the rest of the Region. The area's anemic economic performance apparently has affected the demand for banking services.* For example, aggregate C&I loans in the **Syracuse** field office declined 3.6 percent in 1996. Aggregate real estate loans rose only 1.8 percent. If weakening housing and employment trends persist, loan growth can be expected to remain weak.

Norman Gertner, Regional Economist

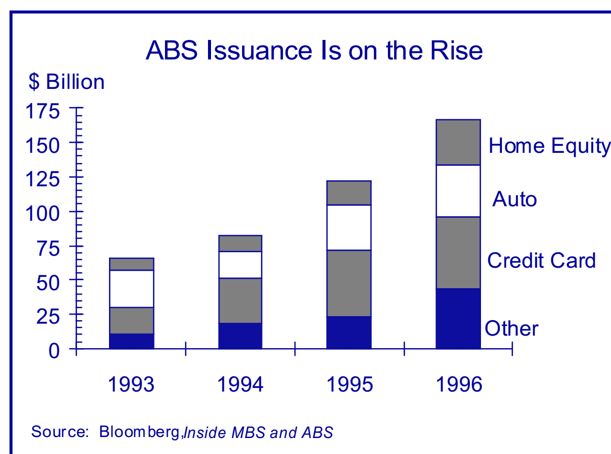
Financial Markets

- **While demand for asset-backed securities continues to be strong, further deterioration in consumer credit quality could have adverse effects on both investors and issuers.**
- **Although there has been little net change in the Treasury yield curve between September 30, 1996, and early March 1997, rates in the 5-year to 30-year segment of the yield curve did fluctuate modestly during this time period.**
- **During the fourth quarter 1996, the S&P Composite Bank Index and the New York Region's Bank Index both outperformed the S&P 500, gaining 12 percent and 13 percent, respectively, compared to an almost 8 percent gain for the S&P 500.**
- **Banks' price/earnings ratios relative to the broader market have been trending upward since 1994, perhaps signaling an improved perception of the quality of bank earnings.**

The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

Asset-backed securities (ABS) are debt securities that are backed by loans such as credit cards, car loans, and home equity loans. Over the past ten years, the ABS market has grown dramatically. In 1996, the issuance of ABS was $167 billion, up from $65 billion issued in 1993 as illustrated in Chart 1. Commercial banks and credit card companies accounted for approximately 35 percent of total ABS issuance last year. Major buyers of ABS were mutual funds, insurance companies, corporations, and foreign and domestic banks. Although it is difficult to quantify the amount of bank investment in the ABS market, market participants have observed that small and midsized banks have recently increased their holdings of ABS.

CHART 1



Monoline credit card banks and large banks with significant credit card operations have been particularly active ABS issuers. Issuing banks generally structure ABS transactions as nonrecourse sales (loans that cannot be "put back" to issuers upon default), which results in the removal of the assets from the bank's balance sheet and lowers capital requirements. In order to receive investment grade ratings on their ABS, issuers must provide credit support either in the form of over-collateralization, reserve accounts, or third party credit enhancement from bond insurers.

Bank issuers benefit from the sales treatment of assets into the security without completely severing their economic interest in the income generated by the assets. The economic interest results when the revenue generated by the sold assets after charge-offs, servicing fees, and interest coupon payment is recognized as income by the issuer. This surplus is referred to as excess spread. Banks that issue ABS usually continue to service the underlying assets, which not only generates servicing income but also permits customer relationships to continue.

Delinquency and charge-off rates rose in 1996 on consumer loans, particularly in credit cards and auto loans. Despite this rise, the difference between ABS and Treasury yields of similar maturity did not increase. As Chart 2 (next page) shows, the average spread to the two-year Treasury note on selected ABS products continued to tighten during 1996. The lack of widening spreads despite the overall weakening in consumer credit quality reflects strong demand from an expanding investor base, which increasingly includes overseas

buyers. Spreads on selected credit card and auto ABS products began to increase during the first quarter of 1997, however, as investors reacted to higher than expected charge-offs reported by some of the larger issuers.

The increasing frequency of rating agencies' reviews for possible downgrades of credit card transactions, as well as problems in the auto finance sector, have raised some concerns in the ABS market. How would a further deterioration in consumer credit affect the ABS market? For the issuer, higher charge-offs, absent a corresponding increase in fees or rates, reduces the excess spread from the ABS. If deterioration worsens, the ABS face potential rating downgrades. This situation may compel the issuer to improve the overall loan quality in the ABS or face what is termed an "early amortization" event. An early amortization event may result in the termination of the ABS issue prior to the maturity date. Once an early amortization occurs, new receivables associated with the accounts in the asset-backed security no longer move into the security but must be funded by the bank on their balance sheet and accounted for in determining capital requirements. In addition, an issuer's access to the ABS market may become more costly after an early amortization if investors demand higher yields on subsequent issues.

For the investor, the threat of a ratings downgrade usually impairs the market value of the security. Investors also may forfeit some interest income in an early amortization because principal may be paid prior to the scheduled maturity date. ABS investors would lose principal, however, only if the deterioration in the quality of the underlying loans is severe enough to deplete the entire credit support. The high level of credit support demanded by rating agencies on existing ABS deals minimizes the risk of principal loss by investors.

During 1996, some bankcard issuers took steps to prevent a ratings downgrade or a possible early amortization. Methods used by bank issuers to support deteriorating ABS have included the sale of new receivables at a discount, the repurchase of low quality receivables from the issue, and the infusion of additional cash into a reserve account of the ABS. However these strategies were specifically cited by the Office of the Comptroller of the Currency (OCC) as actions that could be considered recourse and require full risk-based capital treatment for the assets in the particular ABS issue. The FDIC is working with other regulatory agencies through the Federal Financial Institutions Examination Council (FFIEC) on new Risk-Based Capital Guidelines that are expected to address limitations on post-sale actions and capital requirements for direct credit substitutes or credit enhancements for ABS.

Given the continuing trend of higher charge-offs and delinquencies for credit card loans, investors consider the ABS market less homogeneous in terms of issuer quality and therefore are scrutinizing the securitizations of issuers more closely. Although the risks vary by ABS issuer, banks that issue or invest in the ABS market should be cognizant of the changing market conditions and potential risks associated with ABS.

Changes in Interest Rates and Bond Values

Chart 3 (next page) shows little change in the Treasury yield curve between September 30, 1996, and early March 1997. What this chart does not show, however, is how rates in the 5-year to 30-year segment of the yield

CHART 2

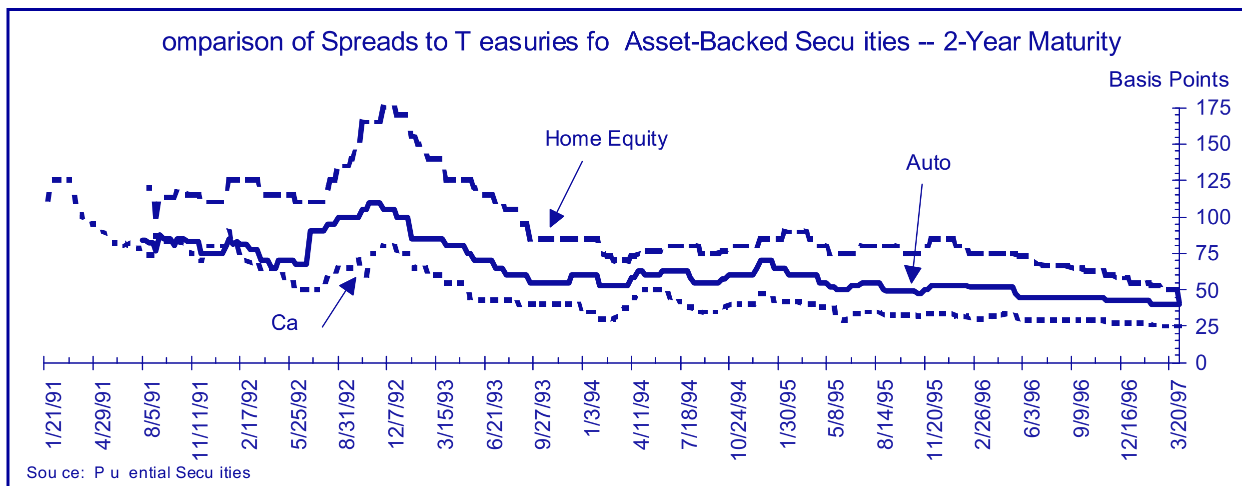


Chart 3

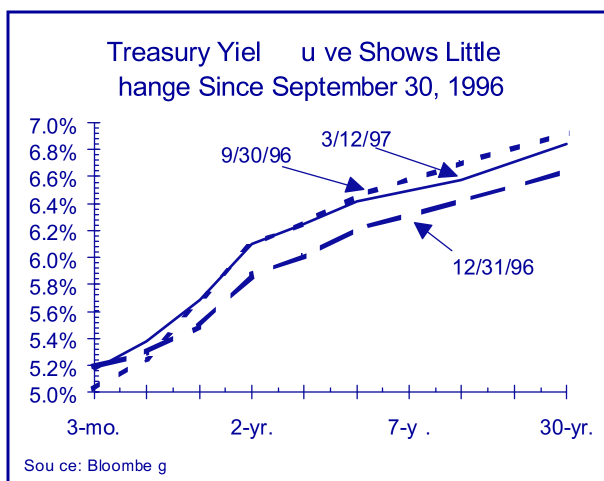
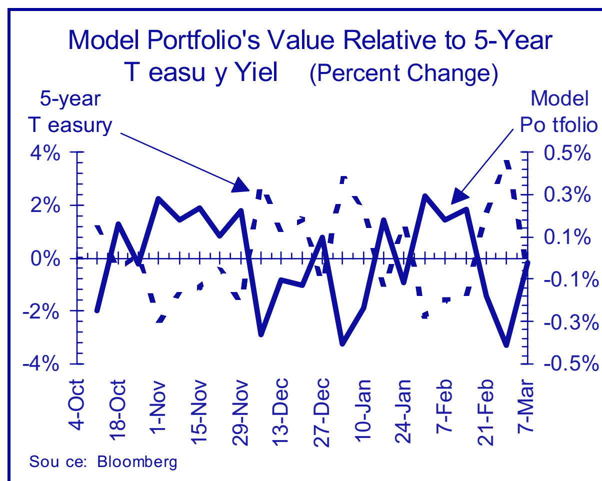


Chart 4



curve fluctuated during this time period. The path of yields on Treasury bonds with 5-year through 30-year maturities changed directions four times, rising or falling by more than 30 basis points. Movements in the shorter segment of the yield curve have been less pronounced.

In order to consider the effect that these rate swings may have had on banks' fixed income portfolios, Chart 4 shows the percent change in the yield on the 5-year Treasury and the percent change in the market value of a model bank portfolio created by the Division of Insurance. The presentation of this model portfolio extends an analysis that was introduced in the first quarter 1997 edition of the ***Regional Outlook***, which looked at the market values of several common fixed income instruments relative to interest rate movements.

In order to enhance the model portfolio's applicability to bank portfolios, the type and amount of the securities chosen for the portfolio are based on an aggregation of securities-related Call Report data. The limitations of Call Report data concerning the maturity distribution of securities required that assumptions be made when choosing the maturity of the securities for the model portfolio. An effort was made, however, to construct a model portfolio that approximates, in the aggregate, the maturity distribution of the aggregate commercial bank portfolio. The model portfolio is shown in Table 1.

As shown in Table 1, the total market value of the portfolio changed less than one-half of 1 percent since September 30, 1996. The portfolio's period-high value, representing a 1.51 percent increase from September 30, 1996, occurred on November 29, 1996, when the 5-year

Table 1

Type of Security	Par Value	Percent of Portfolio	Maturity or WAL	Percent Change from 9/30/96 to 12/31/96	Percent Change from 12/31/96 to 3/12/97	Percent Change from 9/30/96 to 3/12/97
U.S. Treasury 5.6%	2,000	20%	1yr	0.35%	-0.05%	0.30%
FNMA Agency 5.8% Callable	1,200	12%	2yr	0.59%	-0.25%	0.34%
State County Municipal GO 4.8%	800	8%	11yr	1.95%	-0.64%	1.95%
FNMA Mortgage Passthrough 7.5%	3,000	30%	8yr	1.08%	-0.30%	0.78%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5yr	0.58%	-0.68%	-0.10%
Credit Card Asset-Backed Security	1,000	10%	5yr	0.10%	0.00%	0.10%
Total	10,000	100%	4.85yr	0.77%	-0.29%	0.48%

Treasury rate fell to its period-low of 5.83 percent. Observe that, while longer term rates fluctuated modestly over the reporting period, the reasonably short weighted average life (WAL) of the portfolio further moderated the value changes sustained by the portfolio. Changes in the value of the model portfolio demonstrate a higher correlation to changes in the 5-year Treasury yield than to other maturities along the yield curve because the 5-year bond's maturity better matches the WAL of the model portfolio. Even though the 30-year Treasury rate is often cited as a benchmark for daily rate changes, it may not be the most significant rate in assessing exposures of bank securities portfolios to changes in interest rates.

On March 25, 1997, the Federal Reserve Open Market Committee met and raised the target federal funds rate 25 basis points to 5.50 percent. By the following day, the 5-year Treasury yield had risen to 6.66 percent, 23 basis points higher than the 5-year Treasury yield dated March 12, 1997, displayed in Chart 3 (previous page). The rise in rates from March 12 to March 26 caused the model portfolio's market value to fall 0.56 percent to $9,965.

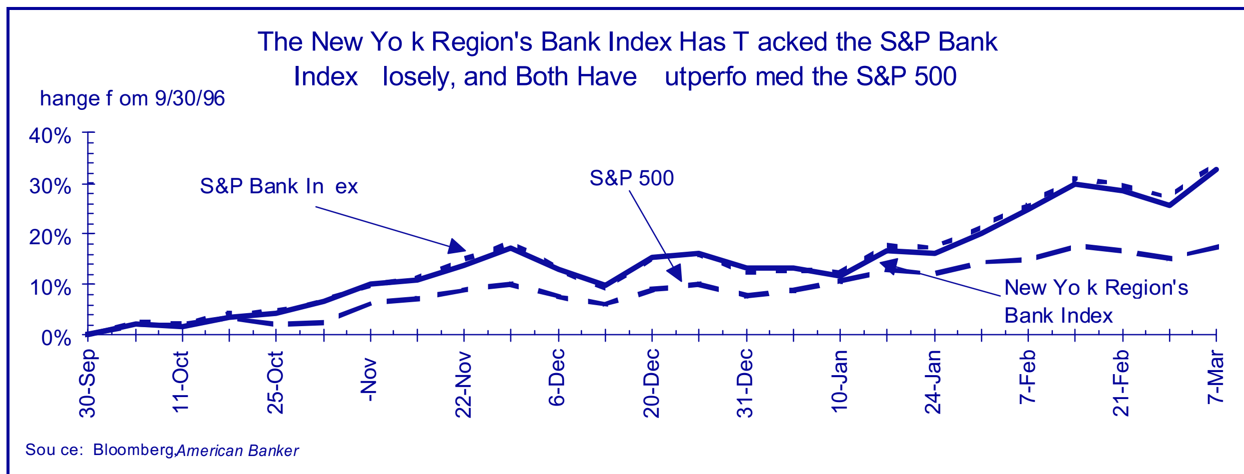
This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect a portfolio's relative volatility.

Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market Improving its Perception of the Quality of Bank Earnings?

During the fourth quarter of 1996, the S&P Composite Bank Index outperformed the S&P 500, gaining over 12 percent compared to an almost 8 percent gain for the S&P 500. The fourth quarter results topped off a year during which the S&P Composite Bank Index gained 37 percent compared to a 20 percent gain for the S&P 500. As shown in Chart 5, the New York Region's Bank Index (NYRBI) gained a little more than 13 percent in the fourth quarter 1996. Moreover, the NYRBI returned 38 percent for the year with performance that tracked closely to the S&P Composite Bank Index. The year's moderate economic growth, contained inflation, and favorable interest rates are credited for providing a friendly environment for bank stocks. As 1997 began with much the same economic conditions, bank equities have continued to do well. Year-to-date, the NYRBI is up over 17 percent compared to an almost 20 percent gain for the S&P Bank Index and a 9 percent gain for the S&P 500 through March 7, 1997.

While appreciating stock prices provide an obvious positive signal about the health of the industry, the market provides other information about the prospects for the industry through the price/earnings (P/E) ratio. The P/E ratio presents the price of a company's stock as a multiple of its earnings per share and is derived by dividing the stock's market value by the company's earnings per share. Typically investors are willing to pay a higher price for a company with earnings that are expected to be consistent and growing. However, firms with more volatile earnings are generally penalized by investors in terms of stock price and lower P/E ratios. Generally, a higher P/E ratio can be interpreted to mean that investors have more confidence in the outlook for

CHART 5

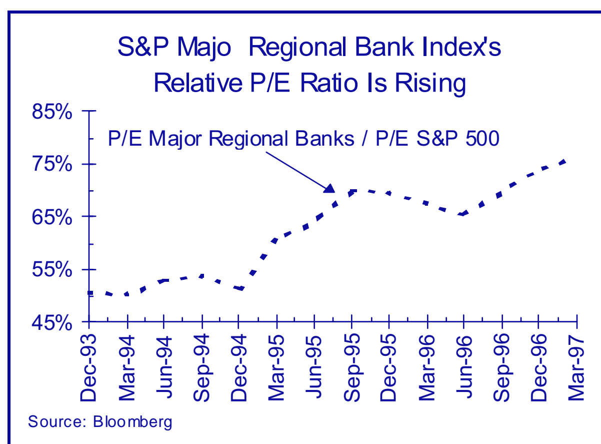


future earnings performance.

The relationship between bank P/E ratios and the P/E ratios for the broader market provides further insight into the market's perception of the quality of bank earnings compared to other firms. Historically, bank P/E ratios have been lower in the aggregate as compared to the rest of the market. The rationale posed for this discounted bank P/E ratio relative to the broader market has been that the primary sources of bank revenue, deposit taking and lending activities, traditionally have been viewed as being more volatile because they are prone to rising and falling with changes in the business cycle. For example, despite recording some of the highest quarterly return on equity averages ever at the end of 1993, the P/E ratio of the major regional bank index was at a level that was still only about 50 percent of the broader market P/E.

Over the past two years the magnitude of the banking sector's P/E discount has declined. As seen in Chart 6, the P/E discount has gone from 50 percent to only 24 percent (a relative P/E ratio of 76 percent). The higher P/E ratio may represent a view by market participants that bank earnings are becoming less sensitive to the business cycle, perhaps as a result of geographic or product-related diversification and more efficient management of overhead expenses. Another factor contributing to higher bank P/E ratios could include speculation on bank stocks as investors anticipate potential acquisitions.

CHART 6



Allen Puwalski, Banking Analyst
Kathy R. Kalser, Chief,
Financial Sector Analysis Section

Current Banking Trends in the New York Region

- **Even as bank consolidation in the New York Region slowed, aggregate transaction value soared, reflecting the number of large transactions completed in the Region during 1996.**
- **Bank mergers with nonbanks, thrifts, and monolines are changing the nature of consolidation in the financial services industry while potentially creating unique risks.**
- **Fueled by merger and acquisition activity, increased investor demand, and greater attention by rating agencies, the banking industry set new syndicated lending records. Banks in the New York Region led the nation in syndicated loan activity in 1996.**
- **The increased volume of syndicated lending activity has resulted in the narrowing of loan pricing spreads. Analysts are watching this market closely for signs that lenders are continuing to be adequately compensated for risk.**

Despite four fewer transactions in 1996, the aggregate value of bank and thrift mergers and acquisitions in the Region increased nearly five times compared to 1995. This statistic reflects the number of large bank and thrift transactions involving banking companies headquartered in the Region (see Table 1). The largest was the Chemical Banking Corporation acquisition of Chase Manhattan Corporation, which closed on March 31, 1996 and had a final value of $13.3 billion.

In the year ending December 31, 1996, 46 transactions, with an aggregate value of $30 billion, were completed involving New York Region banks and thrifts. In 1995, 50 transactions, with an aggregate value of $6 billion, were completed.

Consolidation May Change the Face of the Financial Services Industry

The merger between Morgan Stanley and Dean Witter Discover & Co. was a watershed event for the financial services industry. By combining investment banking, funds management, securities, and credit card businesses, Morgan Stanley has laid the groundwork for a one-stop financial services supermarket. Many analysts speculate that the merger of these firms, which have such different strategies and customer bases, presages the future of the financial services industry.

Market dynamics are compelling banks to become better providers of financial products and services. At

Table 1

Five of the Ten Largest Mergers/Acquisitions Involved New York Region Banking Companies (Transactions Completed in 1996 in Order of Value)

	Buyer Name	Seller Name	Date Announced	Date Completed	Value ($B)
1	Wells Fargo & Co., CA	First Interstate Bancorp, CA	01/24/96	04/01/96	$ 13.708
2	Chemical Banking Corp., NY	Chase Manhattan Corp., NY	08/28/95	03/31/96	$ 13.286
3	First Union Corp., NC	First Fidelity Bancorp., NJ	06/19/95	01/02/96	$ 6.130
4	CoreStates Financial Corp.,PA	Meridian Bancorp, PA	10/10/95	04/09/96	$ 3.434
5	Fleet Financial Group Inc., RI	Natwest Bank NA, NJ	12/19/95	05/01/96	$ 2.700
6	National City Corp., OH	Integra Financial Corp.,PA	08/28/95	05/03/96	$ 2.414
7	Bank of Boston Corp., MA	BayBanks Inc., MA	12/12/95	07/29/96	$ 2.308
8	Washington Mutual Inc., WA	American Savings Bank, FA, CA	07/22/96	12/20/96	$ 2.045
9	Citizens Financial Group, RI	First NH Banks, NH	11/30/95	04/20/96	$ 1.850
10	NationsBank Corp., NC	Bank South Corp., GA	09/05/95	01/09/96	$ 1.739

Sources: Sheshunoff Information Services, Inc.; SNL Securities

a minimum, this means that banks must study and learn from nonbanks and other corporations that excel in financial and other service industries. Ultimately, market forces may drive banks to partner with, merge with, or acquire dissimilar entities to capture new market opportunities.

Analysts predict that commercial banks will take a closer look at thrifts as acquisition targets in 1997, citing several reasons including:

- a diminishing pool of bank acquisition targets;
- growing similarities between bank and thrift products and balance sheets;
- capitalization of the SAIF, which has eliminated a lingering question;
- a recent tax accounting provision allowing acquiring banks to retain deductions taken by thrifts for bad debt reserves in excess of the deduction allowed for banks; and
- the well-developed deposit gathering branch system of many thrifts that may be particularly appealing to banks interested in supplementing their existing branch network.

Mergers between banks and monoline companies have the potential to change consolidation trends in the financial services industry. Monolines are companies that have a singular focus on a specific line of business, such as mortgages, credit cards, leasing, or auto finance. These focused companies often have volume and cost efficiencies in specific business lines which banks desire. Bank One Corporation's announcement of its intention to acquire First USA Inc. may be reflective of a new trend toward monoline acquisitions and consolidation of the credit card industry.

Risks in Newly Merged Institutions Are Unique

The continuing wave of merger and acquisition activity among financial services companies creates a unique set of risks. These risks include the blending of systems, informal processes, and cultures. Those companies most adept at mergers tend to blend cultural sensitivity with clear integration strategies from the outset. ***KPMG Peat Marwick LLP*** presented a framework for evaluating the newly merged institution at the ***Federal Financial Institutions Examination Council EmergingIssues Conference (Multinational).*** The framework emphasizes the importance of :

- the management of the control environment;
- the ability of operations to process expanded volumes accurately and on a timely basis;
- the ability of management to manage a much larger and more complex institution; and
- the infusion of a common corporate culture.

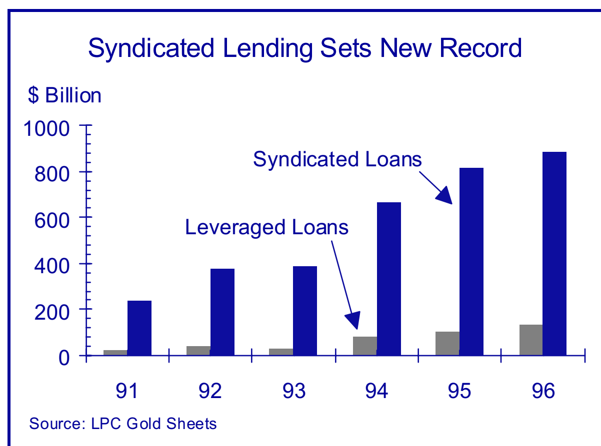
Failure to address these issues beforehand could derail the benefits anticipated from a merger. Time and money could be wasted on integrating incompatible systems. An inability to smoothly blend informal processes and cultures, due to poor planning or unanticipated resistance to change, could create inefficiencies and hurt employee morale. Such scenarios have the potential to cost a newly merged financial institution extra headaches and extra dollars.

Syndicated Lending Activity Soars in 1996

Syndicated loan volume in 1996 totaled $888 billion, nearly 9 percent more than the then-record $817 billion logged during 1995 and easily eclipsing the lofty levels set during the late 1980s. In the fourth quarter alone, banks originated $265 billion in syndicated loans, the most ever for a quarter.

Leveraged lending also has been increasing, though not

CHART 1



at the record levels of the 1980s. During 1996, some $134 billion in leveraged loans were originated, comprising about 15 percent of all syndicated loans. Leveraged loans are made to companies that have high levels of debt and debt service compared to their cash flow. Chart 1 (previous page) shows the growth of syndicated and leveraged lending since 1991.

In 1996, New York Region banks led the nation in syndicated lending activity. According to data compiled by ***Loan Pricing Corporation***, the top three New York Region syndicated lenders alone held over 15 percent of the combined agent and co-agent dollar volume of syndicated loan originations. Additionally, the top three New York Region leveraged lenders held a substantial 32 percent of agent-only leveraged loan originations.

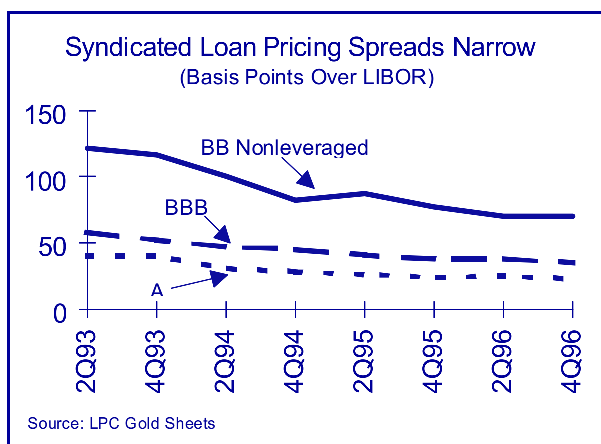
Several factors have contributed to syndicated lending growth. First, and perhaps most important, is rising merger and acquisition activity, which generated about $159 billion of syndicated loans in 1996. Although equity is still the preferred choice for financing merger and acquisition transactions, syndicated lending, especially leveraged lending, also has played an important role. As merger and acquisition activity has picked up, syndicated lending to this segment has increased.

A second factor is an ever expanding demand for earning assets by U.S. banks, foreign banks, insurance companies, mutual funds and investment banks. According to the Office of the Comptroller of the Currency (OCC), 57 percent of syndicated loans generated were purchased by foreign banks, 26 percent were either retained by the syndicating banks or purchased by nonbank investors, and 17 percent were purchased by other commercial banks, so-called "downstream banks." Institutional interest in higher yielding investments has been a driving force in leveraged lending market activity.

The volume of lending activity also has resulted in stiff competition from market participants to originate these loans, putting pressure on pricing and fees. These competitive pressures have provided an opportunity for borrowers to refinance previous debt at favorable rates. During the year, almost $300 billion of the $888 billion in syndicated loans was for debt repayment.

Another factor is the greatly increased involvement of third-party rating services. With expanded coverage by third parties, these large loans are now viewed more like securities. As a result, the secondary market has

CHART 2



expanded. The ***Commercial Lending Review*** indicates that in 1990, secondary market volume totaled only $1 billion but by 1995 had increased to more than $25 billion.

According to Loan Pricing Corporation, most lenders expect that merger and acquisition transactions, and the resulting loan activity, will continue unabated through at least the first half of 1997. These bankers indicate that it would probably take a combination of a weaker stock market and higher interest rates to stall the syndication market.

Syndicated Lending Trends Raise Concerns

The increase in syndicated lending has raised a number of concerns. Of particular note is narrowing loan pricing spreads due to increased competition.

As seen in Chart 2, the spread over LIBOR, a commonly used pricing index, has declined greatly since June 1993 for the best noninvestment quality syndicated loans (BB nonleveraged). Similarly, the spread between one-year tenors and five-year tenors also has declined, making it cost-effective to borrow over longer periods. Market analysts point to these indicators when questioning whether lenders are being adequately compensated for risk.

While loan structures have been weakening, they appear to remain more sound than those of the 1980s. According to Loan Pricing Corporation, leveraged loans have reached average multiples of debt to earnings before taxes and depreciation of around 5.5 times (nonleveraged loans range from 3 to 3.5 times). While debt-to-earnings multiples at this level reflect a trend of

increasing leverage, they are still below the six to seven range of the 1980s. Also, cash flow coverage of operating expenses is better.

There also has been some evidence that downstream participants have become more willing to accept loans without full documentation or an independent credit analysis. The OCC attributes this situation to a desire to increase loan volume, coupled with a sense of complacency about company prospects due to the strong economy and strong corporate profits. As lenders generally agree that there will remain pressure to loosen terms and conditions, continued adherence to prudent screening policies by downstream banks remains important.

Suzannah L. Susser, Senior Regional Analyst
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