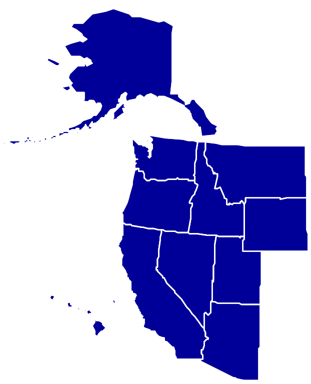
◈ Regional Outlook ◈

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1997

FDIC San Francisco Region



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.*

Division of Insurance

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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 re-think 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 San Francisco Region are 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 $25 billion of small business loans, amounting to 25 percent of all commercial and industrial loans. This is an increase of $1.4 billion or 6 percent from one year ago. There are 382 banks in the Region with small-business loan exposures exceeding equity 100 percent of equity and 103 banks with exposure exceeding 200 percent of equity.

Small banks, those with assets under $1 billion, have a substantial share of the Regions' small-business loans, holding 39 percent. However, large banks over $10 billion are increasing their presence in the small-business lending market. *These large banks seem to be concentrating their efforts on smaller-size loans (under $100 thousand), which grew 35 percent in the last year* (see Chart 1 next page).

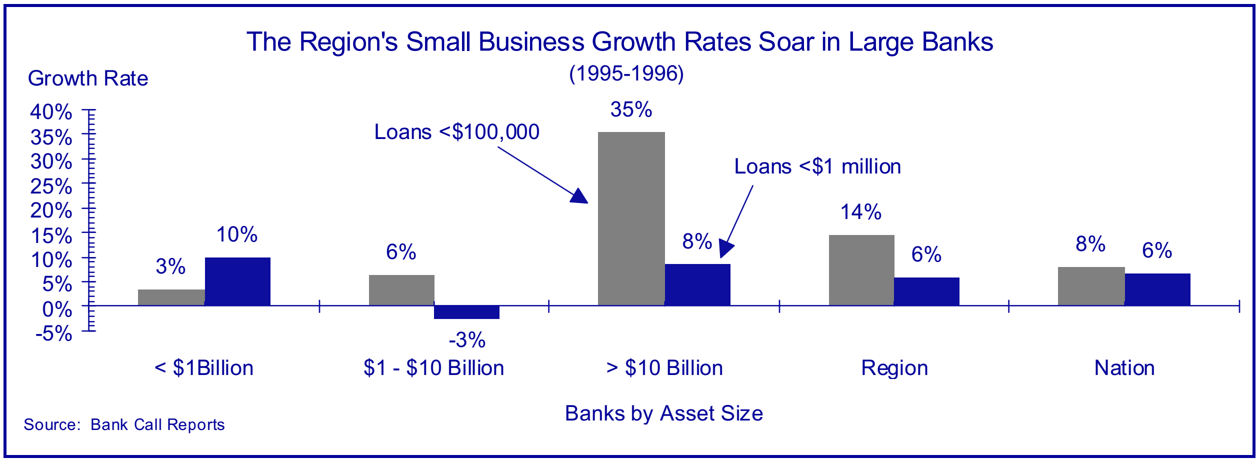
In **California**, the trend is even more pronounced, as some of the state's largest banking companies have announced nationwide programs to increase their market share of small business lending. These nationwide programs may have been prompted by the new credit scoring technology. Several of these companies reportedly are offering pre-approved and pre-qualified lines of credit 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 scoring models are being used.

Small-business credit scoring is a relatively new con-

CHART 1



cept 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 1 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 1 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

TABLE 1

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

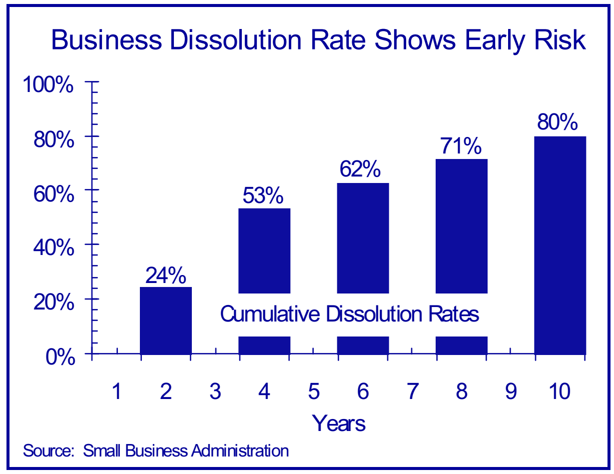
SOURCE: REPORTED BY A LARGE BANK AT A RECENT CONFERENCE ON CREDIT SCORING.

strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

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 2). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

CHART 2



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.

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

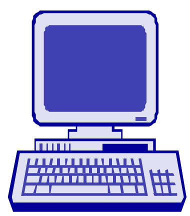
New Technologies, New Opportunities, New Risks

- **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

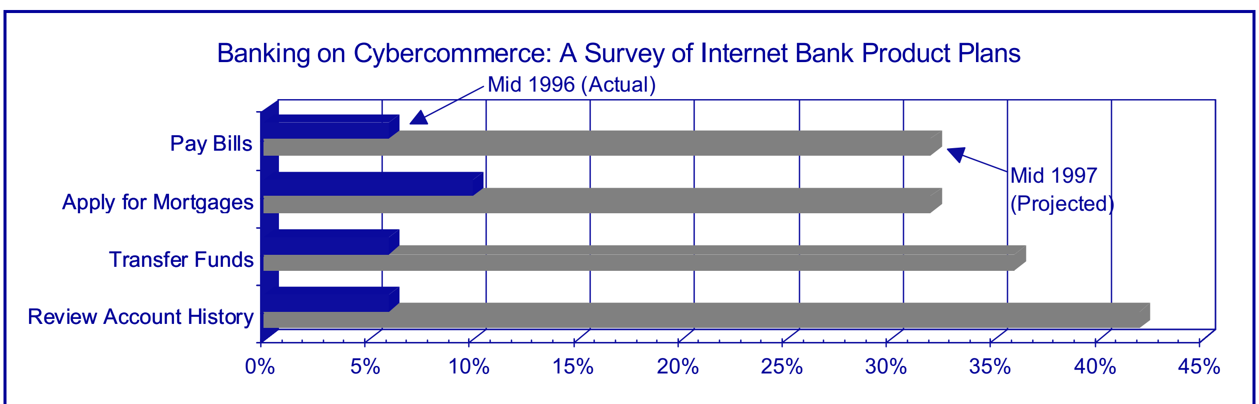


On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking,* 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 San Francisco Region, 120 institutions have an Internet presence but only three allow customers to pay

CHART 1



Source: Grant Thornton "Banking on Cybercommerce: A Survey of Internet Bank Product Plans" bills or 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 for 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 for 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 cyber-borrowers 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.

Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

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 Information:

Division of 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 of Compliance and Consumer Affairs	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 Office Contacts	*J. Richard Mayher, Assistant Regional Director* *Division of Supervision* *San Francisco Regional Office* *(415) 546-0160* *Charles Hasman, Review Examiner* *Division of Compliance and Consumer Affairs* *San Francisco Regional Office* *(415) 974-4476*
Office 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

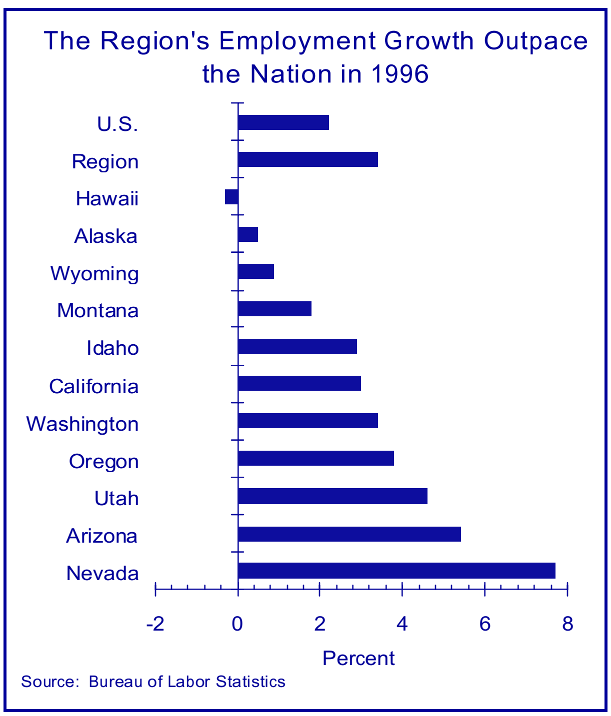
San Francisco Region: Following Separate Paths

- **The economic performance of the states in the San Francisco Region generally fell into one of two distinct groups in 1996, those that were among the nation's top performers or those that were at the bottom of the list in both personal income and employment growth.**
- **Nevada remains the nation's fastest growing state in both employment and personal income. Joining Nevada at the head of the pack in 1996 were Arizona, Utah, Oregon and Washington, with California and Idaho close behind.**
- **Hawaii, Alaska and Wyoming ranked at the bottom nationally in personal income and employment growth in 1996. While Montana recorded near average employment growth, it also fell at the bottom of the list for personal income growth. Soft economic conditions in these states are accompanied by modest deterioration in bank asset quality.**

San Francisco Region Outperforms Nation

Despite the sharp differences in performance within the Region, as a whole it easily outpaced the nation in economic growth in 1996. Employment growth in the Region rose from 2.7 percent in 1995 to 3.4 percent for 1996. In contrast, the employment growth rate for states outside the Region dipped from 2 percent in 1995 to 1.9 percent for 1996. The Region's seven rapidly expanding states accounted for about 29 percent, or almost 740,000 of the 2.6 million jobs added to U.S. payrolls in 1996. This growth is impressive, since the Region as a whole accounts for only 19 percent of nonfarm payroll jobs nationally.

CHART 1



Nevada *lead the nation in 1996 employment growth (7.7 percent) and personal income growth (10.4 percent at an annual rate for the first three quarters of 1996)*. Arizona, Utah, Oregon and Washington followed closely behind, ranking second through fifth nationally with employment growth rates ranging from 5.4 percent to 3.4 percent in 1996. California employment grew at a 3 percent rate to rank eleventh in the nation, followed closely by Idaho, which fell back to fourteenth nationally with a 2.9 percent growth rate. Each of these states also ranked above the national average in personal income growth in 1996. Chart 1 shows the strength in employment growth across the Region in 1996. Moreover, the Federal Reserve's ***Beige Book*** reports that the western region is expected to continue to outperform the nation in 1997.

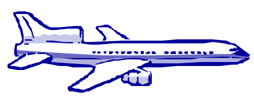
Services Remain Strong in the Region

Service job growth accelerated to a 5.3 percent rate in 1996, well above the 3.7 percent rate elsewhere in the nation, and service employment grew by nearly 340,000 positions in the Region. This key sector accounts for about 30 percent of all jobs in the Region, close to the 29 percent share for the nation. *The Region was paced by Arizona, Utah and Nevada, states that increased their service-sector growth rates to better than 7 percent for the year.* Two other fast-growing states, Oregon and California, also ranked near the top in service-sector growth rates. Lodging and recreation, business services, computer and software services, motion pictures and entertainment all recorded robust growth, and their outlook remains favorable.

Manufacturing Bucks National Downturn

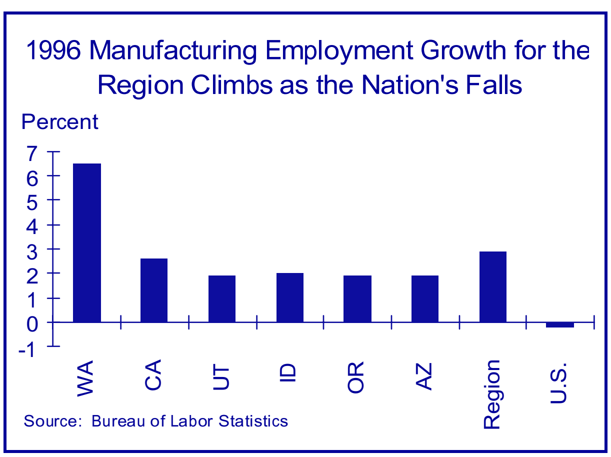
The Region's manufacturing expansion shifted into high gear in 1996, expanding by almost 84,000 jobs in 1996, or 2.9 percent, up from a 2.1 percent increase in 1995. The Region's manufacturing employment boom is tightening labor markets in some states, and contrasts sharply with the slight contraction nationally, as can be seen in Chart 2.

Washington's 6.5 percent increase in manufacturing employment, boosted by the surge in commercial aircraft production, added almost 22,000 jobs to that state's payrolls. High-technology exports and manufacturing also played a key role in the Region, boosting durable goods production, especially for computers and electronic equipment, in California, Oregon, Idaho, Arizona, Utah and Nevada. Nondurable production was helped by a modest expansion in food products in California and Idaho. In addition, California reported robust growth in the apparel industry.



Implications: *The strong, and generally broad-based growth, in the seven fast-growing states in the Region typically is reflected in the health of the banking industry in those states.* While the robust manufacturing growth compared to the nation in 1996 is positive, it has been unusual for the Region to sustain such rapid growth relative to the rest of the nation for much longer than one year. In fact, only once since the 1960s has the Region exceeded the national average by such a wide margin for more than one year in a row.

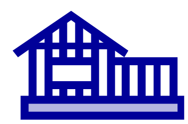
CHART 2



Improved Real Estate Conditions Spur Construction Growth

Real estate markets in the Region have been picking up. Residential and, in some cases, multifamily housing markets have tightened in Seattle, Portland, Las Vegas, Phoenix and the San Francisco Bay Area. Conditions in commercial real estate also have improved. Metropolitan office vacancy rates are now below or well below the national average in most parts of the Region, except for some parts of Southern California and Honolulu. Underscoring the revival of commercial real estate in the Region, ***Marketscore's*** Fall 1996 issue rated several cities in the Region as having excellent real estate investment potential, including San Francisco (office, retail and apartments), San Jose (retail and apartments), Seattle (office), Portland (office and retail), Salt Lake City (office), Phoenix (suburban office), Sacramento (retail), Oakland-East Bay (apartments) and Las Vegas (retail).

Improved real estate market conditions in the San Francisco Region are reflected in both increased real estate lending and construction employment in the Region. Construction jobs expanded at a 6.4 percent rate in 1996, down slightly from 6.8 percent in 1995, but just above the growth rate nationally. For the Region as a whole, housing permits, an indicator of future activity, also rose at a comparable rate to construction employment. Construction was an important factor in adding jobs in Nevada and Oregon, two of the seven fast-growing states that have experienced rapid population inflows.



Implications: *Notwithstanding the generally favorable real estate market statistics reported above, there also are signs of potential concern on the horizon.* For example, the ***Beige Book*** recently reported slower sales for middle-market housing in the fast-growing intermountain states. This slowdown may be evidence of lower population inflows that could affect the building industry in these states. Furthermore, recent increases in long-term interest rates also could dampen the demand for housing. Finally, increased construction and commercial real estate lending in the Region appear to be concentrated at regional and community banks, institutions that in some cases already have a relatively high concentration of such loans in their portfolios (see

Current Regional Banking Conditions).

Hawaiian Recession Continues

Despite the strong overall performance of the Region in 1996, four states ranked in the lower half nationally in economic growth; and three, Wyoming, Alaska and Hawaii, ranked in the bottom five. Hawaii ranked fiftieth in the nation in both employment and personal income growth rates. The evidence for 1996 indicates that the state still did not turn the corner on its long-lasting recession. For example:

- Real personal income growth was negative.
- Job losses totaled 1,400 for the year.
- Bankruptcies for households increased at a rate of almost 65 percent between 1995 and 1996, more than twice the national increase.
- The unemployment rate for December 1996 was 6.5 percent, well above the national average of 5.3 percent during the same period.

The decline in employment marked the fourth time over the last five years that Hawaii has experienced a net loss of jobs. Weakness in Hawaii's economy is evident across all sectors. Even the service sector, which traditionally experiences milder business cycle swings than most other sectors, grew only 1.6 percent for the year, which ranked forty-eighth among all the states.

Tourism has been estimated to account for around 20 percent of Hawaiian economic activity, but that industry has suffered from the prolonged weakness in the Japanese economy. Still, there has been some improvement. Both visitor counts and visitor days increased in 1996, and employment in the lodging industry rose by 3.4 percent in 1996 after declining in 1995. Business services jobs increased over the year at a strong pace; however the large trade sector actually shed jobs in both retail and wholesale employment.

Hawaii's depressed real estate market conditions remain an area of concern for both the state and its financial institutions. Construction employment fell almost 10 percent in 1996, its fourth consecutive annual decline. Vacancy rates for office space in Honolulu rose slightly in 1996 and remain high compared to the nation. Residential property values also are weak. Housing permits fell by more than 40 percent between 1995 and 1996, portending ongoing softness in the construction sector and raising concerns about banks' real estate loan quality.

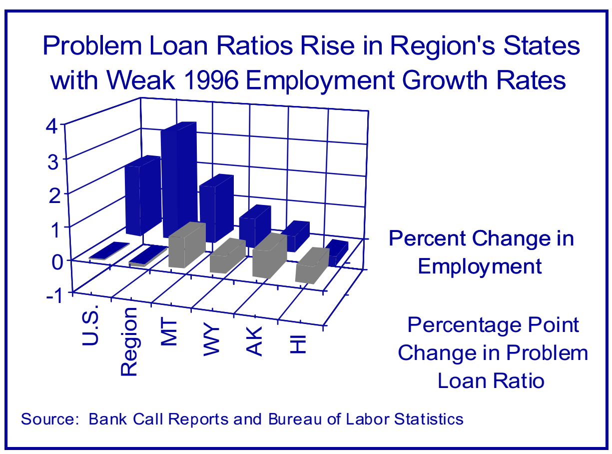
Implications: Analysts do not expect a reversal of Hawaii's poor economic performance in the near term. Tourism and investment spending still appear to be the most likely sources of strength for a rebound in Hawaii given the state's weak employment situation and minimal personal income growth in 1996. However, spending by Japanese visitors and real estate investors both could be slowed by the fall in the value of the yen relative to the dollar. Rising net charge-off and problem loan ratios in 1996, the latter shown in Chart 3, suggest that the state's lengthy recession is having an adverse impact on asset quality at the state's financial institutions.

Alaskan Economy Slows Down

The Alaskan economy remained weak in 1996 after two years of lackluster growth. While the number of Alaskans employed rose by 1,400 over the year, the state ranked forty-eighth in personal income growth and forty-ninth in employment growth.

Alaska has been hurt by its heavy dependence on energy and natural resources and by depressed prices and strong international competition in seafood products. Employment in oil production, mining, lumber and wood products all declined in 1996. Oil price increases have not been sufficient to offset the downward trend in output. Increased demand for many wood products has not had a significant impact on output in the state either; supply is constrained since much of the remaining timber is located in federal forests. The announced closing of the Ketchikan Pulp Company's pulp mill, that area's largest employer, will result in the direct loss of over 500 jobs in Ketchikan.

CHART 3



Meanwhile, the state's largest employment sector, governmental services, remained soft as reductions in federal government employment in part offset increases at the local level. Slower energy production rates and falling revenues also are putting pressure on state government finances, since over 80 percent of state revenues come from energy-related sources.

Still, analysts note some signs for optimism. Transportation employment should benefit from the selection of Anchorage as an international air cargo transfer hub. Announcements of new oil field discoveries, a pick-up in hard rock mining operations and higher prices for lumber could bring about moderate improvement in 1997. As with Hawaii, tourism could be a key to the state's recovery. Visitors were drawn to Alaska in record numbers in 1996, and increased spending by tourists is credited with boosting both retail sales and lodging activity.

Implications: *Alaska's anemic economic performance is likely to have an adverse impact on bank asset quality and the health of the banking industry.* Chart 3 (previous page) suggests that this is already occurring. Conditions in the state should be monitored carefully since the health of Alaskan banks are likely to follow the performance of the Alaskan economy more closely than the national economy.

Softening in Wyoming and Montana

Personal income growth for Wyoming and Montana of around 3 percent (annualized) over the first three quarters of 1996 barely kept pace with inflation and was well below the national increase of 5.7 percent. Employment growth for these two states, measured by year-end employment levels, also has dropped sharply since 1994. Despite the slowdown, both states still reported year-end unemployment rates that were well below the national average and both added jobs in 1996. Wyoming added 1,900 jobs (an increase of 0.9 percent) for the year even though employment peaked in the third quarter. Montana gained 6,400 jobs (an increase of 1.8 percent), although the state only added jobs in three of the last seven months of 1996.

Wyoming ranked last in service employment growth rates in 1996. Service jobs rose by only 0.4 percent despite strength in business services and a small increase in health care employment. In contrast, Montana recorded a healthy 3.9 percent growth in service employment that accounted for more than one-half of the state's 1996 job gain. Services in Montana were generally strong across the board, with a rapid increase in business service employment, as well as strong increases in social services, educational, personal and legal services.

Montana also outpaced Wyoming in the construction sector. Wyoming reported a 1.4 percent increase in construction jobs as the state's building boom subsided in 1996. Montana recorded a strong upturn in construction employment for the year, but the outlook for residential construction appears to have weakened as the number of housing permits issued in 1996 sagged well below 1995 levels.

Both Montana and Wyoming have been hurt by weakness in natural resources-based sectors. Like Alaska, the improved markets for these products nationally have not had a significant impact on overall employment in these states. Montana recorded increases in employment at its mines and sawmills, the latter helped boost the state's small manufacturing sector. In Wyoming rising oil prices have not offset declining production, while higher coal production has been mostly offset by soft prices.

Implications: *Banks in both Wyoming and Montana recorded noticeable increases in problem loan ratios and net charge-offs in 1996.* As can be seen from Chart 3 (previous page), the deterioration in economic performance in these states already is having an effect on the banking industry.

Observations

If the disparate performance of the Region's state economies continues into 1997, it likely will become more evident in the performance of the Region's banking industry as well. Montana's economy has cooled off and is now recording below average growth. Conditions in Alaska and Wyoming have deteriorated significantly, and the economies of these states have fallen well behind the rest of the nation in economic growth. Along with Hawaii, where the recession continued in 1996, these states and their financial institutions should be monitored closely in 1997 for signs of improvement or deterioration.

Gary C. Zimmerman, 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.**

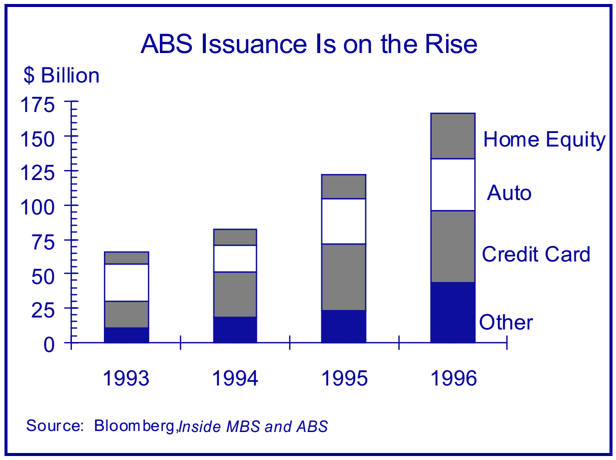
- **During the fourth quarter 1996, the S&P Composite Bank Index and the San Francisco Region's Bank Index both outperformed the S&P 500, gaining 12 percent and 13 percent, respectively, compared to an almost 8 percent gain for the S&P 500.**

- **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 overcollateralization, 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

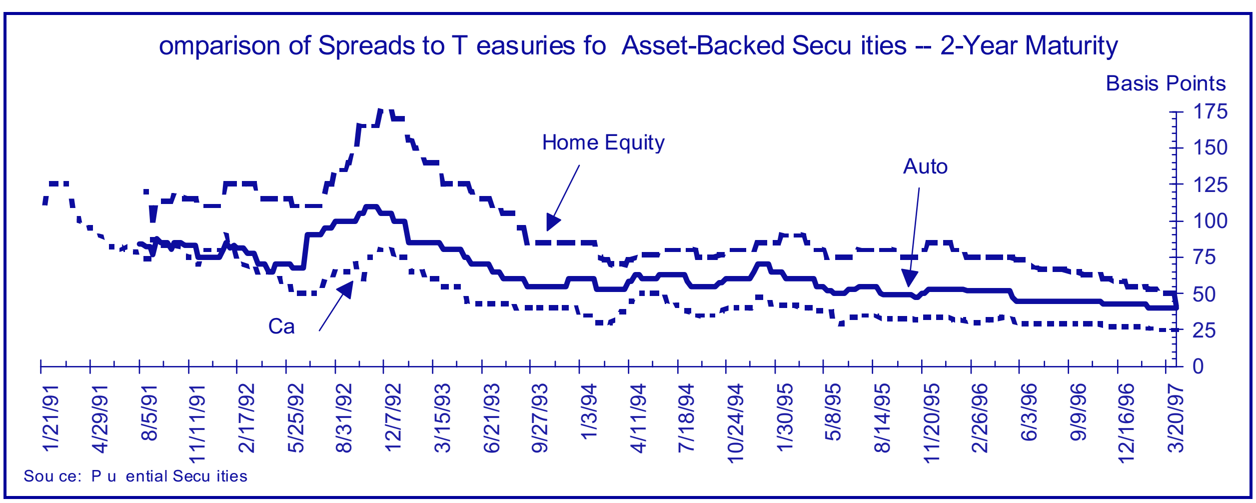


CHART 3

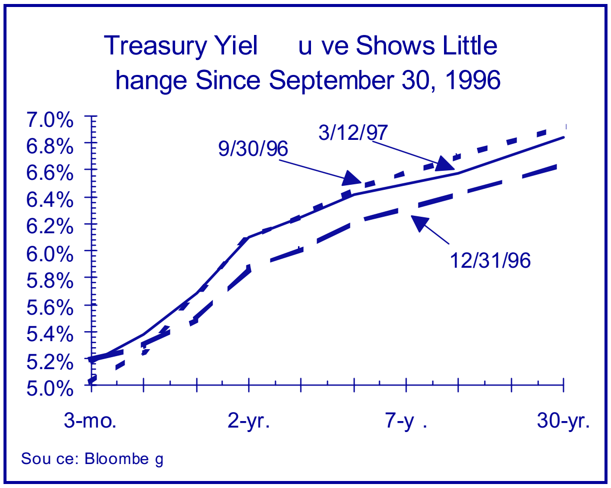
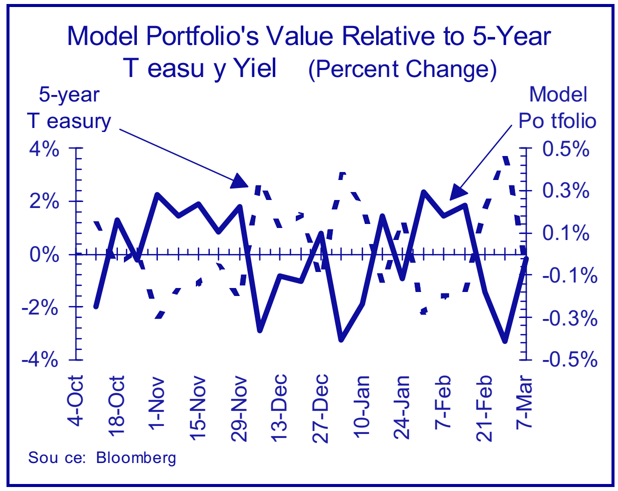


CHART 4



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.

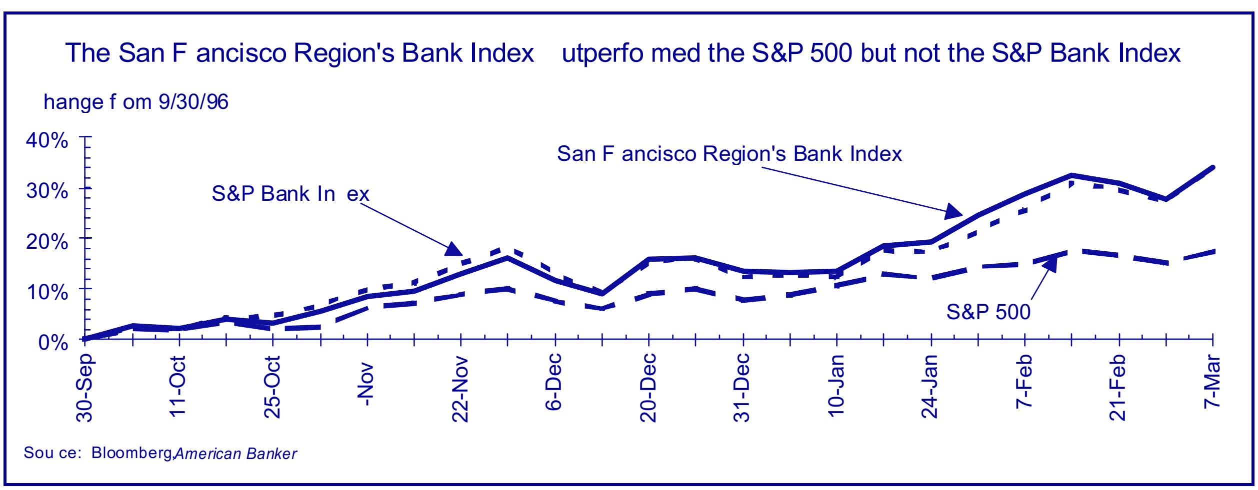
This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect 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 San Francisco Regional Bank Index (SFRBI) gained a little more than 13 percent in the fourth quarter 1996. Moreover, the SFRBI increased 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. The SFRBI is up over 18 percent compared to an almost 20 percent gain for the S&P Composite Bank Index and a 9 percent gain for the S&P 500.

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

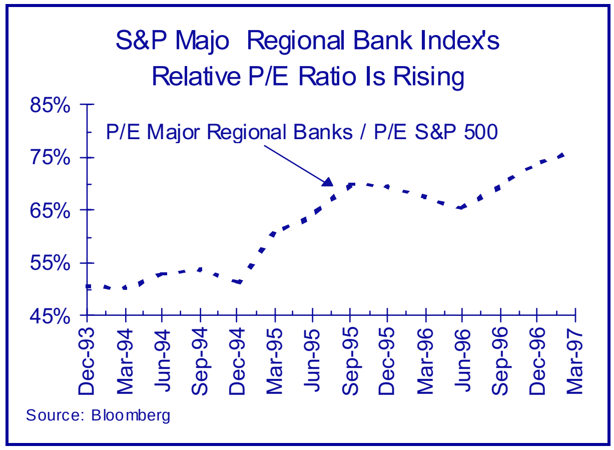


future earnings performance.

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 Regional Banking Conditions

- **Overall, the strength of the San Francisco Region's economy is providing a foundation for favorable bank performance; however, banks in four of the Region's slower-growing states are experiencing minor increases in past-due loans.**
- **Institutions with assets under $1 billion increased an already high exposure to commercial real estate loans in 1996.**
- **The number of banks in the Region is falling due to mergers, especially in California and Montana.**
- **Earnings at the Region's thrifts continue to improve.**

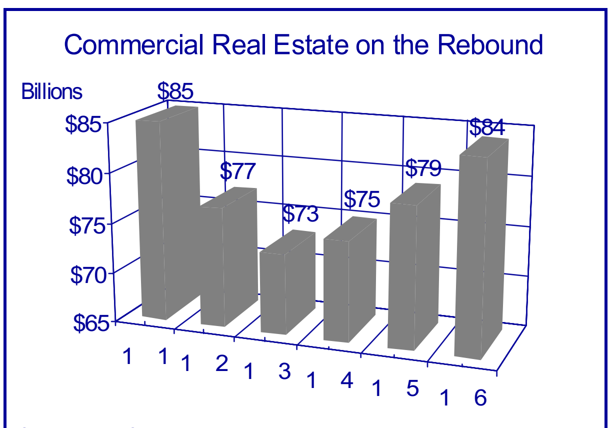
Banks Continue to Outperform the Nation, Despite a Slight Dip in Profits in 1996

Return on Assets (ROA) at commercial banks in the San Francisco Region exceeded the nation for the third consecutive year. Favorable economic conditions contributed to healthy loan growth, strong net interest margins, and hefty fee income growth. An annualized ROA of 1.22 percent compared favorably to the 1996 national average of 1.19 percent but reflected a decline from the Region's 1995 ROA of 1.39 percent. This decline was primarily the result of substantial increases in credit card loan loss provisions and merger-related expenses.

Despite strong earnings performance at the Region's banks, there are several trends that warrant closer attention. Past-due loan ratios (loans 30 days or more past-due plus nonaccrual loans, divided by total loans) trended upward in all states except California. In Alaska, Hawaii, and Montana, past-due loan ratios climbed between 50 and 80 basis points for the year, topping 3 percent by year-end. Past due loan ratios in Wyoming also climbed over 50 basis points but remained below 2 percent at year-end (see ***San Francisco Region: Following Separate Paths***).

In addition, commercial real estate lending activity picked up in the Region's midsize and smaller banks. Exposure in the Region's smaller banks (with assets less than $1 billion) is high relative to levels held at institutions in other asset size groups. Finally, increased merger activity has occurred throughout the Region, particularly in California and Montana.

CHART 1



Source: Bank Call Reports

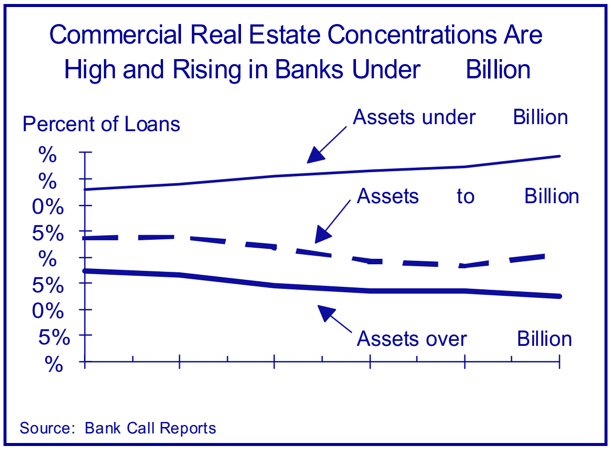
Commercial Real Estate Loan Portfolios Growing Once Again

After declining from 1991 through 1993, commercial real estate lending began to pick up again in 1994. As shown in Chart 1, by year-end 1996, commercial real estate loans (including loans secured by commercial properties, construction projects, and multifamily properties) had returned to levels last seen at the beginning of the decade.

Commercial real estate exposures in this Region vary substantially by bank size, with the smaller banks generally having the greatest exposure (see Chart 2 next page). Smaller institutions (with assets less than $1 billion) have continued to build their commercial real estate portfolios throughout the 1990s. Over the past year, midsize institutions (with assets of $1 to $10 billion) also have begun adding to their portfolios.

As of year-end 1996, more than one-half of institutions with assets of less than $10 billion had commercial real

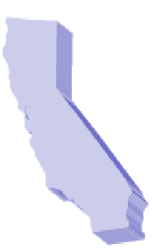
CHART 2



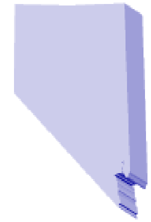
real estate exposures exceeding 25 percent of their total loan portfolios. In contrast, the Region's largest institutions generally had much lower commercial real estate concentrations.

Region's Merger Activity Picks Up

Similar to the nationwide trend, the San Francisco Region has seen the number of insured commercial banks decline by 228 since 1990. This decline includes 257 unassisted mergers, 57 failures, and 12 other closures and absorptions resulting from charter conversions and self-liquidations. However, the declines were offset, in part, by 98 new charters. The rate at which the Region's banks are merging has gradually increased over the past six years. In 1996, the Region reported 50 mergers as compared to 44 in 1995 and 35 in 1994. (Wells Fargo's acquisition of First Interstate Bancorp accounted for seven of the 50 mergers in 1996.) New bank activity also has increased. There were 24 new charters granted in 1996, which is up from 21 in 1995 and only 5 in 1994. Alaska and Hawaii were the Region's only two states that did not add new banks in 1996.



The decline in the number of banks is not evenly distributed across the Region. The number of banks in California declined by 122 in the last six years, representing 54 percent of the Region's total contraction in bank charters. However, California continues to hold a dominant share of the Region's financial institutions, with 360 banks or 45 percent of the Region's total banks. The pace of mergers in Montana, the second most active state in terms of numbers of mergers, picked up after the 1989 change in that state's mergers and acquisitions banking law. Since 1990, Montana has experienced a net reduction of 56 banks, or a 36 percent decline in the number of banking charters in that state. Table 1 (next page) shows rapidly expanding Nevada at the opposite end of the spectrum with seven new banks.

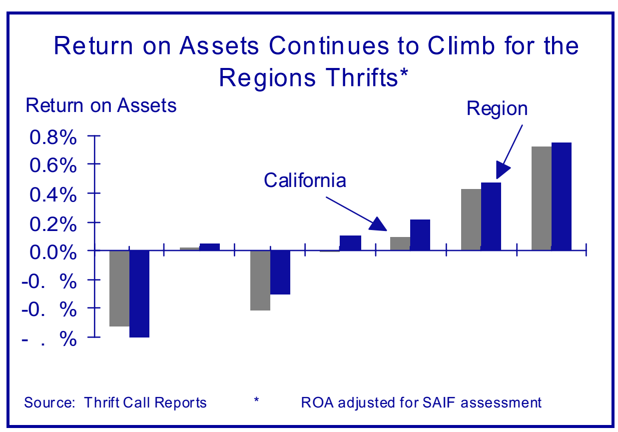


Increased competition from banks and nonbank financial institutions, coupled with the arrival of *interstate* banking this year, likely will result in further industry consolidation. Prospects for further consolidation are particularly evident in Montana where legislation to allow *intrastate* branching recently passed. Under the old regulations, Montana's 100 banks could branch only on a county-wide basis. Passage of this bill could result in a reduction in the number of banks in the state by at least 20 if all 12 multibank holding companies in the state convert their subsidiary banks to branches.

A Thrift Recovery in Progress

The third quarter SAIF deposit insurance assessment temporarily depressed an otherwise improving thrift industry performance (see Chart 3). *Exclusion of this one-time charge from 1996 thrift earnings reveals a 0.74 percent ROA for the full year versus an unadjusted ROA of 0.31 percent.* Improved earnings are attributed to a reduced cost of funds and a loan growth rate of 9.24 percent. The 1996 loan growth was centered in

CHART 3



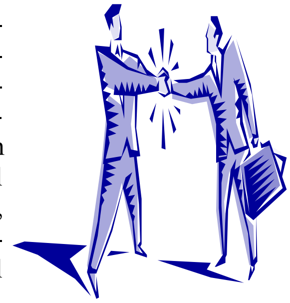
centered in consumer, single-family residential, and construction loans.

Rising earnings at the Region's thrifts appear to be fostering merger activity, particularly in California where earnings are catching up with the Region as a whole. In the San Francisco Region, 12 nonaffiliated thrifts merged in 1996 compared to only five in 1995. Nine of the 12 thrifts that merged in 1996 were headquartered in California. This is more than twice the number of 1995 nonaffiliated California thrift mergers.

Analysts are predicting further merger activity in the near term. Among the reasons cited are the following:

- A 39 percent market share of California's bank and thrift assets;
- Extensive retail branch networks;
- Favorable tax accounting provisions enjoyed by thrifts with respect to bad debt reserves; and
- An improving state economy.

As has been widely publicized, both San Francisco-based First Republic Bancorp, with $2.2 billion in assets, and the $41.3 billion Great Western Financial headquartered in Chatsworth, California, have been targeted by suitors as potential merger candidates.



Catherine I. Phillips-Olsen, Senior Regional Analyst
Roger Stephens, Financial Analyst
David Pfeifer, Examiner, Division of Supervision

Table 1

Bank Consolidations in the San Francisco Region Follow National Trends

STATE	INSURED COMMERCIAL BANKS* 12/31/90	INSURED COMMERCIAL BANKS 12/31/96	PERCENT CHANGE
ALASKA	9	9	0%
AMERICA SAMOA	1	1	0%
ARIZONA	38	35	-8%
CALIFORNIA	482	360	-25%
MICRONESIA	1	1	0%
GUAM	1	2	100%
HAWAII	21	14	-33%
IDAHO	22	15	-32%
MONTANA	156	100	-36%
NEVADA	19	26	37%
OREGON	51	44	-14%
UTAH	55	48	-13%
WASHINGTON	106	96	-9%
WYOMING	71	54	-24%
Region Totals	1,033	805	-22%
U.S. Totals	12,799	10,117	-21%

Source: Bank Call Reports
* Commercial Bank Charters: National, Nonmember, State Member, Mutual Insured

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