Regional Outlook

Federal Deposit Insurance Corporation — Fourth Quarter 1997

FDIC Dallas Region

Division of Insurance

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In Focus This Quarter

◆ ***Bank Earnings: Competitive Pressures and Cyclical Risks*—Intense competition to preserve or attract business can lead to relaxed underwriting standards and other changes to risk management practices that can reduce banks' ability to weather a downturn. As this economic expansion reaches an advanced age, prudent bankers will evaluate their lending standards and reserve adequacy with an eye to possible adverse changes in economic conditions.** *See page 3.*

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◆ ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets*—Commercial real estate markets in many parts of the United States have rebounded, and commercial banks are once again actively pursuing lending opportunities. Banks are not alone, however, as a broader and more competitive financing market has emerged. Securitization vehicles such as commercial mortgage-backed securities and real estate investment trusts are changing how real estate is owned and paid for.** *See page 9.*

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◆ ***Financial Markets*—Bank holding companies of all sizes have issued trust preferred stock following the Federal Reserve's decision in October 1996 to count these tax-advantaged, capital securities toward Tier 1 capital…rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital.** *See page 20.*

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◆ ***Regional Banking*—Favorable banking conditions continue… Subchapter S tax status institutions are reaping benefits, but earnings analysis should focus on pretax operating income…financial modernization is presenting risks and opportunities to small and large banks alike…banking consolidation has been most pronounced in metropolitan areas.** *See page 24.*

By Alan C. Bush and Jeffrey A. Ayres

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Bank Earnings: Competitive Pressures and Cyclical Risks

- **Rapid loan growth, record low credit losses, vigorous expansion of income sources, and cost-cutting continue to propel bank earnings to record levels.**

- **Intense competition to preserve and attract business can lead to aggressive loan pricing, relaxed loan underwriting standards, increased portfolio concentrations, and other changes to risk-management practices that can reduce banks' ability to sustain earnings and capital through a downturn.**

- **As this economic expansion approaches an advanced age, prudent bankers will allow for the possibility of an adverse change in economic conditions.**

As the U.S. economic expansion continues through its seventh year, the banking industry continues to run at full throttle. Earnings climb to ever-higher levels, driven by rapid loan growth, record low credit losses, aggressive expansion of income sources, and vigorous cost-cutting. Some analysts argue that banking has entered a new era in which the development of non-interest income sources and new risk-management techniques will insulate banks from swings in the business cycle.

Yet banks face risks that should not be overlooked. Assertions that bank earnings will be less sensitive to business cycles remain untested. Meanwhile, competition to attract and maintain business can result in relaxed underwriting standards and easing of loan terms, or increased focus on business lines whose risks are difficult to manage. Policies that boost short-term shareholder returns, including high dividends and stock repurchase programs, can reduce banks' capacity to weather a future downturn. There is evidence that these things are occurring to varying degrees in banking today. Accordingly, as this expansion reaches an advanced age, prudent bankers will give careful regard to the quality and sustainability of the earnings generated by today's strategic decisions.

Credit Quality

Variations in credit quality have been and are likely to remain for some time the primary source of large swings in bank earnings (see Chart 1). Banks manage the risks of large swings in credit quality by adjusting underwriting standards and loan terms, by diversifying loan portfolio exposures, and by supplying adequate amounts to the allowance for loan losses. In large part, the degree to which bank earnings can be sustained during a downturn will depend on decisions made about these factors during the expansion.

Some perspective on the cyclical nature of credit quality can be gleaned from Charts 2 and 3 (next page). As shown in Chart 2, bank loan growth has exceeded growth in gross domestic product (GDP) for ten of the past twelve quarters, even without considering the substantial volume of loans originated and sold in securitized pools. Moreover, Chart 3 shows that growth in loan losses has tended to follow episodes of rapid loan growth.

Credit standards are important tools for individual banks to manage these cyclical fluctuations in credit quality. According to the Federal Reserve's August 1997

CHART 1

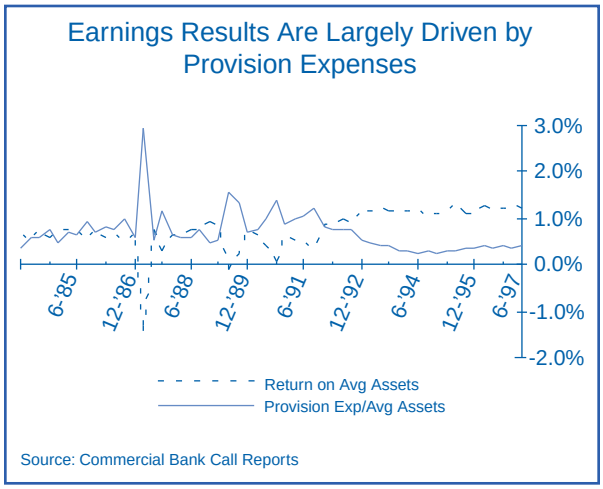


CHART 2

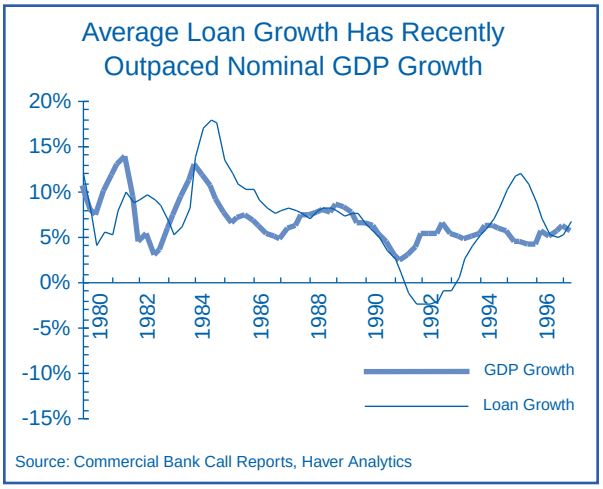
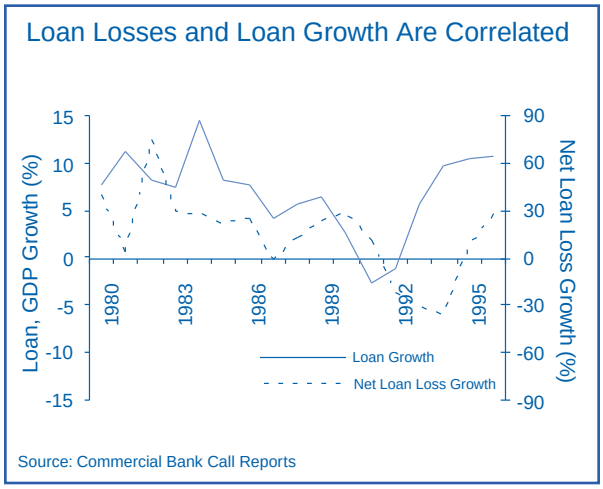


CHART 3



Senior Loan Officer Survey, during the preceding three months, a large percentage of banks had eased terms on commercial and commercial real estate loans, including reducing loan interest rates, increasing credit lines, and easing loan covenants and collateralization requirements. A "small but significant" share reported willingness to accept increased levels of risk on commercial real estate loans. In a similar vein, the Federal Deposit Insurance Corporation's (FDIC) ***Report on Underwriting Practices*** (second quarter 1997) did not note any widespread problems with underwriting practices but reported that about 24 percent of institutions examined that were actively involved in construction lending were "frequently or commonly" funding speculative construction projects. About 18 percent of institutions examined that were actively involved in business lending "frequently or commonly" made unsecured business loans that lack documentation of financial strength.

Maintaining an adequate allowance for loan losses is another important way for banks to sustain earnings and capital during downturns. The aggregate allowance held by commercial banks has decreased from 2.74 percent of total loans in the first quarter of 1992 to 1.90 percent in the second quarter of 1997; 166 banks reported negative loan loss provisions in the second quarter.

Although in the aggregate these reserve numbers remain high relative to the early to mid-1980s, when reserve levels ranged from 1.20 percent to 1.74 percent, the Office of the Comptroller of the Currency (OCC) recently issued an advisory letter expressing concern about declining reserve levels and the need to maintain an adequate allowance. This letter was a response to weakness in the credit card sector and to trends in the market for syndicated commercial loans, including increasing leverage, declining spreads, and a weakening in other underwriting terms, all stemming from increasing competitive pressures.

Diversifying loan portfolios is another way for banks to help reduce susceptibility to economic downturns. It has often been noted that the trend toward interstate banking and branching may improve loan diversification. It should also be noted, however, that many banks retain high concentrations of credit exposure to specific economic sectors. For example, commercial real estate lending and construction lending has been a source of volatility in bank earnings since the real estate investment trust (REIT) crisis of the 1970s. As discussed in ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***, banks are leading a resurgence in commercial real-estate lending. As Table 1 shows, 28 percent of FDIC-insured institutions grew their total commercial real estate and construction portfolios more than 30 percent from mid-1996 to mid-1997, and 16 percent had total commercial real estate and construction exposures[1] exceeding 200 percent of equity and reserves. Concentrations and rapid growth do not necessarily portend difficulties, but the greater the concentration of credit to a specific sector, the greater the importance of strict adherence to sound underwriting policies and standards and the maintenance of adequate loss reserves.

The most immediate concerns about credit quality have been expressed regarding credit cards and some other

[1] Includes loans secured by multifamily dwellings and nonfarm nonresidential structures, as well as construction loans.

consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 1991. Noncurrent rates on these loans are at near-historic highs of 1.94 percent, and some examiners are commenting that these rates would be even higher were it not for some of these balances being rolled over into home equity debt consolidation loans with loan-to-value ratios as high as 135 percent. Home equity lines are a rapidly growing business for some banks; 25 percent of banks and thrifts grew their home equity lines by more than 30 percent during the year ending mid-1997 (see Table 1).

Except for credit cards and some other consumer loans, loan losses are at historically low levels. Nevertheless, lending decisions that assume a continuation of favorable economic conditions should be closely examined this far into the expansion. Institutions that maintain strong underwriting standards, an adequate allowance for losses, and prudent diversification of the loan portfolio will be best positioned to sustain earnings and capital during a downturn in credit quality.

Net Interest Margin

Net interest margin (NIM) is another primary driver of bank earnings. Indeed, a sharp improvement in NIM helped lead the banking industry's dramatic recovery from the last recession (see Chart 4). Commercial banks' NIM has declined slightly in recent years, but at 4.23 percent still remains near the top of the range within which it has fluctuated since 1984 (see Table 2, next page).

The banking industry's rapid loan growth in recent years has been one of the factors supporting the current high NIM. (Since loans generally yield more than securities, a higher proportion of loans generally results in a higher yield on the total portfolio of earning assets.) Economic fundamentals cannot sustain rapid loan growth indefinitely, however. Accordingly, a

Chart 4

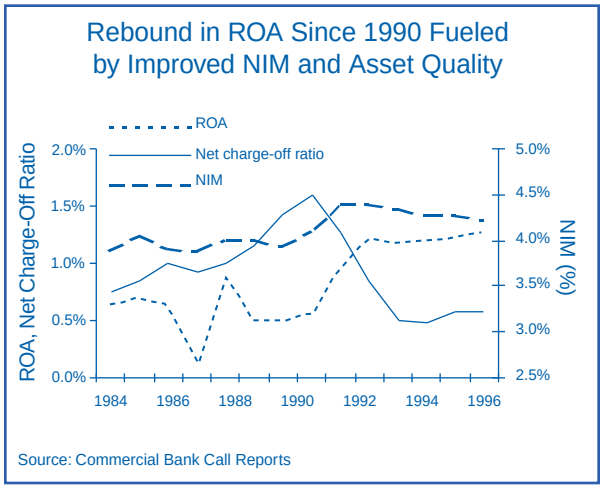


Table 1

Rapid Loan Growth Is Occurring at a Significant Number of Institutions (4 qtrs growth ending 6/97)	Percentage of Institutions with Loan Category Growth Approximating		
	20% to 30%	30% or More	Total Over 20%
Total Loans and Leases	11	13	24
Construction Loans	4	36	40
Commercial Real Estate Loans	9	27	37
Total CRE	10	28	38
1-4 Family Residential Loans	11	17	29
Home Equity Lines	4	25	29
Total Residential	12	18	29
Credit Card Loans and Related Plans	4	17	21
Other Consumer Loans	9	18	27
Total Consumer Loans	9	18	27
Commercial Loans	9	26	35

Source: Bank & Thrift Call Reports

Table 2

1997 Commercial Bank Performance Compared with Historical Averages			
	6/30/97	Industry Averages 1984-1996	
	Annualized (%)	Low (%)	High (%)
Net Interest Income/Average Earning Assets	4.23	3.89	4.36
X Average Earning Assets/Average Assets	86.50	86.21	88.42
= Net Interest Income/Average Assets	3.66	3.36	3.89
+ Noninterest Income/Average Assets	2.13	1.10	2.13
– Noninterest Expense/Average Assets	3.50	3.05	3.90
– Provision Expense/Average Assets	0.40	0.28	1.28
+ Other Items/Average Assets	0.03	–0.02	0.15
– Taxes/Average Assets	0.68	0.18	0.64
= Net Income/Average Assets (ROA)	1.25	0.10	1.20

Source: Bank & Thrift Call Reports

risk in the current environment is that in the effort to support their NIM by generating new lending, banks may make compromises in loan underwriting, pricing, and portfolio diversification.

Recent pricing trends have tended to weaken NIM, offsetting to a degree the effects of rapid loan growth. On the liability side, over the past six years, commercial banks' average annual deposit growth rate of 3.2 percent has been outpaced by the 4.9 percent average annual growth rate of earning assets. As a result, nondeposit borrowings have increased significantly in importance, rising from about 12.6 percent of earning assets in 1991 to 19.1 percent at mid-1997. Since the average cost of nondeposit borrowings has exceeded the average cost of deposits over the period by an average of 135 basis points, the greater use of relatively higher cost borrowings to fund earning asset growth has been an obstacle to wider margins. The slower deposit growth can perhaps be attributed to the increasing array of choices available to small savers; its effect is that bank funding is becoming more expensive and more interest-rate sensitive.

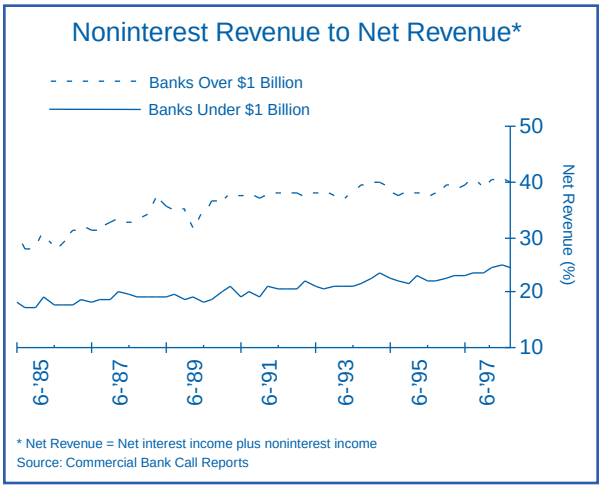
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads on investment-grade debt are at all-time lows. Reportedly, some deals are being done at minimal or no risk-adjusted spreads simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures on institutions not able to achieve the volumes necessary to efficiently utilize this new funding vehicle.

The thin spreads available from high-quality lending may tempt some institutions to finance higher yielding, riskier credits in an effort to preserve or boost profit margins. For example, recent forays by some banks into subprime lending (see ***Subprime Lending: A Time for Caution***, Third Quarter 1997) may be one indication of how competitive pressures on NIMs are affecting bank behavior. Over the long term, institutions that manage their NIMs with a prudent regard for how their newly booked business may fare during a cyclical downturn will have a better chance of sustaining earnings performance through the business cycle.

Growth in Noninterest Income

Industry analysts often cite the increasing contribution of fees and other sources of noninterest income as evidence of the evolution of the banking industry. As Chart 5 (next page) illustrates, for commercial banks with over $1 billion in assets, noninterest income now averages over 40 percent of net revenue (net interest income plus noninterest income). In contrast, banks

CHART 5



with under $1 billion show a profile of reliance on more traditional banking activities, with only 25 percent of revenue from these noninterest sources.

Noninterest income growth is being driven both by new business lines and higher deposit-related fees. Examples include fees from sales of mutual funds and other nondeposit products, investment banking activities such as securities underwriting and asset management, and increases in traditional fee sources such as from automated teller machines. Increasing securitization of assets, in which the accounting conventions convert interest income to noninterest income, has also affected the growth in reported noninterest income.

With the exception of trading revenue, noninterest income has historically shown a growth trend that has not been especially sensitive to economic cycles. However, newer fee-based businesses such as mortgage banking, mutual funds, and securities underwriting may ultimately share the same cyclical characteristics as traditional bank lines of business, and therefore may not reduce banks' historical exposure to economic cycles.

The Effect of Expense Control on Earnings Performance

Cost-cutting efforts in banking continue to show their effects. Since 1991, commercial banks' efficiency ratio,[2] a measure of an institution's effectiveness in generating revenue, has steadily improved (see Chart 6).

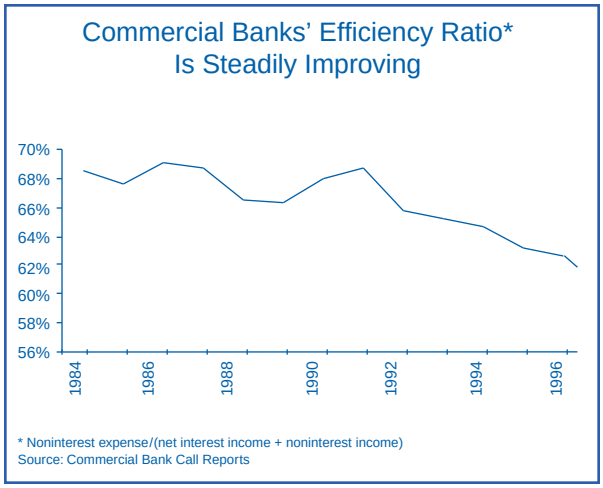
[2] The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

Other measures of productivity have shown similar improvement. For example, commercial banking assets per employee doubled, from $1.5 million to $3 million, between 1984 and 1997.

Growth in overhead expense has been contained largely through consolidation, technological advances, and low levels of problem assets. Mergers have resulted in the wringing out of redundant expenses. Information technology (IT) has been deployed to trim underwriting expense, manage customer relationships, speed back-office processing, and facilitate the creation of new products and services. Favorable economic conditions have reduced costs associated with loan collection and asset workouts.

Whether the downward trend in overhead expenses will continue is an open question. Should problem loans increase from their cyclical lows, collection and work-out costs will increase (evidence of this effect can be discerned for the late 1980s in Chart 6). The rapid change in information technology may prompt increasing expenditures. The 1996 Atlantic Data Services/Tower Group ***Survey of Information Technology Services in Banking*** noted that the banking industry is "faced with an aging IT infrastructure." The survey suggests that most technology-related expenses could increase at a 5.6 percent compounded growth rate until the year 2000 and that expenses for outside services could increase 11 percent over the same period. The ability to generate future revenue gains may depend on additional bank investment not only in technology but also in the development of new products and services.

CHART 6



In any event, cost-cutting is not without its risks. For example, reductions in personnel, or excessive reliance on automated underwriting procedures (see ***Will Credit Scoring Transform the Market for Small-Business Lending?*** Second Quarter 1997), may raise concerns about the effectiveness of internal administration and control processes. Cost-cutting that cuts too deeply into customer service can erode franchise value. Mergers can reduce redundant expense, but at some point there may be diseconomies to managing a large organization.

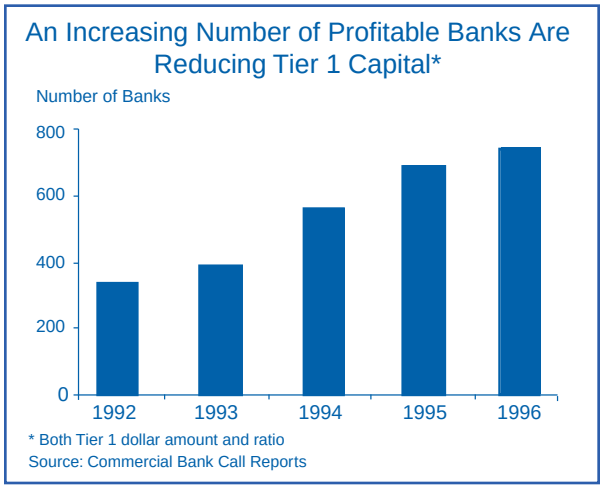
The Role of Capital in the Management of Earnings

Management, shareholders, and analysts often evaluate earnings in relation to the level of capital using measures such as return on equity (ROE) and earnings per share (EPS). One result has been pressure on banks to continue to grow ROE and EPS; these objectives have been made progressively more difficult to attain by the significant level of capital that has built up over the past five years.

Finding effective ways to deploy historically high capital levels appears to be one driving force behind the recent rash of mergers and acquisitions, high dividend payout ratios, increased stock repurchases, and the development of alternative types of hybrid capital such as trust preferred stock (see ***Financial Markets***). For example, during 1995 and 1996, major merger and acquisition deals included some $835 billion in bank and thrift assets. During 1996, commercial banks with over $1 billion in assets had an average dividend payout ratio over 89 percent, up significantly from the 67 percent payout rate of 1994. Banks with under $1 billion in assets averaged 55 percent for 1996 and 52 percent for 1994. In addition, banks and bank holding companies have issued some $21 billion in trust preferred stock during the last nine months, some of which has been used to fund the almost $42 billion in share repurchase programs announced by large banks during 1996 and early 1997.[3]

While the book value of equity and other capital ratios has increased at the aggregate industry level, a number of banks are reporting declines in equity capital and leverage capital ratios despite positive earnings (see Chart 7). For all institutions, the ability to actively manage capital accounts going forward will depend largely on having earnings available above the levels needed to fund dividends and growth, after assuming capital protection adequate for the level of business risk. Bankers and examiners will need to carefully review strategies that increase bank leverage or increase business risk without considering the potential effects of a downturn in credit quality or other weakening in the economy.

CHART 7



Summary

The most profitable period for U.S. banks in the post-World War II era is paradoxically occurring during a time when banks' traditional business lines are coming under greater competitive pressure than ever. While the industry as a whole is adapting well to these competitive pressures, there may be a tendency for some insured institutions to respond by accepting greater risks to preserve or gain business.

The nature of banking is to profit by taking calculated risks, and naturally more profits will be made during the expansionary phase of a cycle than during a downturn. Nevertheless, the institutions that are best able to sustain their earnings and capital over the complete cycle will be those that allow for the possibility of an adverse change in business conditions, and prudently balance the levels of risk taken with the expected returns.

Ronald Spieker, Chief, Depository Institutions Section
Steve Linehan, Assistant Director, Analysis Branch
George French, Deputy Director

[3] Salomon Brothers.

Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets

- **Commercial banks are leading a resurgence in commercial real estate financing; many metropolitan markets are experiencing rapidly rising rents and single-digit vacancy rates, suggesting the likelihood of further development.**
- **New funds directed toward commercial real estate are being increasingly supported by commercial mortgage-backed securities and real estate investment trusts.**
- **Some analysts have expressed concern that these financing vehicles may serve to heighten competitive pressures that will lead to more aggressive loan pricing.**

In the wake of declining values and the large losses of the late 1980s and early 1990s, commercial real estate is making a comeback. There are two stories here of interest to lenders. The first entails the remarkable resurgence in commercial real estate demand. The second involves the major changes taking place in how real estate is owned and paid for and—of greater interest to banks—who is financing this expanding activity.

Commercial Banks Show Renewed Interest in Commercial Real Estate

Strong evidence of commercial real estate's rebound can be seen in its renewed attractiveness to lenders. ***Federal Reserve*** figures show that nearly $58 billion of new commercial mortgage debt was added to the market in 1995 and 1996 (see Table 1). While this new net lending pales in comparison with that of the late 1980s—when nearly $74 billion in net new debt was added in 1987 alone—it positively shines when compared with the $89 billion *shrinkage* of commercial real estate loans from 1991 to 1994. Table 1 shows that commercial banks are leading this resurgence with a $37 billion net increase in mortgage lending during 1995 and 1996.

Perhaps the most convincing evidence of commercial real estate's recovery comes from the market itself. Rising prices and tightening supplies of space in most major markets and for most property types suggest a growing demand for new commercial property stock. Numerous indices and market studies support this notion:

- As measured by ***Koll/NREI*** national composites, prices and rents turned up sharply after 1993, with rents surpassing their 1988 to 1989 levels by 1995 (see Chart 1, next page). For office properties in particular, the ten fastest-growing cities in terms of rental rates saw increases exceeding 20 percent in 1996.[1]

[1] Those cities are, in order, Minneapolis, Columbus, Dallas, Portland, Salt Lake City, Atlanta, San Jose, Phoenix, San Francisco, and San Diego.

Table 1

Banks Are Increasing Their Flow of Funds into Commercial Real Estate ($ Billions)

	1991	1992	1993	1994	1995	1996
Net New Borrowing, All Sources	$ –15.6	$ –47.1	$ –21.5	$ –4.4	$ 22.6	$ 35.1
Commercial Banks	3.1	–8.4	–4.3	7.5	18.0	18.7
CMBSs	1.3	8.7	10.3	11.3	10.6	16.1
Savings Institutions	–22.4	–18.5	–7.5	–6.8	–1.8	0.8
Life Insurance Companies	–5.6	–15.1	–13.4	–10.5	–3.3	–2.5
All Other Sources	8.0	–13.5	–6.6	–5.9	–0.9	2.3
Equity Capital Flow, All Sources	$ 4.9	$ 3.1	$ 17.4	$ 21.6	$ 21.5	$ 30.3
REIT Equity Offerings	1.6	2.0	13.2	11.1	8.2	13.0
Pension Funds	–4.8	–4.3	–0.7	9.6	13.8	14.3
All Other Sources	8.1	5.4	5.0	0.9	–0.5	3.0

Sources: Federal Reserve, National Association of Real Estate Investment Trusts (NAREIT), LaSalle Advisors Investment Research

- Property capitalization rates, which measure the annual income generated by a property as a percentage of its purchase price, are falling (see Chart 2). These falling rates indicate that investors are paying higher prices for each dollar of current income generated by the property. Overall, however, prices have not yet caught up with rents, which now exceed their previous highs in some markets, suggesting that the current recovery is not yet peaking.

- Declining vacancy rates reflect strong demand for office properties, which ***Grubb & Ellis*** cast as the hottest sector in its 1997 forecast. Nationwide, office vacancies have fallen dramatically, by 5 to 10 percentage points during the last four years (see Chart 3). Moreover, ***Torto-Wheaton Research*** estimates that 21 of the 56 metropolitan areas it tracks had single-digit vacancy rates at the end of first quarter 1997. Not surprisingly, many of the tightest markets are those with the greatest rent inflation.

While the unrestrained commercial development of the 1980s continues to cast a shadow over the industry, that shadow is fading as declining vacancy rates and rising rental rates for existing properties fuel optimism among lenders and investors and strengthen the case for new development. Lenders, examiners, and analysts, however, must be diligent in monitoring commercial real estate markets to identify possible imbalances between supply and demand. It is particularly important that lending decisions be made on the basis of economic feasibility and realistic property cash flow projections rather than solely on the basis of competitive pressures.

Borrowers' Financing Options Expanding

Although banks are clearly the largest source of financing for resurgent commercial real estate markets, a broader and more competitive financing market has emerged. In this market, financing often bypasses banks, being funneled instead through entities that purchase and securitize commercial real-estate-secured debt or the properties themselves, parceling them into smaller, more standardized, and thus more liquid pieces that are attractive to institutional and individual investors alike. This trend is illustrated in Table 1, which shows the increasing roles commercial mortgage-backed securities (CMBSs) and real estate investment trusts (REITs) have played in funding commercial real estate over the past five years. This increase in public

Chart 1

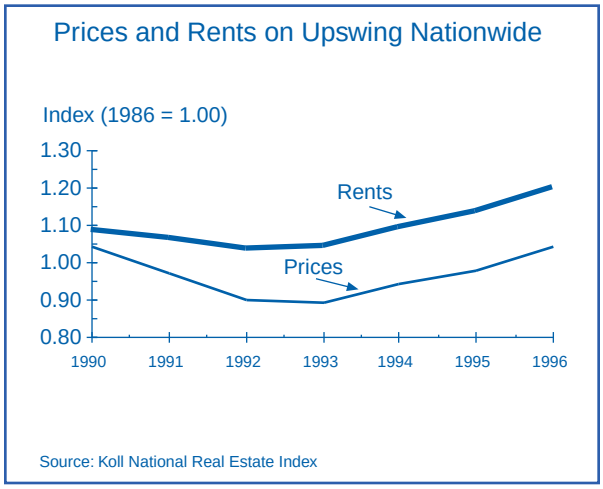


Chart 2

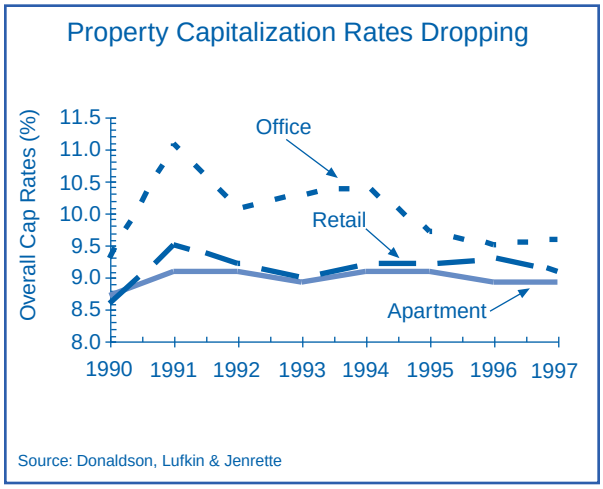
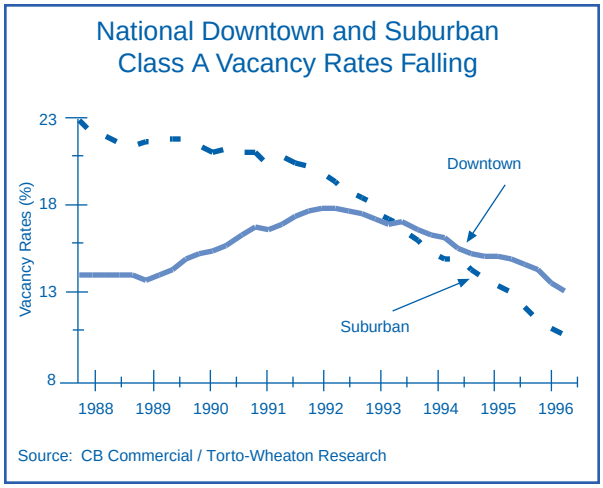


Chart 3



financing left financial institutions in 1996 with approximately a one-third share of all new net commercial real estate financing, down from well over half just a decade before.

From a lender's perspective, CMBSs offer several advantages over traditional portfolio lending. Most significantly, lenders can generate fee income from loan production and servicing activities while avoiding the excessive concentrations of credit risk that plagued lenders during the last real estate downturn.[2] According to ***Commercial Mortgage Alert***, outstanding CMBSs reached $125 billion in 1996 on a record $30 billion of new issuance. While outstanding volume is still dwarfed by the $3 *trillion* market for residential mortgage-backed securities (MBSs), the growth in CMBS volume has been remarkable considering that such securities were virtually nonexistent prior to 1991.

At present, most commercial banks are not active in issuing CMBSs, accounting for only $2.6 billion of CMBS issuance in 1996, according to ***E&Y Kenneth Leventhal Real Estate Group***. Rather, the primary source of these securities is investment banks, which generate substantial fees by converting existing loans into securities. CMBS issues also are being increasingly underwritten by *conduits*, which are entities created to originate mortgage loans for distribution to investors in the secondary market. ***Nomura Securities International*** estimates that such conduits accounted for over one-third of CMBS issuance in 1996, nearly double the volume of 1995. Only a handful of the largest commercial banks have set up conduit programs—the five largest banks accounted for $3.3 billion of the $10.2 billion in conduit issuance during 1996. Aside from this relatively small number of bank competitors, investment banks are among the largest and most active conduit issuers.

There is no fundamental reason why banks cannot take greater part in the rapidly growing CMBS market. In fact, they possess many distinct advantages over investment banks. Their distribution networks, lending experience, and back-office capabilities are naturally suited to facilitating loan demand, evaluating repayment risk, servicing loans, and monitoring a project's development. Obstacles of scale may preclude smaller institutions from directly issuing CMBSs ($500 million in volume is often cited as a minimum for efficiently assembling a deal). However, if the CMBS market develops like that for MBSs, standardized underwriting may enable small institutions to remain competitive either by cooperatively forming their own conduits or by selling their loans to existing conduits.

Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array of funding options. Moreover, the costs of public financing reflect efficiencies born of standardization and liquidity. In short, investors, including banks, can price, enter, and exit their positions in securitized debt more easily than could be done with whole loans. While improved efficiencies are a positive aspect of the growth in securitized investments, these efficiencies threaten to dictate bank pricing, thereby potentially reducing margins or driving institutions to lend on less economically feasible projects in an effort to preserve margins and market share.

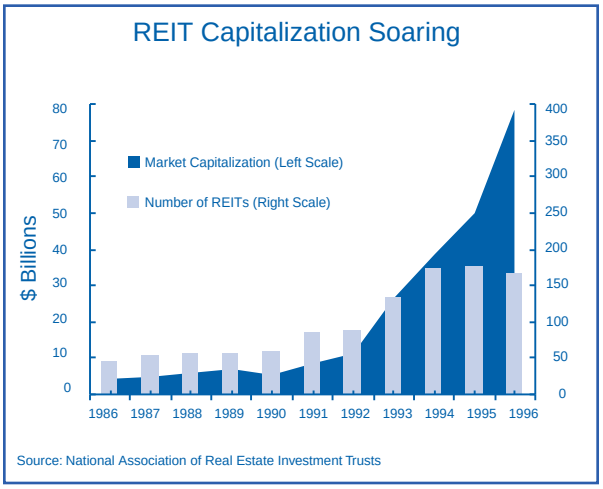
REITs: An Alternative to Traditional Capital Sources

Commercial real estate financing is evolving in other ways. REITs have become major players in the industry since 1993, accounting for fully one-fifth of funds flowing into real estate in 1996. REITs are much like mutual funds in that they allow indirect investment in real estate through purchases of equity in the REIT. The REIT itself holds title to the underlying properties and, provided it meets certain requirements, can directly pass through its earnings to investors without any intermediate tax. Although ***Moody's*** estimates place REIT holdings at less than 3 percent of all U.S. commercial real estate, outstanding REIT shares have grown considerably, with market capitalization doubling nearly three times in just four years (see Chart 4, next page). Accompanying this rise in capitalization has been an equally dramatic rise in bank lending to REITs. According to ***Loan Pricing Corporation***, bank lending to REITs surged to $12.8 billion in 1996, a 16 percent increase over 1995's then-record volume and more than a tenfold increase over the period 1990 to 1992.

The rise in REIT capitalization can be attributed in part to pent-up institutional demand for real estate. REITs

[2] While securitization of loans purports to shift credit risk to investors, many analysts and rating agencies have recently expressed concern over recourse arrangements, both contractual and voluntary, whereby the seller/servicer effectively assumes all or most of losses experienced by the security.

CHART 4



have a particular appeal to fund managers since they offer the benefits of investment diversification without the dual headaches of property management and asset illiquidity. Aside from the direct credit risk posed by lending to REITs, their rising popularity confronts banks with an indirect threat as well—the threat that banks could be crowded out of lending opportunities if investors find REIT funding structures more attractive from a cost and control standpoint. The degree to which this crowding out may occur is unclear, for according to ***Nomura Research***, REITs historically have borrowed 40 cents for each dollar of real estate held. However, well over half of this borrowing takes place through public offerings of secured and unsecured debt, leaving only a small portion to be financed by banks and other private lenders. Because REITs tend to focus on the highest quality projects, their increasing presence also creates concerns that banks may be driven to lend to less attractive or more risky properties to preserve market share.

Many analysts have also expressed unease over the rapid rise in the valuations of REITs, some of whose shares are priced at a considerable premium to the properties themselves. Anecdotal evidence suggests that premiums as high as 40 percent over market value have been paid for some REIT shares in recent months. Such market-based valuations create concern over the extent to which an REIT's capital structure allows it to pay more for properties than an investor who employs greater financial leverage. Accordingly, while REITs may make up a fairly nominal amount of overall real estate holdings, they may be quite influential in determining how commercial properties are being valued or appraised.

Commercial Real Estate Securitization: Some Broader Implications

Maturing CMBS markets could eventually improve the overall stability of commercial real estate markets not only by improving market liquidity but also by enabling investors to diversify and share their credit exposures among a greater number of participants. In addition, loan performance could become increasingly transparent to the general marketplace, thereby encouraging more uniform and prudent underwriting standards. However, concern naturally arises because CMBSs are a major source of commercial real estate market funding that has not been tested through a serious market downturn. This situation leads to questions concerning the impact they will have on property values and market liquidity and whether today's underwriting terms, driven largely by competitive factors, will stand up to tomorrow's market downturn. Another question is whether the standardized structures underlying these securities offer enough flexibility to borrowers to renegotiate loan terms—a critical workout tool during times of financial stress. The answers to these questions will ultimately determine the extent to which lenders and investors suffer as a result of the inevitable cyclical swings in commercial property values.

There are also questions about how REITs will affect commercial real estate markets. One argument is that the appetite for REIT investments, combined with the premiums that the trusts can pay for properties, will push the price of commercial space beyond sustainable levels. Those who hold this view see REITs, and other Wall Street innovations that increase the supply of funding, as potentially amplifying cyclical swings in real estate values. The contrary view holds that REITs will improve market efficiency by providing continuous pricing benchmarks through daily share price movements and thus enforce discipline upon developers and lenders. This discipline, it is argued, will prevent excessive development and dampen the severity of real estate cycles.

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estate-

based instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose how best to compete against—or participate in—these new real estate financing strategies.

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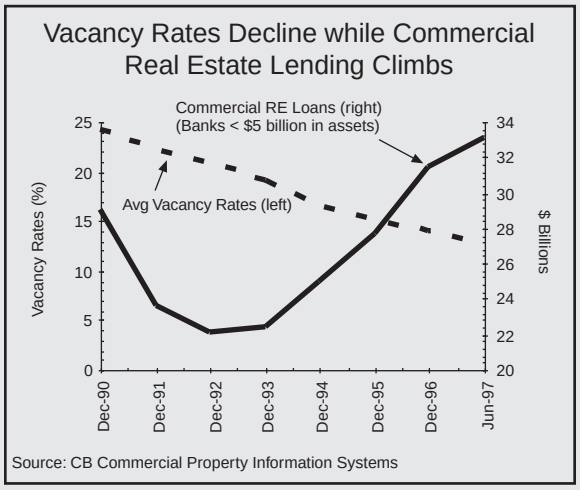
Commercial Real Estate Lending Is on the Increase in the Dallas Region

Average commercial office property vacancy rates for major metropolitan statistical areas (MSAs) in the Dallas Region have declined, as a group, from 25.6 percent as of the first quarter of 1990 to 12.7 percent as of the second quarter of 1997. The major MSAs in the Dallas Region include **Albuquerque, Austin, Denver, Dallas, Fort Worth, Houston,** and **Oklahoma City**. While all MSAs have shown declines in vacancy rates, Austin has shown the most dramatic reduction. In the first quarter of 1990 the Austin market experienced an average commercial vacancy rate of almost 30 percent; by the second quarter of 1997 that number had declined to 8.2 percent.

CHART 5



Denver is the only other MSA in the Dallas Region to report less than a 10 percent commercial vacancy rate. Oklahoma City, Dallas, and Houston all reported vacancy rates in excess of 15 percent as of the second quarter of 1997.

Commercial real estate lending trends in the Dallas Region have been consistent with the improvement in office markets. Since December 1993, commercial real estate lending (including commercial real estate, construction and land development, and multifamily loans) in the Dallas Region has increased almost 50 percent, to over $33 billion as of June 30, 1997. This analysis includes banks with total assets of less than $5 billion, which includes more than 99 percent of the institutions in the Region. Larger banks were excluded because many have headquarters outside the Dallas Region and frequently manage balance sheet positions by moving loans among subsidiary banks or selling loans to third-party investors. It should be noted that the above figures are for bank financing only. There also is considerable activity by real estate investment trusts (REITs) and conduits issuing collateralized mortgage obligations (CMOs) (see Chart 5).

Increased commercial estate lending has been accompanied by increased demand for space as reflected in higher office rents (see Table 2, next page).

The Dallas Region's commercial real estate market, like the nation's, has benefited greatly over the past several years from numerous positive factors. These factors include increased liquidity (bank lending, REITs, and CMOs), reduced vacancy rates, and a

generally favorable economy (relatively low interest rates, inflation, and unemployment). These factors have generally resulted in increasing commercial real estate prices throughout the Dallas Region as well as a resurgence in commercial real estate lending. Well-managed institutions will continue to base lending decisions on economic feasibility and realistic property cash flow projections rather than solely on competitive pressures.

Alan C. Bush, Regional Manager
Jeffrey A. Ayres, Financial Analyst

Table 2

Average Cost per Square Foot for Class A Office Space in Selected Dallas Region MSAs

Metropolitan Area	2Q96	2Q97	% Increase
Albuquerque	$17.38	$18.12	4.3
Austin	20.15	22.00	9.2
Dallas–Fort Worth	17.53	18.80	7.2
Denver	17.79	18.38	3.3
Houston	14.34	16.33	13.9
Oklahoma City	12.58	12.84	2.1

Source: CB Commercial National Real Estate Index

NAFTA: Three Years Later

- **Three years after the passage of NAFTA, prospects for growth in trade with Mexico appear good.**
- **Rapid growth in the high-technology industries has been instrumental in the Dallas Region's outpacing the U.S. as a whole during this decade.**
- **Rural economies, which experienced job losses throughout much of the 1980s, have recovered strongly during the 1990s.**

Three years after NAFTA: An Overview

This past summer, the Clinton administration released a report examining the economic effects of the North American Free Trade Agreement (NAFTA) after three years in operation. Although the report measured the economic effects of NAFTA on all three nations, this article will concern itself with the effects of trade with Mexico on the Dallas Region, because of the proximity and importance of Mexico's economy to the Region. The administration's report—a compendium of several independent studies—found that the economic effects of NAFTA on the United States were positive, albeit small.

The goal of NAFTA was to reduce trade barriers between the United States, Canada, and Mexico. In the year before NAFTA, the average Mexican tariff rate applied to U.S. exports was 10 percent. After NAFTA, from 1993 to 1996, Mexico's average tariff rate on U.S. exports dropped to 2.9 percent. In the same three-year period, U.S. exports to Mexico grew nearly 36.3 percent ($15.1 billion) to a record high of $56.8 billion in 1996. By comparison, exports from the Region to Mexico grew only 22.1 percent ($3 billion) to $16.8 billion over that period.

Accounting for the Difference. The divergence in export performance between the United States and the Dallas Region was largely the result of two factors. The first was the rapid expansion of Mexico's maquiladora industry during the 1990s. The second was the negative effects of Mexico's peso crisis in December 1994 and Mexico's subsequent recession in 1995.

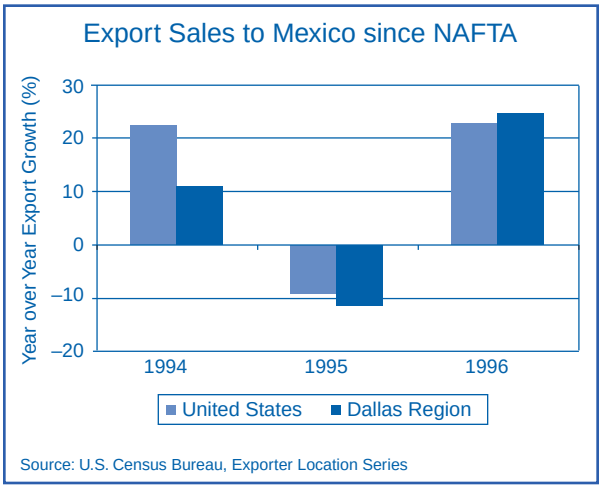
A maquiladora plant takes U.S. intermediate goods and transforms them into final goods, ready for duty-free re-export back to the United States. Almost half of Mexico's manufactured-goods exports in 1996 were produced in maquiladora plants. Nearly three-quarters of maquiladora employment is concentrated in three sectors: electronics, transportation equipment, and apparel/textiles. Furthermore, nearly 85 percent of Mexico's merchandise exports in 1996 were manufactures—up from 45 percent ten years earlier.

As a result of the long-standing access to duty-free production on the other side of the border enjoyed by manufacturers in the Dallas Region, exports from the Region to Mexico after NAFTA did not grow as fast as U.S. exports to Mexico. This phenomenon manifested itself in a faster rate of growth in the non-maquiladora component of Mexican imports relative to the maquiladora component, a result of the former's ability to realize the full benefits of lower tariff rates. Given the geographic proximity, it is believed that a significant portion of U.S. maquiladora activity occurs within the Dallas Region. The disparity in export growth rates to Mexico between the United States and the Region should disappear over time as manufacturers adjust to the new realities of NAFTA.

Another factor that affected export sales from the Region was the devaluation of Mexico's peso in December 1994. Devaluation substantially increased the cost of U.S. imports to Mexico, plunging the Mexican economy into recession. Consequently, exports from the United States and the Dallas Region fell sharply in 1995 (see Chart 1, next page).

Winners and Losers. It is still too early to tell definitively which industries in the Region have benefited most since NAFTA's passage. ***U.S. Census Bureau*** data (Exporter Location Series) by industry sector exist for the years 1994 and 1995; however, export data for both years were contaminated by the devaluation of the peso during that period, making it extremely difficult to

CHART 1



discern NAFTA's true impact on exports from the Region. On the basis of dollar volume, the industries that stood to gain the most were electrical and electronic equipment, industrial machinery and computers, chemical products, and transportation equipment. Approximately half of the Region's export sales to Mexico involved one of these four industry sectors.

The initial effects of NAFTA were not as favorable for some industries. The U.S. Department of Labor (DOL) found that, as of May 31, 1997, nearly 130,000 U.S. workers had lost their jobs as a result of NAFTA. DOL estimates that about one out of eight of these workers were from the Dallas Region, and nearly 40 percent were employed in either the apparel or electronics industry. In addition to the effects on employment, there remains a great deal of dispute on issues regarding environmental and labor concerns, the handling of cross-border litigation, and inadequate funding for worker/business assistance programs and project development along the border.

Implications: Although exports from the Region to Mexico have not grown as fast as those of the nation as a whole, future benefits from U.S.-Mexican trade should promote economic prosperity in the Region because of large trade flows. This is particularly true now that Mexico is once again enjoying healthy economic growth. If export sales to Mexico continue to grow at the current double-digit rate, U.S. bankers will likely experience increased lending opportunities.

Cross-border lending may involve risks that are not present in domestic lending. An important set of issues involves questions of cross-border jurisdiction. International lawyers are reporting a rise in the number of cross-border lawsuits and arbitration cases. For example, one case involved a South Texas cattle rancher and his Mexican lender. The lender originally won a judgment against his borrower that was later upheld by the Mexican Supreme Court. A U.S. magistrate in Houston, however, ruled in favor of the rancher, arguing that the contract violated state usury laws, and recommended that U.S. courts disregard the Mexican ruling. In another case, a federal judge in Houston ruled that foreign debtors living in the United States fell under the jurisdiction of U.S. bankruptcy laws. The ruling set a precedent that Mexican banks could pursue borrowers who have property in the United States, especially when those borrowers live and do business in the United States. Although these two cases involved lenders and debtors from Mexico, U.S. banks and their borrowers could some day face comparable circumstances.

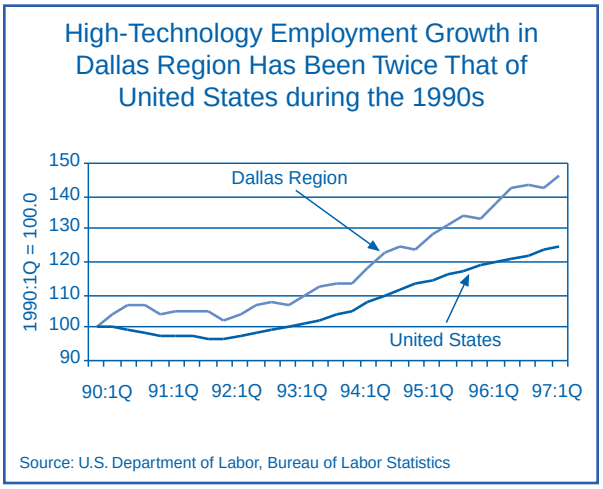
High Technology Propels Region's Growth in the 1990s

One of the driving forces behind the Dallas Region's strong economic growth in the 1990s has been the emergence and rapid growth of its high-technology industries. Although there is no single definition of what constitutes a "high-technology industry," for purposes of this article it will include industrial machinery and equipment, electronics and other electrical equipment, communications, and business services. While this definition is somewhat arbitrary and captures a significant number of non-high-technology industries, these four industries include most high-technology firms and allow for national and regional comparisons.

High-technology industries have flourished in **Austin**, **Dallas**, **Denver**, **Tulsa**, and **Rio Rancho**, **New Mexico**. High-technology firms that are either headquartered in the Region or have facilities here include Texas Instruments, Motorola, Compaq, Dell, and Intel, to name a few. High-technology employment in the Dallas Region grew nearly twice as fast as high-technology employment in the nation during the 1990s, 46 percent versus 25 percent (see Chart 2). Perhaps not coincidentally, total nonfarm employment grew almost twice as fast in the Dallas Region as in the nation as a whole over that same period (23 percent versus 12 percent).

According to the ***American Electronics Association's (AEA) Cyberstates*** report—a state-by-state overview of the high-technology industry—the Dallas Region

CHART 2



employed approximately 475,000 high-technology workers in 14,200 establishments as of 1995, with an estimated payroll of almost $22 billion. The average high-technology worker received an annual salary of $46,000. In 1995, high-technology exports from the Region totaled almost $35 billion, or 45 percent of total exports from the Region that year.

What are the industry's growth prospects? Two major factors driving the high-technology industry will be the growth of the personal computer (PC) market and the continued investment boom for new information-technology equipment by businesses. Analysts expect PC shipments to grow at annual rates of 15 percent to 20 percent through the year 2000. The current penetration rate for computers (the percentage of U.S. households that already own a computer) is 40 percent, far below the penetration rates for other household electronics such as television sets or telephones. Analysts expect household demand for PCs to be spurred by

- a strong U.S. economy and rising incomes;
- a continued increase in Internet usage; and
- the introduction of high-quality low-end ($1,000 or less) computers.

According to ***U.S. Department of Commerce*** data, U.S. businesses invested nearly $800 billion in information-technology equipment during the five-year period that ended in 1996, and slightly more than one-third of this total was in computers and peripheral equipment. Adjusted for inflation, that was an average annual growth rate of almost 17 percent. Chart 3 shows business investment in information-technology equipment plotted against real gross domestic product. Clearly, strong investment by businesses has contributed greatly to the growth of the high-technology industry.

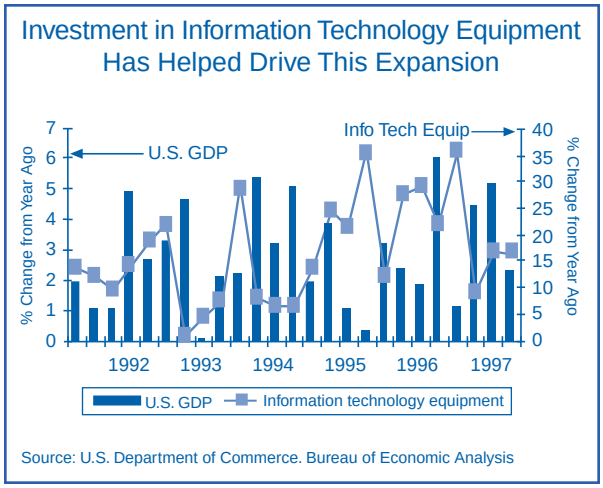
Implications: The Region's high-technology industry has contributed to its strong economic growth; however, business cycles may be more pronounced in this area precisely because of its large high-technology base. Although the dominant firms in the industry tend to raise their funds through capital markets, many small suppliers, support industries, and the workers they employ depend on depository institutions for their borrowing needs. Thus, lending opportunities may be plentiful for these rapidly growing industries. Lenders should be cognizant, however, of the boom-bust nature of the industry and apply appropriate risk-management measures.

Rural Economies Recovered Strongly in the 1990s, after Suffering Job Losses in the 1980s

Job growth in metropolitan and rural areas in the Dallas Region during the past 15 years has been a study in contrasts. Total employment in the Region's metropolitan areas grew, albeit slowly, during the 1980s. Rural employment, on the other hand, declined over the same period. In the 1990s, however, both rural and metropolitan areas were experiencing employment growth faster than the nation.

Table 1 (next page) shows annual average growth rates in nonfarm employment for two different time periods

CHART 3



for **New Mexico**, **Oklahoma**, and **Texas** (Colorado was omitted because of data gaps). From 1982 to 1989 (Period I), rural areas experienced employment losses in all three states totaling 210,100, with Texas rural areas alone losing 152,000 jobs. Economic downturns in agriculture and the oil and gas industry were largely responsible for the decline in jobs in many of these resource-dependent communities.

Metropolitan areas, meanwhile, did not altogether escape the economic fallout from agriculture and oil. These two depressed industries, combined with weaknesses in banking and real estate, held metropolitan average job growth in Texas (1.9 percent) and Oklahoma (–0.1 percent) far below the national average growth rate (2.7 percent) during this period. Metropolitan average job growth in New Mexico (4.6 percent) was the exception, stimulated by large defense expenditures as a result of the Reagan defense buildup.

By the 1990s, the three states' rural areas were once again adding jobs. Rural economies generated 250,200 jobs from 1989 to 1996. Table 1 shows rural areas in all three states growing at virtually the same rates as their metropolitan counterparts in Period II. Both metropolitan and rural economies in the Region grew faster than the nation's economy.

Rural economies are growing again in the 1990s, partly as a result of agriculture's improved financial and economic health. Net farm annual income in the Dallas Region has averaged $5.3 billion this decade, twice as much as the $2.6 billion averaged during the 1980s. According to the ***U.S. Department of Agriculture's Economic Research Service (ERS)***, U.S. net farm annual income in 1997 should be close to its 1990 to 1995 average of $43 billion. Although the ERS does not make a separate forecast for individual states, the Dallas Region is expected to record solid gains in net farm income this year as well. Higher beef cattle prices caused by reductions in the beef herd and strong export demand are expected to contribute to this projected gain. Cattle and calves account for about half of state farm receipts in Colorado, Oklahoma, and Texas, and slightly more than one-third in New Mexico. Together, these four states account for 30 percent of the nation's farm receipts in cattle and calves. Rising agricultural exports have been another major contributor to a healthy farm sector. U.S. agricultural production has outstripped domestic consumption, so strong export demand is important for farmers. Agricultural exports from the Dallas Region in 1995 totaled $4.8 billion, or 8.8 percent of total U.S. agricultural exports. Leading exports from the Region were cotton, live animals, feed grains, wheat, and hides and skins.

Table 1

Metropolitan and Rural Employment Growth Converge in the 1990s

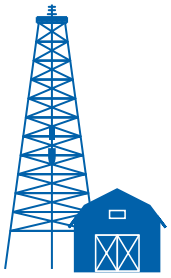
Period	I 1982–1989		II 1989–1996	
	AAGR	Jobs Gained (Lost)	AAGR	Jobs Gained (Lost)
New Mexico	2.5%	88,600	3.1%	131,800
Metropolitan Areas	4.6%	97,700	3.1%	86,300
Rural Areas	–0.6%	(9,100)	2.9%	45,500
Oklahoma	–0.6%	(53,100)	2.2%	190,800
Metropolitan Areas	–0.1%	(4,100)	2.2%	144,800
Rural Areas	–2.1%	(49,000)	2.1%	46,000
Texas	1.3%	577,400	2.7%	2,130,700
Metropolitan Areas	1.9%	729,400	2.7%	1,972,000
Rural Areas	–2.4%	(152,000)	2.6%	158,700
United States	2.7%	18,340,000	1.5%	11,639,000

AAGR = Annual Average Growth Rate
Source: U.S. Department of Labor, Bureau of Labor Statistics

The resurgence of the oil and gas industry in recent years has also contributed to growth in certain rural areas. Although oil prices are below their early 1980s peak, industry restructuring and the development of new technologies have enabled producers to cut costs, improve productivity, and open up new areas of exploration. The cost of finding and developing a barrel of oil today is 40 percent lower than five years ago. The result is that producers can now earn profits with oil at $16 per barrel or natural gas at $1.60 per thousand cubic feet.

Agriculture nevertheless remains a major factor driving economic and employment growth in many rural communities. ERS data show agriculture-related employment as a share of total rural employment in the Dallas Region—from production to wholesale and retail—ranging from 19 percent to 28 percent. By contrast, agriculture-related employment in the Region's metropolitan areas accounted for only 13 percent to 14 percent of total employment, the overwhelming majority of which is in wholesale and retail trade.

Implications: The resurgence of rural economies is just one reason why employment growth in the Dallas Region has outpaced U.S. employment growth in the 1990s. Behind this improved performance has been the recovery of two of the Region's basic industries—agriculture and oil—and the expansion of high-technology industries. Loan growth and credit quality of banks and thrifts in this Region will continue to be influenced substantially by development in these industries.



Adrian R. Sanchez, Regional Economist

Financial Markets

- **Bank holding companies of all sizes have issued trust preferred stock following the Federal Reserve's decision in October 1996 to count these tax-advantaged capital securities toward Tier 1 capital.**

- **Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget this year, there still exists the possibility that the Internal Revenue Service may alter the tax treatment of trust preferred dividends.**

- **Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the potential risks associated with excessive reliance on debt-like capital instruments.**

Bank holding company capital requirements were effectively relaxed in October 1996 when the Federal Reserve ruled that trust preferred stock may be included in the portion of cumulative preferred stock that can compose up to 25 percent of a bank holding company's Tier 1 capital. In the wake of this decision, financial institutions moved quickly to issue trust preferred stock. Trust preferred stock can be a less expensive form of Tier 1 capital for bank holding companies because of the tax deductibility of the dividend payments paid on this type of preferred stock.

Approximately 90 banking organizations issued an estimated $21 billion of trust preferred shares from October 1996 through June 1997.[1] The dollar amount of trust preferred stock issued represented almost 95 percent of the incremental amount of Tier 1 capital added by those institutions during the period. A number of these institutions used the proceeds of trust preferred stock issues to fund stock buyback programs. As an example of the relative importance of these stock buyback programs, one large bank holding company's Tier 1 capital ratio would be 7.25 percent excluding the trust preferred shares, and 8.34 percent including the shares.

Rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital because of its limited life and debt-like characteristics. These characteristics include the tax treatment of trust preferred dividends,[2] the limited life of the shares, and the ability of investors to accelerate their claims against the bank holding company. Institutions contemplating issuing trust preferred stock should be aware of the concerns expressed by rating agencies and of the possibility that excessive reliance on debt-like capital instruments could increase their financial fragility during times of economic stress.

Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative

Trust preferred shares, also known as capital securities, are traded under different names depending on the underwriter, payment terms, and maturity. Some of the more common acronyms include TOPRS (Trust Originated Preferred Shares), QUIPS (Quarterly Income Preferred Shares), and MIPS (Monthly Income Preferred Shares).

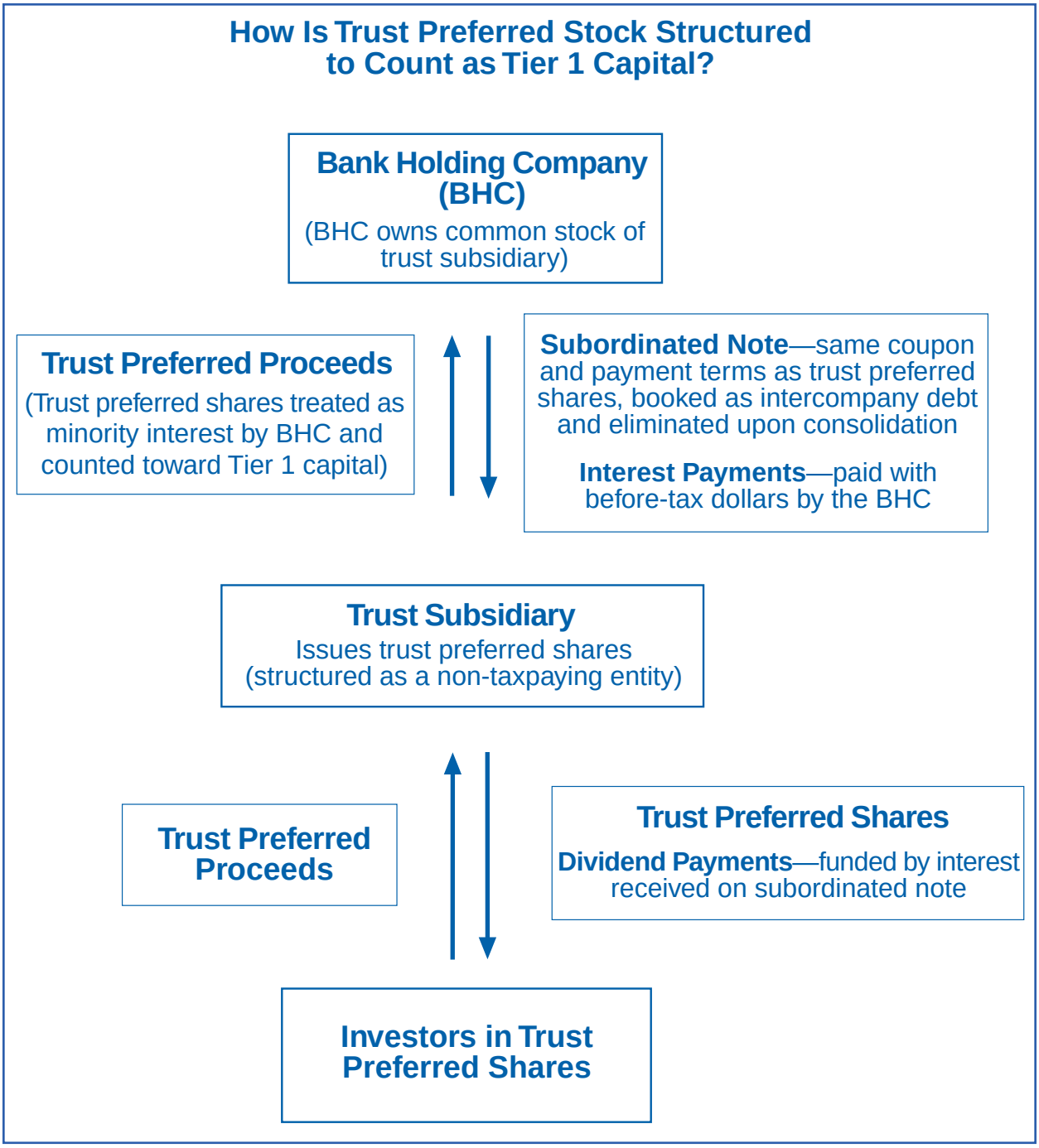
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary is owned by the bank holding company, and the trust preferred stock is sold to investors. The trust upstreams the proceeds from the sale of the preferred shares to the bank holding company in exchange for a long-term, deeply subordinated note with terms identical to the trust preferred shares. (The subordinated note must be the sole asset of the trust and subordinated to all other debt of the bank holding company.)

On a consolidated basis, the trust preferred stock is treated as a minority interest of the bank holding company, and the subordinated note is eliminated as inter-

[1] The amount of trust preferred stock outstanding is not delineated in Call Reports.

[2] Trust preferred dividends, unlike dividends on traditional preferred stock, are treated as a tax-deductible expense at the bank holding company level and as taxable income by investors of the trust preferred shares.

CHART 1


How Is Trust Preferred Stock Structured to Count as Tier 1 Capital?
Bank Holding Company (BHC)
(BHC owns common stock of trust subsidiary)
Trust Preferred Proceeds
(Trust preferred shares treated as minority interest by BHC and counted toward Tier 1 capital)
Subordinated Note—same coupon and payment terms as trust preferred shares, booked as intercompany debt and eliminated upon consolidation
Interest Payments—paid with before-tax dollars by the BHC
Trust Subsidiary
Issues trust preferred shares (structured as a non-taxpaying entity)
Trust Preferred Proceeds
Trust Preferred Shares
Dividend Payments—funded by interest received on subordinated note
Investors in Trust Preferred Shares

company debt. The interest paid by the bank holding company on the subordinated note, which is tax-deductible at the bank holding company level, is used to fund the dividends on the trust preferred shares. In short, the issuing trust serves as a conduit for exchanging cash flows between the bank holding company and the investors in the trust preferred shares.

To be eligible for Tier 1 capital treatment, trust preferred dividends may be cumulative, but dividends must be deferrable for a minimum of five years. If the dividends are not paid for more than five years, the trust preferred shares could be exchanged for junior subordinated debt of the trust. After the exchange, the trust preferred holder could declare an event of default and accelerate the claim against the bank holding company. Trust preferred shareholders would then be treated similarly to deeply subordinated debt holders or preferred stockholders of the bank holding company.

Trust preferred shares typically have maturities of 30 years or more and contain call options and redemption provisions. The redemption provisions, which are subject to Federal Reserve approval, permit the issuer to redeem or buy back the preferred shares prior to maturity upon an adverse event such as the loss of Tier 1 capital treatment or the tax deductible status.

Banks are not permitted to count trust preferred stock toward Tier 1 capital because of the cumulative feature of trust preferred dividends. While bank holding companies are permitted to include up to 25 percent of Tier 1 capital as cumulative preferred stock, including trust preferred shares, banks must exclude cumulative preferred stock from Tier 1 capital ratios pursuant to the Risk-Based Capital Standards set by the Basle Accord.

Bank Holding Companies of All Sizes Have Issued Trust Preferred Stock

The flood of trust preferred stock issuance was prompted in part by the threat of extinction under the 1997 federal budget. Bank holding companies rushed to take advantage of a potentially short-lived tax loophole, while investors were attracted by the opportunity to earn higher rates than on similarly rated bank debt. Bank holding companies have used proceeds from trust preferred stock to retire or call more expensive outstanding preferred issues, to provide capital to bank subsidiaries, to finance acquisitions, and to buy back common stock.

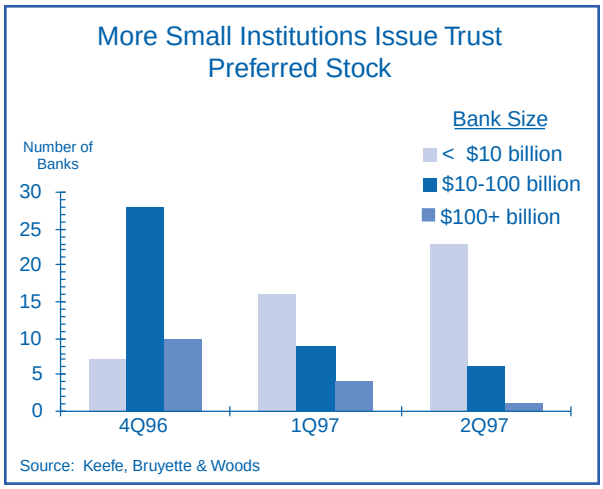
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated $4.3 billion in the first quarter of 1997 to just under $2.5 billion in the second quarter. Trust preferred issuance by larger banks declined as some approached their limit on Tier 1 trust preferred, while more smaller banks took advantage of the market for trust preferred stock. (See Chart 2 for a distribution of the number of banks in various size categories that have issued trust preferred stock in recent quarters.) Investment bankers are reportedly working on new structures that may make it easier and more cost effective for smaller institutions to issue these capital securities, perhaps through some pooling arrangement.

REIT Preferred Stock—Another Type of Tax-Advantaged Tier 1 Capital

Prior to the Federal Reserve's announcement last October, the REIT (real estate investment trust) preferred stock structure was the chosen way for financial institutions to issue tax-advantaged preferred shares. Bank-issued REIT preferreds lost favor once trust preferreds debuted, because the trust structure is less costly and easier to administer than REIT preferreds.

In an REIT preferred structure, the issuer establishes a corporation that elects REIT tax status. Proceeds from the preferred shares that are sold to investors are used to purchase qualifying real estate assets such as mortgage-backed securities or equity interests in real property. Cash flow from the real estate assets funds the REIT's

CHART 2



operating costs and preferred dividends. As long as the subsidiary continues to qualify for REIT tax status,[3] dividend payments on the common and preferred shares are tax deductible by the holding company.

Will the Tax-Advantaged Status of Trust Preferred Stock Continue?

Although the tax-advantaged status of trust preferred stock was not eliminated in the federal budget, the possibility still exists that the Internal Revenue Service (IRS) may alter the tax treatment of trust preferred dividends. (In the first half of 1997, the IRS issued a ruling that eliminated the tax-advantaged status of a specific type of preferred stock known as Step-Down preferred stock.) If the tax advantage is eliminated, REIT preferred shares might again become a more popular means of raising tax advantaged Tier 1 capital.

Issues and Concerns

A number of bank holding companies have embarked on stock buyback programs financed by trust preferred stock issuance, thereby boosting earnings per share by reducing the number of common shares outstanding, while maintaining Tier 1 regulatory capital ratios. Rating agencies and investment analysts, however, generally view trust preferreds as analogous to preferred stock or deeply subordinated debt of the issuer. *In fact,* ***Standard & Poor's*** *has announced that bank holding companies with trust preferred stock in excess of 10 percent of Tier 1 capital may be subject to a ratings review.* This announcement reflects the view of some analysts that trust preferred stock is a weaker form of Tier 1 capital than other forms of capital such as common and perpetual preferred stock, because of its limited life and treatment upon a liquidation of the trust.

A recent regulatory interpretation has underscored the debt-like nature of trust preferred stock. The Office of the Comptroller of the Currency (OCC) has determined that investments by banks in trust preferred stock should be treated as investments in debt securities.[4] The OCC cited a number of similarities between trust preferred stock and debt securities, including the fact that an investment in trust preferred securities is functionally equivalent to an investment in the underlying subordinated debt issued by the bank holding company, and that the trading characteristics of trust preferred securities are similar to traditional debt securities.

Banking organizations should be aware of the views of rating agencies and bank analysts toward trust preferred stock. In times of economic stress, excessive reliance on debt-like capital instruments could result in increased financial fragility of the overall organization, a higher cost of raising new capital, and potential ratings downgrades. In extreme scenarios, pressures on the bank to service the obligations (explicit or implicit) of the holding company could attract the attention of bank regulators.

Kathy R. Kalser, Chief
Financial Sector Analysis Section

[3] To qualify as an REIT, the subsidiary must comply with Section 856 of the U.S. Federal Income Tax Code, which requires that 75 percent of the REIT's income come from real property rents, interest income from mortgage debt on real property, and other related sources. In addition, the REIT must distribute at least 95 percent of its net income to shareholders.

[4] In a letter dated April 8, 1997, the OCC stated that subject to applicable rating and marketability requirements, bank investments in trust preferred stock would be treated as Type III investments under 12 CFR Section 2 1.2 (k).

Current Regional Banking Conditions

- **Banks and thrifts in the Dallas Region continued to report strong financial performance in the second quarter.**
- **Banks that elected Subchapter S corporation tax status report higher earnings, but institutions considering this election should be aware of both the benefits and the drawbacks of this tax status.**
- **Insurance and securities sales are changing the landscape of the financial services industry.**
- **Banking consolidation in the Dallas Region is most prevalent among metropolitan banks.**

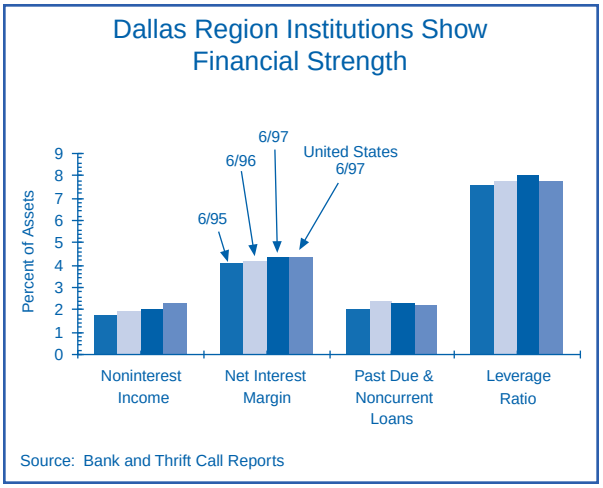
Overview

The Region's insured institutions are reaping the benefits of a strong economy, stable interest rates, and increasing fee income. Banks and thrifts in the Dallas Region continue to display solid financial condition (see Chart 1). During the second quarter of 1997, they saw

- the aggregate Tier 1 capital ratio climb six basis points to 8.06 percent of average assets;
- total past-due loans decrease by 19 basis points to 2.28 percent of total loans and leases; and
- net interest income and noninterest income increase as a percentage of assets.

In past ***Regional Outlook*** publications, concern was expressed over farm banks in Oklahoma and the Texas panhandle as a consequence of low cattle prices and poor wheat harvests. Cattle prices have since rebounded and the strength of this year's wheat harvest surprised many. These factors helped **Oklahoma** farm banks (institutions with agricultural loans greater than 25 percent of total loans) increase their quarterly return on assets (ROA) from 0.74 percent in the second quarter of 1996 to 1.42 percent in the second quarter of 1997. Despite this recent improvement, income volatility of this magnitude merits the continued attention of banks in these areas.

CHART 1



Subchapter S Banks

This section revisits the Subchapter S tax status issue originally discussed in the first quarter 1997 ***Regional Outlook*** In Focus article "New Tax Benefits for Owners of Community Banks." (Back issues of the ***Regional Outlook*** for each region are available on the FDIC's website at http://www.fdic.gov/publish/regout/index.html.) By the end of the second quarter, 144 of the Region's 1,554 institutions, with assets of $11.3 billion, had elected the Subchapter S corporation tax status. This corporate tax structure, which passes the federal income tax liability through the corporation directly to shareholders, is a benefit directed at closely held institutions, usually smaller banks. The median-size Subchapter S bank in the Dallas Region has assets of $51.5 million. Eighty (55 percent) of the banks are located in nonmetropolitan areas. Nine out of ten of these nonmetropolitan Subchapter S banks are located in counties with populations of less than 20,000.

Banks in the Region that have taken advantage of the Subchapter S corporation tax status are realizing anticipated benefits. From 1994 through 1996, the average ROA for Subchapter S banks was 1.36 percent, com-

pared with 1.17 percent for all institutions in the Region. Aided by the new tax status, these banks increased their ROA to 2.29 percent for the second quarter of 1997, which compares very favorably with 1.27 percent for all institutions in the Region. (The ROA data for Subchapter S banks in this discussion excludes the largest Subchapter S bank in the Region because its performance indicators skew the averages.) Table 1 shows the significant effect of eliminating income tax at the corporate level.

Election of Subchapter S status may affect a bank's financial results in several ways. Because Subchapter S banks no longer pay federal income tax, net income or financial ratios that use net income may be misleading if they are compared with earlier performance as a Class C entity or with other Class C status banks. One solution to that problem is to analyze profit measures at the pretax level. Also, shifts in securities portfolios—possibly at the behest of shareholders—may occur to take advantage of the benefits of tax-free securities that will now pass through directly to shareholders. While the new tax status adds pressure to pay dividends to provide shareholders with funds for tax payments, the dividend payout ratio is not out of line with that of other banks in the Region. As the year draws to an end and the income picture for these banks and other investments held by Subchapter S shareholders crystallizes, the dividend payout could become more pronounced.

Table 1

Subchapter S Banks—Before and After Tax Status Election

Quarterly Income Stream Components as a Percent of Average Assets—Annualized

	Jun-97	Jun-96
+ Net Interest Income	4.69	4.73
+ Noninterest Income	1.49	1.64
– Provision Expense	0.17	0.27
– Overhead Expense	3.74	3.74
= Pretax Net Operating Income	2.28	2.35
+ Securities Gains/Losses	0.00	0.01
– Applicable Income Taxes	–0.01	0.78
+ Extraordinary Items, Net	0.00	0.00
= Return on Average Assets	2.29	1.57

Source: Bank and Thrift Call Reports

In addition to potential pressure for dividend payment—possibly motivated by investors' needs—this tax structure could mean less flexibility for an institution that may want or need to increase capital resources. Subchapter S institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. Consequently, should a bank operating with a Subchapter S structure need to raise capital, difficulties could arise because the total number of shareholders must remain at 75 or fewer to preserve the S status. Furthermore, no new classes of stock may be issued. This restriction may limit the potential sources of new capital to existing shareholders. Growth or acquisition opportunities requiring additional capital may also be hindered with capital resources being confined to a limited number of shareholders.

Update on Insurance and Securities Activities

Insurance. The Supreme Court determined in March 1996 that state laws cannot prevent or significantly interfere with national bank powers under Section 92 of the National Banking Act, which allows national banks to sell insurance from small towns with fewer than 5,000 residents. Since then, 19 states have enacted or revised their laws governing how banks may enter the business. Measures enacted thus far take many different approaches. In the Dallas Region, **Colorado** allows banks to sell insurance statewide with few restrictions. In **Oklahoma** and **Texas**, insurance sales offices may only be in towns of 5,000 or fewer residents, and banks must build strong firewalls and follow tough consumer protection requirements. In **New Mexico**, banks are forbidden to offer borrowers a discount on insurance and may not solicit a loan customer until the credit has been approved. Many bankers and analysts see insurance sales as a way to expand the revenue that can be generated from their customer base. Consequently, many banks argue that they should be allowed to sell insurance in larger towns. In this regard, it should be noted that current rules provide an incentive to larger banks to establish branch locations in small towns.

Securities. The Federal Reserve Board first allowed banks to set up securities underwriting units in 1987, under a loophole in Section 20 of the 1933 Glass-Steagall Act. Since then, 44 banking companies have created securities units, usually gaining Tier 1 powers first, which include municipal securities underwriting and dealing and asset securitization. After gaining expe-

rience, banks apply for Tier 2 powers, which permit corporate debt and equity underwriting and dealing.

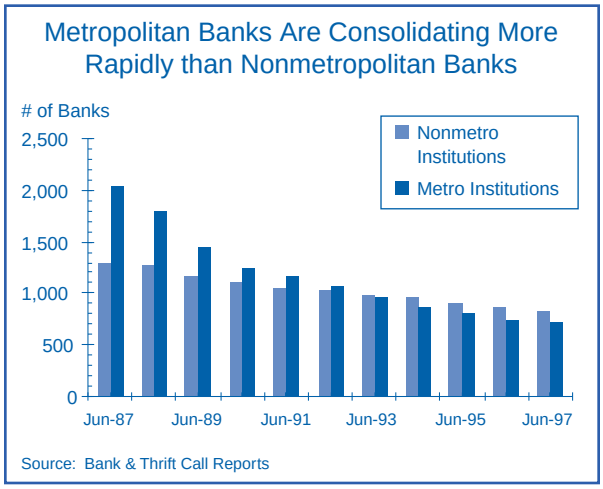
Initially, the Federal Reserve allowed banks to earn only 5 percent of the revenue in their securities affiliates from the new powers. In 1989 the income limit was hiked to 10 percent. Late last year the Federal Reserve raised it again, this time to 25 percent. Prompted by the Federal Reserve Board's relaxation of rules governing bank securities operations, five of the nation's largest banks are acquiring securities firms. The higher limit, which took effect on March 6, 1997, has made it practical for regional banks to actively use their Section 20 units and made it possible for the industry's biggest players to buy investment banks.

The Federal Reserve Board began work on August 21 to abolish nearly two dozen firewalls between banks and their Section 20 affiliates. The firewalls will be replaced by a set of operating standards. The changes are expected by many to allow banks to extend credit to customers of their underwriting affiliates, offer letters of credit and credit enhancements in conjunction with underwriting, buy stocks from related securities firms, and count investments in Section 20 subsidiaries toward the holding company's capital requirements. (A summary of these changes as well as the actual modification to 12 CFR Part 225—Regulation Y—is available at the Federal Reserve website: http://www.bog.fed.us.)

Banking Consolidation Is Most Prevalent in Metropolitan Areas

The pace of banking industry consolidation over the past ten years has been significantly more pronounced for metropolitan banks than for nonmetropolitan banks (see Chart 2). The number of metropolitan banks and thrifts in the Region declined by 65 percent over the ten-year period ending June 1997, compared with 36 percent for nonmetropolitan entities. In 1994 the number of nonmetropolitan banks and thrifts in the Region surpassed the number of metropolitan banks and thrifts. The reasons for the differing speeds of consolidation include the following: (1) demographic growth expectations are higher in metropolitan areas; (2) metropolitan banks tend to be larger, which may provide economies of scale that allow them to offer a broader array of services; (3) concentrated markets may offer the greatest potential for cost savings, through the elimination of redundant branch sites and the capture of large local market share; and (4) due diligence and other related merger and acquisition costs per dollar of acquired assets are greater for smaller acquisitions.

CHART 2



Implications: Consolidation may significantly alter the competitive environment. Banks may feel pressure to alter pricing strategies or credit standards to preserve individual customer relationships or market share in general. In addition, competition may lead banks to venture into unfamiliar product lines. An important challenge for banks will be to remain focused on maintaining sound lending standards and other operating policies despite these competitive pressures.

Alan C. Bush, Regional Manager
Jeffrey A. Ayres, Financial Analyst

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