Regional Outlook

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DANIEL FRYE, REGIONAL MANAGER

NORMAN WILLIAMS, REGIONAL ECONOMIST

CAMERON TABOR, FINANCIAL ANALYST

In Focus This Quarter

Regular Features

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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

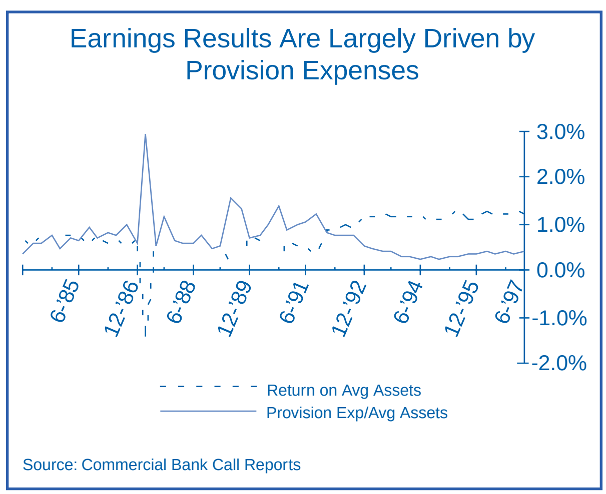


Chart 2

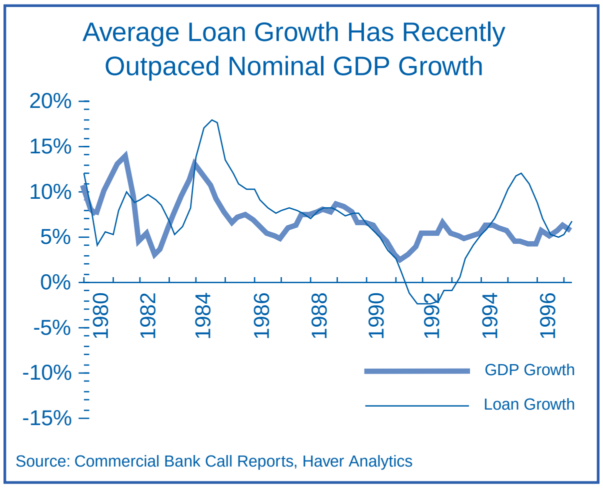
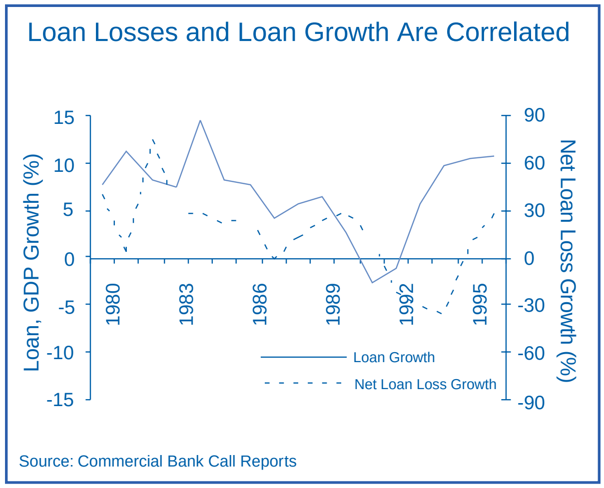


Chart 3



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).

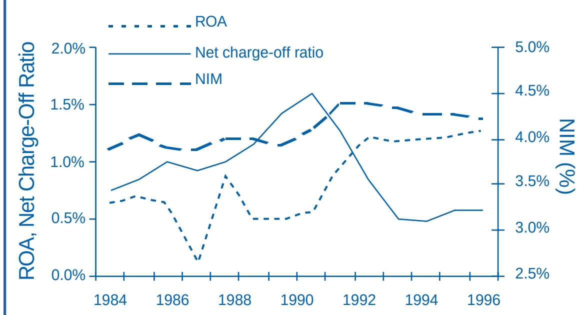
Except for credit cards and some other consumer loans, loan losses are at historically low levels. Nevertheless, lending decisions that assume a continuation of favorable economic conditions should be closely examined this far into the expansion. Institutions that maintain strong underwriting standards, 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).

CHART 4

Rebound in ROA Since 1990 Fueled by Improved NIM and Asset Quality



Source: Commercial Bank Call Reports

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

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.

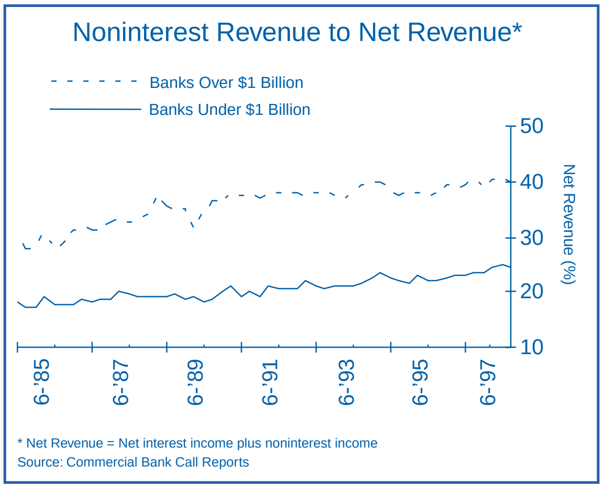
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads 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).

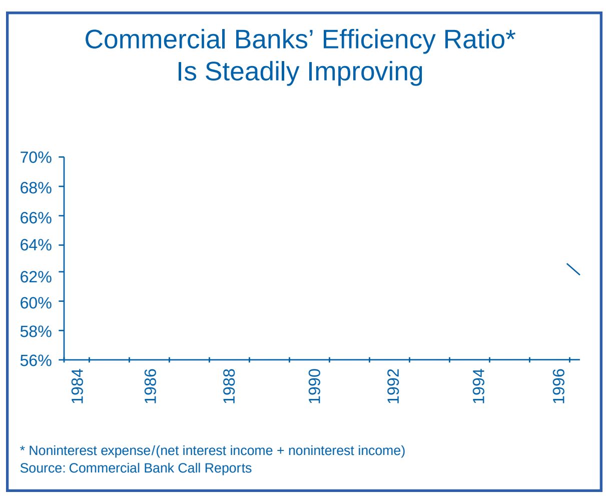
[2] The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

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 workout 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.

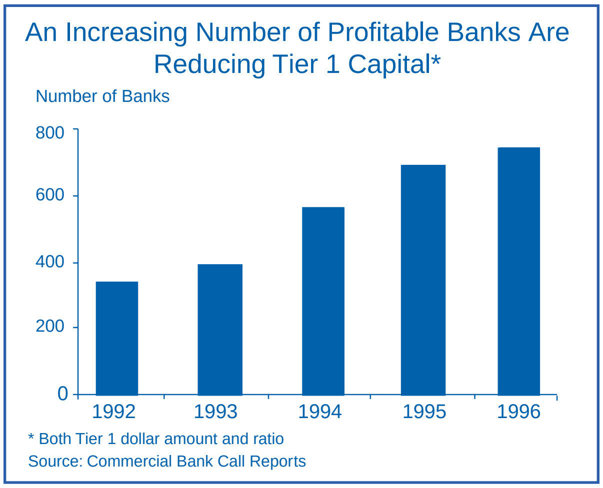
The Role of Capital in the Management of Earnings

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.

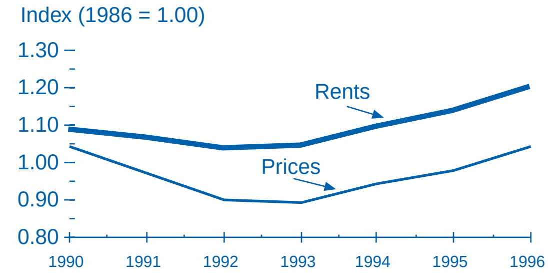
While the unrestrained commercial development of the 1980s continues to cast a shadow over the industry, that shadow is fading as declining vacancy rates and rising rental rates for existing properties fuel optimism among lenders and investors and strengthen the case for new development. Lenders, examiners, 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

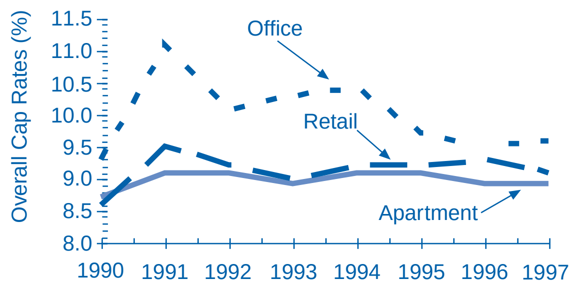
Prices and Rents on Upswing Nationwide



Source: Koll National Real Estate Index

CHART 2

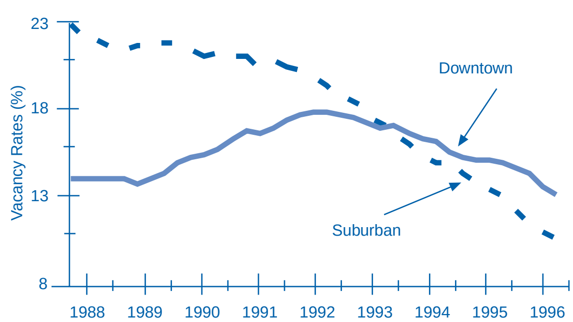
Property Capitalization Rates Dropping



Source: Donaldson, Lufkin & Jenrette

CHART 3

National Downtown and Suburban Class A Vacancy Rates Falling



Source: CB Commercial / Torto-Wheaton Research 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.

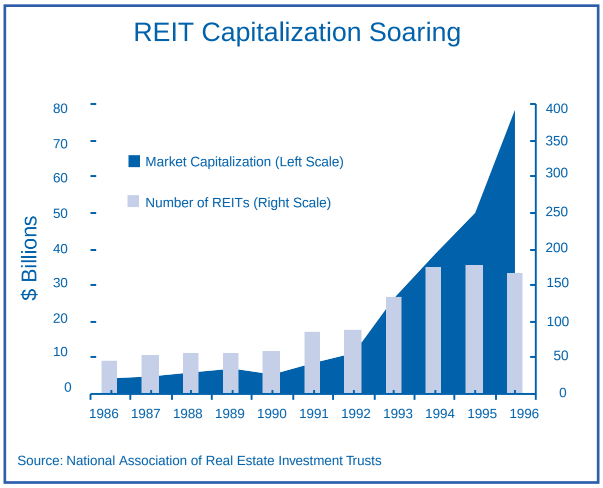
REITs: An Alternative to Traditional Capital Sources

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.

Steven Burton, Senior Banking Analyst
sburton@fdic.gov
Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

New England Real Estate Markets Running Hot and Cold

- **Home sales are strong in many parts of the Region, but prices generally remain subdued. Residential construction activity is gradually gaining steam. Greater Boston is the Region's most active residential real estate market.**

- **Rising demand for multifamily units in greater Boston, coupled with a dearth of inventory, has spawned a rush to build new apartment and condominium projects—posing a potential risk to lenders with exposure to this sector should the economy slump abruptly.**

- **Commercial real estate markets remain slack in many of the Region's major metro areas, including Hartford, Connecticut, and Providence, Rhode Island, but conditions in the greater Boston area are very tight.**

- **A sizable increase in commercial office inventory is expected in the Boston suburbs before 1999, but strong absorption rates and little in the way of new construction downtown should mitigate any decline in occupancy rates and rents.**

Residential Markets Not Likely to Overheat Soon

Home Sales Rising, but Prices Remain Subdued

Existing home sales have been very strong throughout the Region. The ***National Association of Realtors*** (NAR) reported that home sales increased 13 percent in **Massachusetts** in the first half of 1997 versus a year earlier, following a gain of nearly 21 percent in 1996. The market in eastern Massachusetts has been so strong this year that the traditional summer slowdown in home shopping failed to emerge, especially in the most sought-after areas. Likewise, sales rose 6 percent through the first half of this year in **Connecticut** and were 13 percent higher in **New Hampshire**. Sales in **Rhode Island**, the Region's poorest-performing economy by many measures, posted roughly 10 percent gains in 1996 and in the first half of 1997. Although they also have been improving modestly across the Region, home prices in the larger metropolitan markets, particularly in central Connecticut, remain subdued. Boston has been a notable exception to this trend (see Table 1).

The figures in Table 1 are based on a survey of median prices by the NAR. Reported median prices can be skewed if properties in a certain price class (e.g., starter homes) have been predominant in recent sales activity. Another measure, an index by the ***Office of Federal Housing Enterprise Oversight*** (OFHEO), is based on average price changes in repeat sales or refinancings on the same properties—so-called paired-sales analysis. The price data are reported at the state level and cover all conforming conventional mortgages purchased or securitized by Fannie Mae or Freddie Mac—or about 37 percent of all single-family mortgages in 1996. The OFHEO housing price index helps corroborate the NAR information, indicating that Massachusetts housing prices are again approximately where they were in the late 1980s (conditions in the Boston and Worcester markets likely drive the statewide figure). Prices are also mostly recovered in **Vermont** and **Maine**, while they remain down about 8 percent in Rhode Island. In Connecticut, the OFHEO index suggests that prices are

Table 1

Median Home Prices around the Region Still Subdued
(Current prices relative to peak in 1988/89)

	Nominal	Inflation-Adjusted*
Boston, MA	+3.8%	–24.7%
Hartford, CT	–18.2%	–54.0%
New Haven–Meriden, CT	–19.2%	–55.0%
Providence, RI	–9.4%	–45.2%
Springfield, MA	–18.0%	–46.4%
Worcester, MA	–6.7%	–42.5%

*Using change in Boston CPI-U between 1988/89 and 1997
Source: National Association of Realtors and Bureau of Labor Statistics

still off 13 percent from peak levels (Table 1 implies that some metro-area prices are even more depressed). Meanwhile, New Hampshire prices are also off by about 13 percent from their recent peak. Chart 1 shows the trend for New England and U.S. home prices according to the OFHEO index. Prices are now only about 5 percent shy of their late-1980s peak for the Region as a whole. While still remaining well above the U.S. level, the price gap between New England and the United States has closed from almost 90 percent above the U.S. average in 1987 to about 40 percent above in 1997. This trend bodes well for the long-run competitiveness of the Region by helping to lower its notoriously high cost of living relative to other sections of the country.

New Construction Picking Up Modestly

After the extraordinary boom in residential construction in New England in the 1980s and subsequent collapse of housing prices, residential construction in New England's metro areas seems to have returned to a steady growth path that is more in line with local economic conditions (see Chart 2). Single-family housing construction has increased about 26 percent from the trough reached in the last recession, driven primarily by increases in eastern Massachusetts. Most of the other states in the Region have also contributed to the recovery, but Rhode Island and Vermont have seen only modest gains in the past six years. Besides greater Boston, southern Maine also has experienced a sizable pickup in residential construction.

The recent resurgence in multifamily permit issuance is perhaps more noteworthy than the gradual improvement in the single-family market. Massachusetts and Connecticut, because of their larger shares of the Region's economy, are driving the rise in multifamily permits. However, Vermont also has seen a large percentage jump in multifamily construction in 1997 (related to ski resort improvements), and New Hampshire is on course for an all-time high this year. Chart 2 shows the history of building activity, as measured by residential permits, for the Region.

Boston: Growing Demand and Low Vacancies Spur New Multifamily Construction

As in single-family construction, the greater Boston area is leading the Region in new multifamily projects. Near Boston, few apartment complexes were constructed between the early 1980s and 1994, except for those built with subsidies or with some share of units targeted for government housing programs. Coupled with a much stronger economy, this situation has resulted in an average apartment vacancy rate of 1.3 percent this year, versus a rate of 5.3 percent in late 1992, according to figures provided by the ***Greater Boston Real Estate Board*** (GBREB). Within the I-495 beltway, several projects already are under construction, while many more are in early planning. The recent strength in residential housing in eastern Massachusetts has not been duplicated in the western part of the state, primarily because economic growth west of Worcester has not been as robust. The GBREB reports that apartment vacancy rates are averaging 6.5 percent in the western metro areas and just above 6 percent in central Massachusetts.

In addition to a lack of apartment space, strong demand for condominiums and town houses (some of it spurred by a dearth of rental opportunities) also is driving the upturn in multifamily permits, particularly in

CHART 1

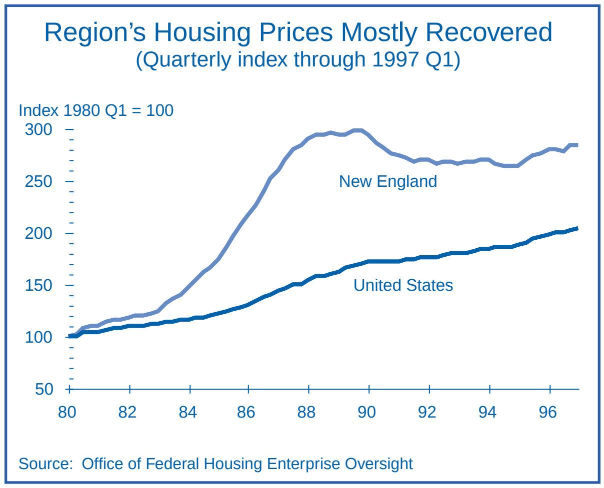
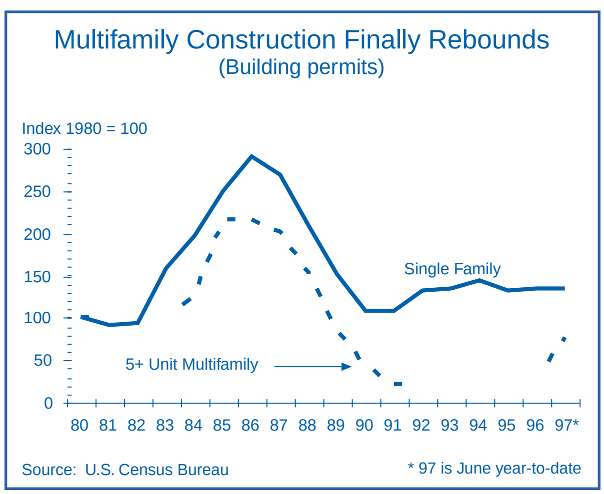
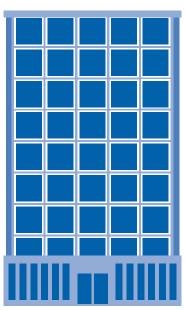


CHART 2



the greater Boston area. During May 1997, the ***Massachusetts Association of Realtors*** reported that sales of condominiums exceeded 1,000 properties—the highest one-month total this decade. Much of the activity has centered in luxury or high-end properties in the city's better neighborhoods, as the final elimination of rent controls in Boston has encouraged the conversion of apartments, lower-end office space, and even warehouse properties into new condominium projects.

Despite the heated conditions in the greater Boston market, several aspects of the current acceleration in residential real estate differ from those in the period just before the market crashed in the early 1990s. First, condominium and town house demand is being driven primarily by owner-occupied purchases, not purchases by investors and speculators as in the late 1980s. Among these new owners are wealthy parents of foreign students attending area universities; young, well-paid urban professionals; empty-nesters trading suburban homes with massive accumulated equity for a place in the city; well-heeled out-of-state residents purchasing second and third homes; and corporations acquiring housing for transient or relocating executives. Second, as mentioned earlier, the volume of new construction remains far below what it was in 1989, while market prices (unlike construction costs) have failed to rise with inflation over the past ten years. Third, outlying suburbs are increasingly exploring caps on building permits and higher taxes to fund land banks, thus limiting access to developable land. Finally, apartment construction, while picking up, will continue to face hurdles in terms of zoning requirements and other regulatory procedures, lawsuits by abutters in certain cases, and resistance in some areas of the city because of the perceived burdens on public services associated with high-density dwellings.



Implications: Any risk to insured institutions from another 1980s-style bust in residential housing seems remote at this juncture. One potential problem could develop in greater Boston if multifamily construction continues to accelerate at the pace seen in the first half of 1997—permits more than doubled to 1,500, up from 603 in the first half of 1996. As the number of condominiums available for sale increases, the odds are greater that a slowdown in the local economy, such as might arise from a protracted bear market in equities or a national downturn, might push many unsold owner-occupied units into the rental market. These would compete directly with a then much larger supply of apartments, possibly forcing rental rates below economically viable levels for both property types.

Commercial Office Real Estate: In Boston, Hot—Elsewhere, Not

Metro Office Markets Gradually Improving

With few exceptions (most notably Boston), most metropolitan office markets in the Region continue to slowly recover from peak vacancy rates reached at the height of the last recession. Table 2 offers a snapshot of commercial office vacancy rates for those New England markets followed by the ***Society of Industrial and Office Realtors*** (SIOR). Office vacancy rates in central Connecticut and **Providence**, Rhode Island, remain fairly high. **Hartford** has seen only modest declines in its vacancy rate because of ongoing layoffs and restructuring associated with its major employers, such as the insurance industry (see the second quarter 1997 ***Regional Outlook*** for more details). Meanwhile, the continued high vacancy rate in Providence reflects Rhode Island's generally weak economy and modest office employment growth. Apart from Boston (discussed in the next section), only **Portland** and **Springfield** had single-digit (average Class A and B) vacancy rates in 1996.

TABLE 2

MANY NEW ENGLAND OFFICE MARKETS ARE STILL SLACK
(PERCENT OF CLASS A & B OFFICE SPACE VACANT)

	1996	RECENT PEAK
BOSTON, MA	6.0	20.0
SPRINGFIELD, MA	9.9	28.5
HARTFORD, CT	15.0	17.5
STAMFORD, CT*	14.5	25.2
NEW HAVEN, CT	21.7	30.0
NASHUA, NH	12.0	24.1
PORTLAND, ME*	6.4	10.6
PROVIDENCE, RI*	18.6	25.9

*DATA ARE INCOMPLETE; VACANCY RATES ESTIMATED BY AUTHOR
SOURCE: SOCIETY OF INDUSTRIAL AND OFFICE REALTORS, VIA TELERES

The improvement in Portland is not surprising given that market's small size and minimal deterioration during the last recession. However, the 9.9 percent vacancy rate reported for Springfield for 1996 was down dramatically from 18 percent just one year earlier. This startling one-year improvement, according to the SIOR statistics, was due to significant declines in vacant space at Class A buildings, both in the central business district (CBD) and in the suburbs, and at Class B space outside the CBD. As remarkable as it seems, assuming occupancy rates of 250 square feet per worker, the modest growth in office employment seen in the Springfield metropolitan area during 1996 would have supported this hefty decline in vacant space (a net absorption of about 265,000 square feet).

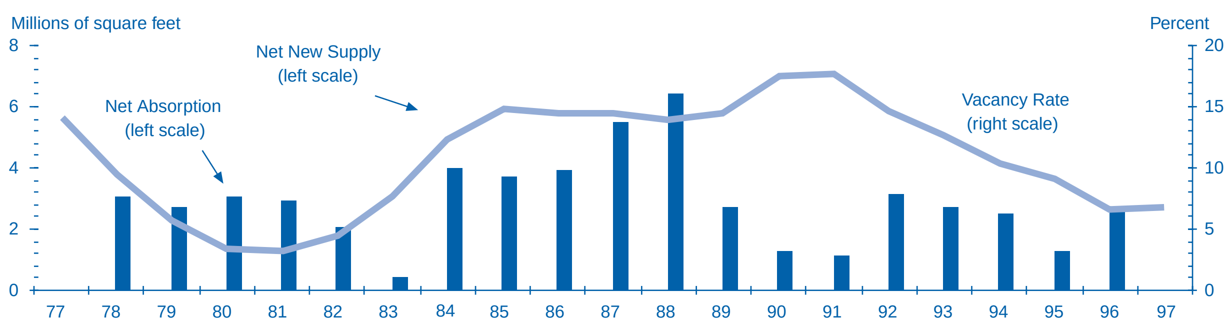
Greater Boston Office Market Poised for New Construction

Because of the tight office market around Boston (see Table 2), industry experts believe rents in many parts of the metro area have been driven to levels that can support new construction. However, limited space and longer approval times in the CBD have made suburban markets prime candidates for new development. Greater Boston's suburban area (inside I-495, but outside Suffolk County) has seen a significant increase in planned projects and new construction. According to ***F.W. Dodge***, plans for new office space in greater Boston increased from 16.5 million square feet at the end of March 1997 to 18.4 million square feet just three months later. *If realized, the midyear total of planned projects would result in a 12 percent increase in current inventory levels.* Chart 3 provides a history of net absorption, net new space, and the average vacancy rate for office space in the greater Boston market. Total inventory increased by 3.9 million square feet in the first half of 1997, according to ***Cushman & Wakefield***, representing a gain of 3 percent. However, this was accompanied by a pace of absorption 40 percent greater than the prior year's rate—1.8 million square feet in the first six months of 1997, versus 2.6 million square feet for all of 1996. In addition, many of the planned projects reported above may not be constructed, as many developers seem to be avoiding purely speculative buildings. Recent anecdotal reports suggest that developers typically are not proceeding with construction in earnest until at least one large tenant is secured.

Today's low vacancy rates are encouraging tenant behavior that could raise the risk of an overbuilt market. Because of limited space availability, many companies are engaging in defensive leasing, whereby they secure more space than they need (or secure space far in advance of their current lease expiration) in order to ensure they will have adequate room to meet expected growth. Also, some firms presently scattered among several office buildings plan to consolidate into single sites currently being built to suit their needs. Others are withholding space that otherwise would be available for sublet. Thus, as tenant companies relocate and consolidate their space needs, significant amounts of inventory may be left vacant. This condition would only be aggravated by the increasing amount of non-built-to-suit construction that is now occurring. Further, reported construction figures may not include the many rehabilitation or conversion projects currently under way. Despite these factors, it should be noted that today's vacancy rates are much lower than those during the

CHART 3

New Office Construction in Greater Boston Being Met by Strong Absorption … for Now



Sources: CB Commercial/Torto Wheaton (1977–96), Cushman & Wakefield (97H1) building boom of 1987 to 1990—when significant new space was coming on-line despite double-digit vacancy rates (see Chart 3).

Implications: In the author's opinion, current commercial office construction trends are likely to result in at least a modest rise in vacancy rates, and a concomitant decline in rental rates, by late 1998. However, if new building in the CBD remains minimal, firms there would be expected to continue to expand operations into suburban areas, mitigating the potential decline in suburban rents. Insured institutions have been increasing their real estate lending activity in greater Boston during the past 18 months, including financing for office and industrial properties (see ***Regional Banking Conditions***). Despite this pickup, overall exposure to commercial real estate remains far below the levels seen early this decade. Reticence by banks and an increase in funding by other sources, such as real estate investment trusts, has limited the number of insured depository institutions at risk in greater Boston from any downturn in office or industrial real estate.

Norman Williams, 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).

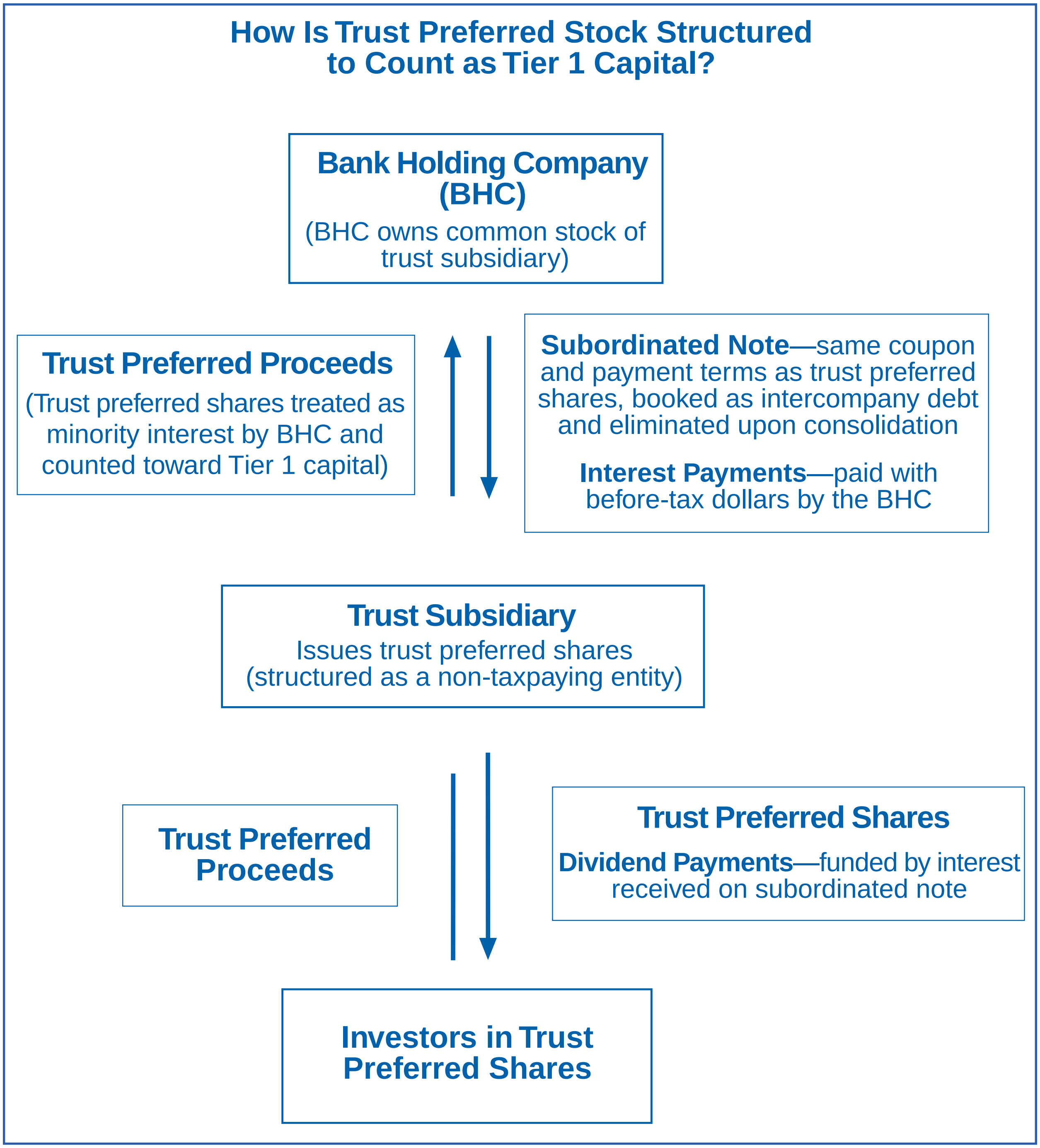
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary 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.

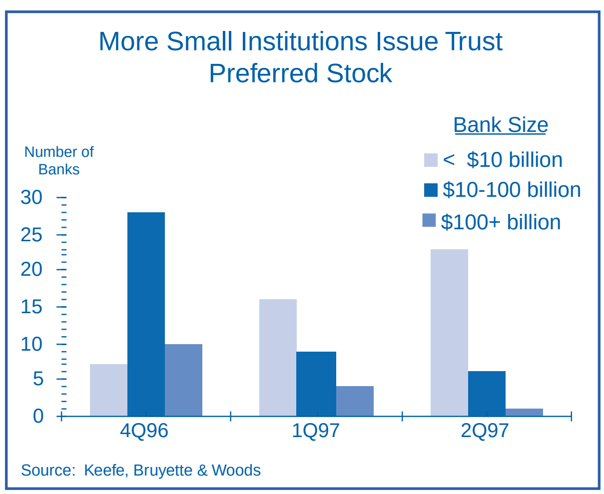
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated $4.3 billion in the first quarter of 1997 to just under $2.5 billion in the second quarter. Trust preferred issuance by larger banks declined 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).

Regional Banking Conditions

- **Insured institutions continue to reflect financial strength.**
- **In the face of ongoing industry consolidation, small institutions are growing profitably but may be doing so on thinner spreads or by relaxing underwriting standards.**
- **Commercial real estate lending is on the rise in selected markets.**
- **New types of lending may increase the risk profile of residential portfolios.**

Banking Conditions Remain Upbeat

Minimal loan losses and improved operating efficiency continue to drive earnings of the Region's insured institutions to new heights. The aggregate return on assets (ROA) for all institutions in the Region was 1.35 percent in the second quarter, well above the 1.19 percent ROA posted by the nation's insured institutions as a whole. A low level of delinquencies and charge-offs has resulted in low provisions for loan and lease losses (PLLL) relative to the nation as a whole (0.22 percent versus 0.39 percent of average assets). Low provisions are the primary factor contributing to the higher earnings performance of the Region's insured institutions. Net charge-offs continue to exceed the PLLL; however, at 1.74 percent of total loans, the allowance for loan and lease losses (ALLL) remains slightly above the national average (see Table 1).

Strong earnings continue to bolster capital levels, despite asset growth of 7.5 percent over the past 12 months and healthy dividend payouts by the Region's stock-owned institutions. The aggregate Tier 1 leverage ratio for the Region's insured institutions is now 8 percent; for institutions with assets under $1 billion, the ratio is 10 percent. The improved financial posture of the Region's banks is reflected in examination ratings. As of June 30, 1997, more than 98 percent of the Region's aggregate assets were held by institutions accorded a composite CAMEL rating of 1 or 2 (see Chart 1) by their primary regulator.

CHART 1

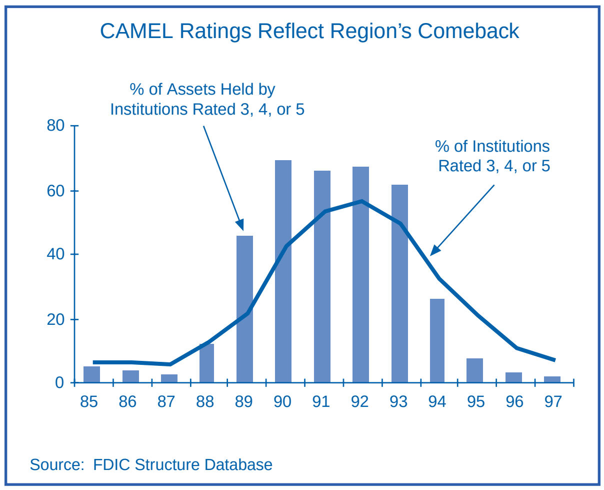


TABLE 1

LOW PROVISIONS AND DECREASING DELINQUENCIES ENHANCE EARNINGS PERFORMANCE

	NATION	BOSTON REGION				
ASSET QUALITY RATIOS (%)	6/30/97	6/30/97	6/30/96	6/30/95	6/30/94	6/30/93
ALLL/AVG LOANS	1.72	1.74	1.95	2.05	2.25	2.59
ALLL/NONCURRENT LOANS	166.59	168.53	145.66	141.49	116.98	97.30
PAST DUE LOANS & LEASES	2.25	2.09	2.65	2.77	3.39	4.60
NET CHARGE-OFFS/AVG LOANS	0.56	0.40	0.38	0.44	0.74	1.02

SOURCE: BANK AND THRIFT CALL REPORTS ALLL = ALLOWANCE FOR LOAN AND LEASE LOSSES

Consumer problems persist, as evidenced by escalating personal bankruptcy filings and charge-off rates on consumer debt. However, excluding the credit card specialists, very few institutions in the Region have large concentrations of consumer loans. Consumer loans (excludes real estate) comprise only 6.0 percent of the Region's assets, compared with about 10.5 percent for the nation as a whole. As discussed below, however, developments in mortgage lending pose a risk that weaknesses in consumer loan portfolios could migrate to some segments of single-family lending.

Absent a severe regional or national recession, the Region's institutions should continue to perform well, with poor competitive decisions (lax underwriting standards, improper pricing) or strategic initiatives among the major impediments to continued success.

Structural Changes Are Reshaping the New England Banking Landscape

The banking industry is undergoing substantial structural change, driven in part by competitive factors, technological innovation, and the increasing demands of investors for higher returns and earnings growth. Expanded powers and interstate banking and branching are regulatory changes that have resulted from these forces and have led to significant consolidation within the industry. New Englanders have witnessed a 35 percent reduction in the number of insured institutions since year-end 1989, compared with a 29 percent reduction for the nation as a whole. A disproportionate share of the nation's bank failures during this period, coupled with a dearth of de novo bank formations, contributed to this larger decline.

Following the implementation of full interstate branching in June 1997, KeyCorp and First Union merged their major New England franchises into their operations based in Cleveland, Ohio, and Charlotte, North Carolina, respectively. Within-Region consolidation of affiliated banks across state lines also has occurred, with Fleet being the most notable example of this activity. Interstate and inter-Region mergers such as these will make it more difficult to monitor banking conditions in specific geographic locations and diminish the usefulness of bank and thrift Call Report data when evaluating regional banking conditions.

Perhaps more significant than the decline in the number of insured institutions is the reduction in the number of banking offices operating within the Region's six states. *Since year-end 1989, there has been a net reduction of more than 900 branches in the Region, a 17 percent decline, versus a 0.2 percent decline for the rest of the nation.* The significant decline in the number of banking offices in New England is a direct by-product of the expansion of the largest institutions in the Region through merger and acquisition of both failed and operating institutions. The push for greater efficiency through economies of scale has resulted in the elimination of many offices with overlapping geographic markets and has driven up the volume of loans and deposits supported by the remaining facilities. This push has also been necessitated by the lack of asset growth in the Region (essentially flat) relative to the nation as a whole (up 23 percent) over the same time frame. Additionally, many traditional "bricks and mortar" facilities have been closed in favor of new formats, including supermarket branches and expanded networks of automated teller machines (ATMs). For example, the ***Massachusetts Division of Banks*** reports that the number of bank-owned ATMs operated in the Bay State increased from 2,291 to 3,463 between 1991 and 1996. The Internet also offers potential as a cost-efficient mechanism for delivery of bank products and services. Technological advances and the ongoing desire to improve efficiency are likely to put continuing downward pressure on the number of traditional banking facilities.

Small Institutions Are Carving Out Niches

Consolidation within the Region has resulted in a growing concentration of assets in the largest banking companies. The five largest banking organizations in the Region today controlled 22 percent of the Region's total assets in December 1989. At that time, there were 46 banking organizations reporting assets greater than $1 billion. Through failure or acquisition, 32 of those institutions no longer exist; many of these were absorbed by today's large players. As a result, the concentration of assets in these five large companies has increased to 56 percent.

This increased concentration has raised concerns that the growing dominance of a few organizations may negatively affect the competitiveness of smaller institutions. An evaluation of the performance of smaller institutions in the Region indicates that they have successfully maintained a niche in a market increasingly dominated by large institutions, although intense competition on both sides of the balance sheet will continue to place downward pressure on profitability.

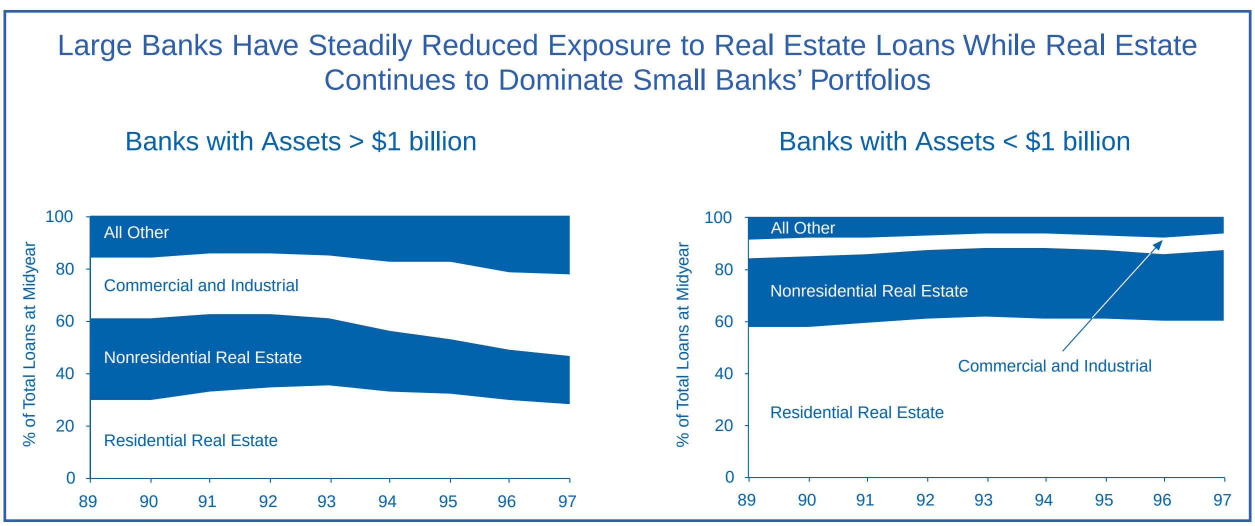
As of June 30, 1997, there were approximately 400 non-specialized insured institutions in the Region that were part of organizations with total banking assets of less than $1 billion (excluding trust banks). Over the past three years, these institutions registered an annualized asset growth rate in excess of 7 percent, compared with just under 4 percent for the larger institutions. Loans have grown at nearly an 8 percent rate as the smaller institutions continue to demonstrate a willingness to fund real estate loans (see Chart 2), maintaining these investments at approximately 57 percent of total assets (versus 27 percent at larger institutions). Conversely, the larger institutions have continued to reduce direct exposure to real estate loans (down 2 percent), although it should be noted that some of the reduction has been transferred to commercial and industrial (C&I) portfolios in the form of working capital loans to real estate investment trusts (see ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***).

Smaller institutions are making similar inroads on the commercial loan front. While C&I loans are a small portion of the asset mix of smaller institutions, these loans have grown at an annualized rate of 14 percent over the past three years, compared with 10 percent for the larger institutions. Concerns have been expressed that large institutions' increased use of credit scoring for small-business loans would have a negative effect on the smaller lenders. However, the smaller institutions in this Region have actually increased their share of small-business loans (those under $1 million) to one-third of the total, up from 28 percent only two years earlier. Similarly, small institutions at mid-1997 held more than 51 percent of all permanent mortgages on nonfarm, nonresidential properties with original amounts of $1 million or less, up from approximately 45 percent in June 1995.

Similar success has been met on the funding side of the balance sheet. Core deposits have been growing at an annualized 5 percent rate over the past 12 quarters but have been essentially flat for the larger institutions. The growth has been concentrated in higher-cost certificates of deposit. The shift in deposit mix to higher-cost funds, coupled with competitive pressure on both loan yields and deposit rates, has resulted in a steady erosion of margins at smaller institutions. Since the fourth quarter of 1994, the spread between the yield on earning assets and the cost of funds has fallen from 3.88 percent to 3.47 percent. The net interest margin fell 25 basis points over the same period.

Small institutions are growing at a steady rate but are doing so on thinner spreads, and they also may be relaxing underwriting standards or expanding into riskier forms of lending to capture new volume. These institutions should ensure that credit quality is maintained in the battle for new business, and that they are being compensated fairly for the risk inherent in that business. Recent FDIC underwriting surveys indicate that in nearly 25 percent of recently examined institutions in this Region, there is a failure to adjust loan pricing for inher-

CHART 2



ent risk. Additionally, more than 25 percent of the institutions were found to have lending practices that differed at least moderately from written policies. Aggressive competition may be a factor here and underscores the importance of close monitoring of policy exceptions by institution management to ensure that loan quality is not compromised.

Real Estate Lending Activity Increasing in Selected Markets

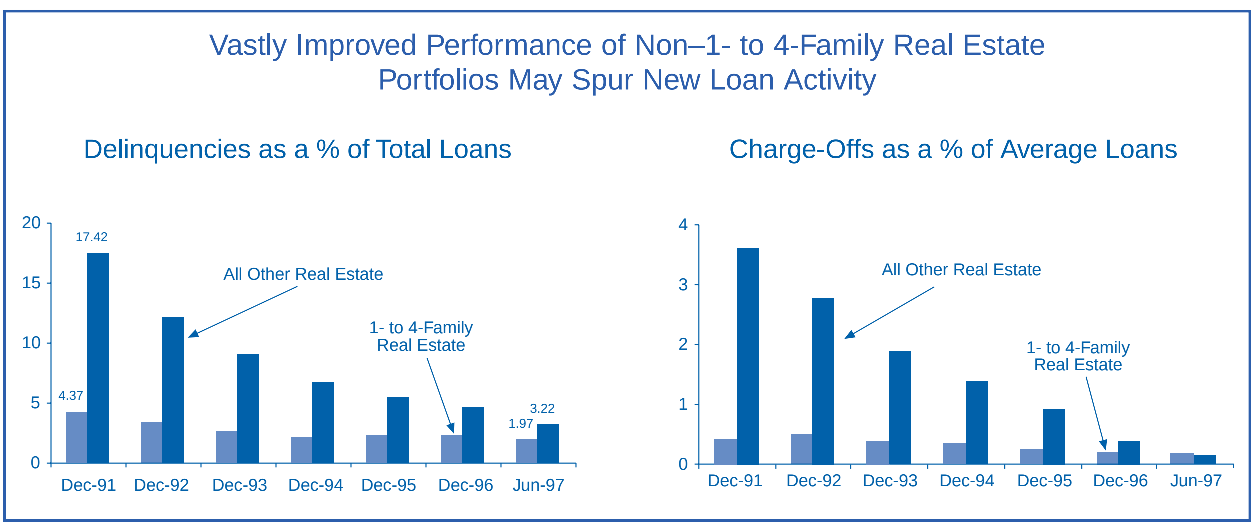
Despite the improved real estate conditions discussed in the ***Regional Economy*** section, the aggregate real estate exposure of the Region's insured institutions has fallen for the past several years, primarily in the larger institutions. Real estate portfolios are performing well, as evidenced by declining delinquencies and net charge-offs in both the residential and nonresidential sectors (see Chart 3). Improved fundamentals and portfolio performance may give rise to a resurgence of new volume. While regional institutions appear to be proceeding cautiously, increased real estate lending activity is evident in selective market areas.

While construction and development loans continue to represent only a small percentage of total real estate loans, several areas in the Region continue to show increases in construction lending. Smaller institutions (those with less than $1 billion in total assets) in the greater **Boston metropolitan area** (Essex, Middlesex, Norfolk, and Suffolk Counties) and in **Fairfield County**, **Connecticut**, have shown rapid growth in construction, real estate development, and multifamily financing. The real estate portfolios of smaller regional institutions are generally more geographically concentrated than those of large institutions and provide a good indication of local market conditions. Over the previous 24 months, banks based in greater Boston with assets under $1 billion have grown their construction and land development real estate portfolios approximately 20 percent annually. Furthermore, there has been a sharp increase in the dollar volume of unfunded commitments for commercial real estate, construction, and land development. Construction and multifamily lending has also heated up in smaller Fairfield County institutions in 1997, with annual growth rates approximating 20 percent. Although the dollars at risk represent a modest percentage of the total loans, it appears that locally based insured institutions are willing to once again expand their portfolios into lending categories that produced such high losses in the early 1990s. However, because far fewer institutions are concentrating in higher-risk real estate lending such as commercial real estate and construction, and because earnings and capital are both significantly better than before the previous recession, the overall risk profile of New England's insured institutions remains relatively conservative.

New Mortgage Products—Potential Risks

The real estate lending market is ever changing. Lenders are competing for a larger market share and are introducing new, innovative products. One of the latest trends in the second mortgage and home equity loan market is loan products with a high loan-to-value ratio (LTV). Such a loan allows a borrower to have total

CHART 3



indebtedness on combined mortgages of as much as 125 percent to 150 percent of the value of the underlying property. Rates on these loans are high relative to those on traditional mortgages but are lower than those on most credit cards and may offer tax advantages not available to credit card debt holders. High-LTV loans do not appear to be common at insured institutions in the Boston Region; however, such loans are being aggressively marketed by national mortgage companies. As area banks attempt to maintain market share and improve margins, these products may become more popular.

While real estate portfolios are performing well, consumer loans continue to show weaknesses that could spread to the single-family loan category. In the aggregate, junior mortgages have grown at an annualized 14 percent rate over the past three years, suggesting that banks' appetite for this type of product is on the rise. While the Region's insured institutions generally appear to be limiting maximum LTVs to 100 percent and exposures remain small, these junior mortgages do increase the risk inherent in single-family loan portfolios.

A recent study by the ***Office of Thrift Supervision*** compared the relative performance of residential mortgages that had seasoned at least 24 months, on the basis of factors such as purpose (purchase or refinance), structure (rate, term, etc.), and LTV. The study evaluated originations from 1991 through 1995 and found that for loans with LTVs between 95 percent and 105 percent, the percentage that were seriously delinquent (more than 90 days past due or in foreclosure) was more than 10 times what it was for loans with LTVs under 80 percent. The study also found that 26 percent of the 1995 originations had LTVs over 90 percent, up from approximately 7 percent for the 1991 through 1993 period. A high level of refinancing during these years undoubtedly reduced the percentage of high-LTV loans; however, the numbers strongly suggest that high-LTV lending is on the rise. The higher rate of serious delinquency, coupled with low or no real equity for these loans, will translate into higher losses. These portfolios warrant close monitoring.

Junior mortgage products provide banks with an opportunity to capture higher yields; however, junior mortgages are often used for consumer purposes, including consolidation of credit card debt. Competition in the credit card industry is strong, and as high-LTV mortgages become more common, borrowers may simply consolidate credit card and other consumer debt into a junior mortgage and then tap their credit cards for future cash flow needs. As both junior mortgages and consumer debt escalate, the burden may become too heavy for some borrowers, possibly resulting in default and loss, particularly if economic conditions deteriorate. The ability of consumers to easily consolidate existing debt heightens the need for institutions to closely monitor and manage unused credit card lines, which may become the indirect source of payment on the "quasi" home equity loan.

Daniel Frye, Regional Manager
Cameron Tabor, Financial Analyst
Gregory Quint, Bank Examiner

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