Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION

FIRST QUARTER 1997

In Focus This Quarter

FDIC DALLAS REGION

■ ***Consumers Declare Bankruptcy in Record Numbers* - Despite favorable economic conditions, the number of consumers declaring bankruptcy is on the rise in the Dallas Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress.** *See page 3.*

■ ***New Tax Benefits for Owners of Community Banks* - The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.** *See page 6.*

■ ***Savings Association Insurance Fund (SAIF) Capitalized* - After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF.** *See page 9.*

DIVISION OF INSURANCE

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Regular Features

◆ *Regional Economy*

- Economic Diversification
- Job Growth
- Personal Income
- Single-family Housing
- Multifamily Housing
- Commercial Real Estate

See page 12

◆ *Financial and Commodity Markets*

- Interest Rates
- Bond Values
- Bank Stocks
- New Products
- Grains and Soybeans

See page 16

◆ *Regional Banking*

- Overall Conditions
- Commercial Real Estate
- Ag Banks

See page 20

Dear Reader,

The prototype edition of the *Regional Outlook* for the Dallas Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial and Commodity Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook*. Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,

Arthur J. Murton
Director

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The authors wish to acknowledge the assistance provided by Don Inscoe and Jon Wisnieski of the Division of Research and Statistics in providing some of the data used in this publication. Any errors are the responsibility of the authors. We would also like to thank the employees of the Division of Supervision and Division of Compliance and Consumer Affairs in the Chicago Region for providing feedback used in the development and design of this publication.

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the Dallas Region.**

- **Oklahoma stands out among the states in the Dallas Region with the seventh highest per capita bankruptcy rate in the country.**

- **Credit card charge-offs are approaching recession levels.**

Despite favorable economic conditions, the number of consumers declaring bankruptcy is on the rise throughout much of the Dallas Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

What Is Occurring in the Dallas Region?

Chart 1 shows the rising trend in consumer loan losses in the Dallas Region as well as the close relationship between these losses and personal bankruptcy filings.

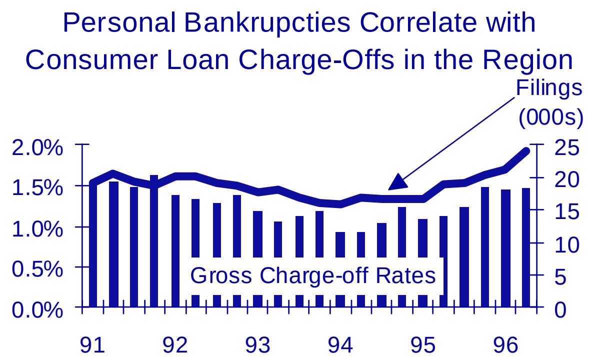
Table 1 (next page) shows that personal bankruptcy rates are rising in all states throughout the Region. Current levels are fairly moderate, compared to other states in the country, with the exception of Oklahoma which has the seventh highest per capita filing rate in the nation. Second quarter rates grew dramatically in Oklahoma despite its low unemployment rate and a relatively high percentage of disposable income to debt.

Why Are Consumer Credit Losses Rising in an Expanding Economy?

The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more willing to incur debt and banks are more willing to lend. Chart 2 shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

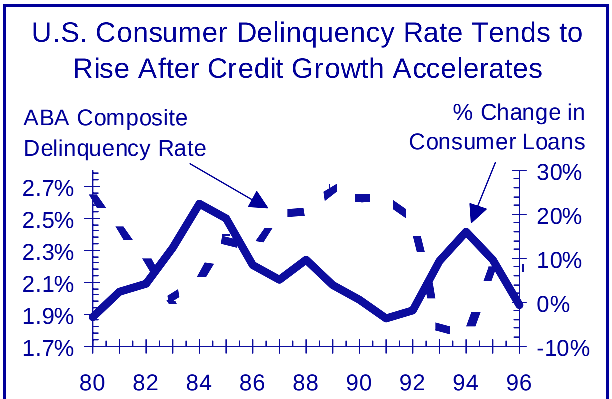
As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed

CHART 1



Sources: Administratie Office of the United States Courts and Bank and Thrift Call Reports (RIS). Based on a design by the FDIC's Division of Research and Statistics.

CHART 2



Sources: American Bankers Association and Federal Reserve Flow of Funds

PROTOTYPE

consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this credit expansion.

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings for 1996 will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors, many of which are interrelated.

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. Among the factors identified by the report as important are:

- inadequate health insurance;
- inadequate auto insurance;
- a large percentage of self-employed workers;
- garnishment of wages;
- high divorce rates; and,
- high debt-to-income ratios.

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy. In Oklahoma, for example, SMR attributes a high volume of bankruptcy filings to a high divorce rate, a very high percentage of the population with no health insurance, and a low level of auto insurance coverage.

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Implications for Insured Institutions

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 3 (next page), credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of

Table 1

Bankruptcy Rates Per Thousand Persons

	1990	1991	1992	1993	1994	1995	3rd Qtr 1996 Annual.	3 Q 1996 State Ranking
Colorado	4.87	4.88	4.31	3.58	3.33	3.49	4.06	22
New Mexico	2.75	2.66	2.57	2.14	1.95	2.38	3.11	32
Oklahoma	5.01	4.52	4.20	3.84	3.71	3.99	5.07	7
Texas	2.52	2.48	2.58	2.23	2.08	2.40	2.98	34
Dallas Region	3.16	3.02	3.17	2.94	2.79	2.93	3.38	NA
United States	3.12	3.46	3.52	3.15	3.00	3.33	4.15	NA

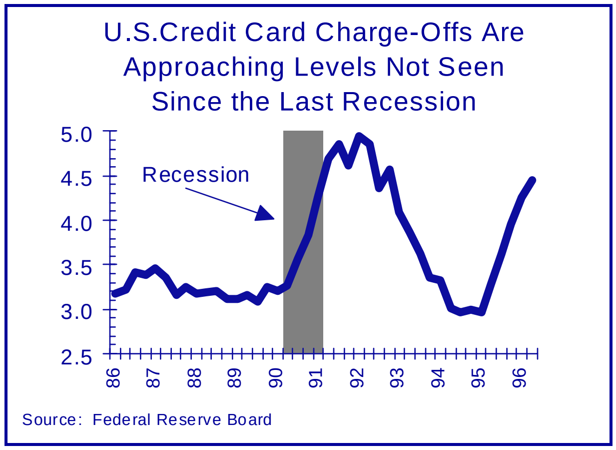
Source: Bankruptcies - Administrative Office of the United States Courts
Population - Census Bureau

managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions. Performance is likely to vary substantially, with results depending on the risk management practices and under-

CHART 3



writing standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst
Alan C. Bush, Senior Regional Analyst

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- **Potential benefits are substantial. A layer of tax expense has been eliminated.**
- **Eligibility is restricted and requires care to maintain.**
- **While no application to the banking agencies is required, the new tax structure has supervisory implications.**
- **The new tax structure has some potential drawbacks.**

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts, and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes, and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions therefore may need to act quickly since changes in either of the above areas may be time consuming.

Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under $500 million in assets that are not part of a group with more than $500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals, estates, and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock

TABLE 1

NUMBER OF BANKS WITH UNDER $100 MILLION IN TOTAL ASSETS

	NATIONAL	NON-MEMBER	STATE MEMBER	TOTAL
COLORADO	65	69	26	160
NEW MEXICO	13	20	3	36
OKLAHOMA	85	164	20	269
TEXAS	301	322	33	661
TOTAL	464	575	82	1,126

SOURCE: PRELIMINARY BANK CALL REPORTS AS OF 9-30-96

Ownership Plans (ESOPs) and other stock bonus plans, may not hold shares in subchapter "S" corporations. Once the subchapter "S" election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Number of Eligible Institutions

While figures on the number of eligible institutions is not available, the numbers of small banks in the Region may provide insight into where the tax election may be seen. As Tables 1 (previous page) and 2 show, there are more than 1,100 commercial banks in the Dallas Region with under $100 million in assets and over 700 with under $50 million in assets. It is expected that a large percentage of these companies would meet the eligibility requirements. Texas has the most banks in the Region that are potential candidates for subchapter S conversion. This is because Texas has several small banks from its days as a unit banking state.

Benefits to Shareholders

The tax benefits of the "S" corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders' personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation's taxable income. Distributions formerly paid directly to the IRS by the institution would generally be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies.

Adding value and flexibility to the "S" corporation structure is the ability to wholly own other "S" corporations. These rules allow holding companies and their bank or savings association subsidiaries to be "S" corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to "S" corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for "Built-in Gains Tax" (BIG tax) to determine any tax at the corporate level.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various "phantom bank mergers" or change-in-control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Table 2

Number of Banks with Under $50 Million in Total Assets

	National	Non-Member	State Member	Total
Colorado	37	54	19	110
New Mexico	5	8	3	16
Oklahoma	47	122	13	182
Texas	175	205	23	405
Total	264	389	58	713

Source: Preliminary Bank Call Reports as of 9-30-96

Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special expertise for the bank in tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital in situations where growth is strong or delinquent assets are rising.

Other Drawbacks

To receive the benefits of the subchapter "S" election, the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

The states of Connecticut, Michigan, New Hampshire, New Jersey, Tennessee as well as the District of Columbia do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend payments to fund debt payments on stock loans.

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks and thrifts.

Ronald L. Spieker, Chief,
*Depository Institutions Analysis Section **

For More Information

<u>Subchapter S Election for Federal Income Taxes</u>. FIL-91-96.

* Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Almost 600 banks and thrifts in the Dallas Region paid $379 million of this total.**

- **Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.**

- **The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.**

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was $3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.

- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.

- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.

- Disparity between SAIF and BIF premiums created strong economic incentives for institutions to transfer SAIF-assessable deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

Over 45 percent of the Dallas Region's institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 ...

What Significant Actions Were Taken?

Special Assessment: In order to address the immediate problems, *the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions*. The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

Table 1

Dallas Region Institutions Affected by SAIF Special Assessment

# of Institutions Affected and Total Assessment by Type	Mutual	Savings Banks	S&L	State Member	National	Non-member	Total
Colorado	0	4	11	1	6	3	25
New Mexico	0	5	5	0	2	1	13
Oklahoma	0	7	4	0	12	14	37
Texas	12	21	19	0	17	11	80
Total	12	37	39	1	37	29	155
Assessment ($000s)	24,161	230,681	25,551	5,809	77,674	15,218	379,094

Source: Derived from early estimates from the FDIC's Division of Finance.

Prototype

- Exempted weak and other specifically defined institutions from paying the special assessment.

- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

Early estimates are that there will be fewer than ten exempted institutions in the Dallas Region. This number of exempted institutions is small compared with the estimated 140-150 institutions in the Region that paid about $379 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about $800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points* (see Table 2). As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

TABLE 2

Summary of 1997 Assessment Rates *			
1997 Adjusted BIF & SAIF Schedule			
Capital Group	Supervisory Subgroup A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
Exempt Institution SAIF Schedule			
1	23	26	29
2	26	29	30
3	29	30	31
FICO Annual Rates			
BIF Institutions		SAIF Institutions	
1.30		6.48	

* Cents per $100 of domestic deposits

Source: FDIC's Division of Insurance

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board lowered the rates on ongoing assessments paid to the SAIF. The FDIC Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit initially from the lower SAIF assessment rates. They will pay according to the 23- to 31-basis point schedule through year-end 1999, unless they choose to make a pro rata payment of the special assessment in the interim.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, over 45 percent of the Dallas Region's institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Chicago Senior Regional Analyst

For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

Dallas Region Outpaces the Nation Again

- **The Region's economy continues to make strides toward diversifying into transportation, wholesaling, and advanced technology manufacturing.**
- **The payroll employment growth rate in the Dallas Region remains among the highest in the nation.**
- **Job creation has tapered off slightly in recent months, particularly in Colorado and New Mexico -- two previously fast growing states.**

Economic Diversification Well Under Way

The Dallas Region is becoming a more services-oriented economy as it continues to reduce its traditional dependence on oil and gas. Over a ten-year span (1985-1995), services saw its share of the Region's nonfarm employment increase from 20 percent to 27 percent and its share of earnings jump from 27 percent to 35 percent. "Services" include such diverse categories as business, health, legal, educational, engineering and management services. The Region's oil and gas extraction industry, by contrast, has seen its share of total earnings fall from 8.6 percent in 1985 to 5.1 percent in 1995. Similarly, the Region's national defense has seen its share of earnings fall during the past ten years -- from 2.8 percent in 1985 to 2.2 percent in 1995.

Increasingly, businesses within the Region are focusing on export markets as a source of new demand for their products. The Southwest also has become a favorite of many high-tech firms seeking to take advantage of the Region's central location, plentiful supply of land, low labor costs and favorable tax structure. Rapid growth in high-tech and trade has given rise to many professional and business service jobs. Many of these are high-skilled, high-paying jobs. The Region is realizing several benefits from this diversification. Perhaps most importantly, *these new activities have been an engine for growth that should lessen the exposure to risk that existed when the Region was more heavily dependent on a few concentrated business activities.*

Job Growth Moderates in 1996

Nonfarm employment in the Dallas Region grew 3.1 percent versus 2.0 percent for the nation through November 1996. *Driven by continuing economic diversification, nonfarm employment growth in the Region has exceeded U.S. nonfarm job growth every year this decade* (see Chart 1). Leading the Region in nonfarm job growth in 1996 is New Mexico (3.8 percent), followed by Colorado (3.2 percent), Texas (3.0 percent) and Oklahoma (2.7 percent).

Job growth in Colorado, however, has slowed considerably since the first half of 1996. Based on seasonally

CHART 1

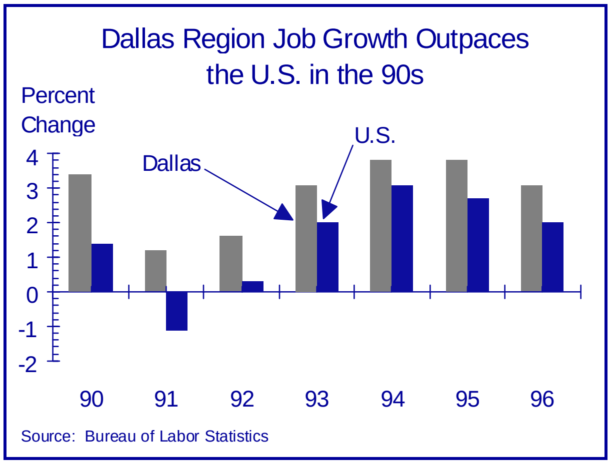
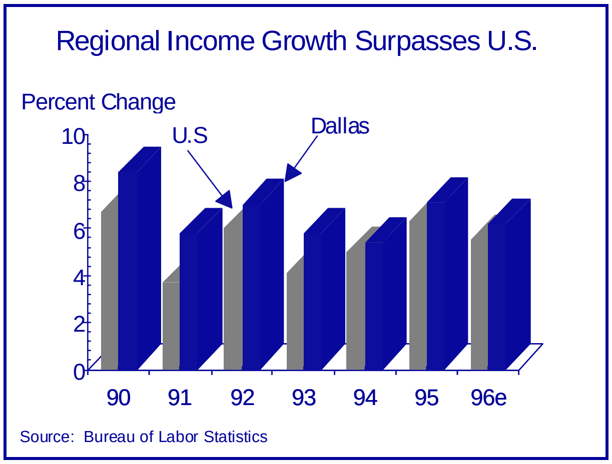


CHART 2



adjusted payroll data, Colorado employment grew 4.3 percent in the first half of 1996 but decelerated sharply during the second half. Employment data for the period July through November 1996 reveal a year-over-year growth rate of only 2 percent.

Some analysts expect job growth in 1997 to be the Region's slowest since 1992, when payroll employment advanced 1.6 percent. ***Data Resources Inc.*** and ***Regional Financial Associates*** are predicting that the Region's job growth will be between 2.0 percent and 2.5 percent in 1997. *A slowdown in the Region could adversely affect the performance of insured institutions whose lending decisions are based on the assumption of continued rapid growth in the Region's economy.*

More Jobs Mean Greater Income and Spending

Households in the Region continued to increase their purchasing power because of strong employment growth and low inflation. *Personal income growth in the Dallas Region advanced at a rate of 6.1 percent in the first three quarters of 1996, compared to 5.5 percent for the U.S.* (see Chart 2 previous page).

Consumer prices rose more slowly in the Dallas Region than in the U.S. as a whole, further boosting purchasing power. The consumer price index for all urban consumers in the Dallas-Ft. Worth and Houston metropolitan areas recorded increases of 2.7 percent and 2.1 percent, respectively, for all of 1996, compared to a 2.9 percent increase for the U.S. Anecdotally, several national chain retailers (e.g., JCPenney and Dayton Hudson) reported having better retail sales gains in their Southwest stores than anywhere else in the country.

Single-family Housing Construction Continues to show Strength…

Single-family housing permits in the Region increased 12.9 percent in 1996, far outpacing the U.S. average of 7.4 percent. Stoking the demand for housing construction has been strong job growth, robust demand for single-family homes, greater income and a surge of migration into the Region. FDIC-insured institutions in this Region are benefiting from the strong residential real estate market as they provide funding to meet the credit needs of both builders and homebuyers.

…but Multifamily Housing Construction is Leveling Off

Multifamily housing permits in the Region increased only 4 percent during 1996, to a level of approximately 50,100. This represents a cooling of the rapid growth experienced during the previous three years, when the level of multifamily permits almost quadrupled from about 12,500 in 1992, to 48,200 in 1995.

The 139,000 multifamily construction permits issued during the period 1994-1996 was the best showing in the Dallas Region since the passage of the Tax Reform Act of 1986, which sharply reduced the tax advantages of real estate investments.

CHART 3

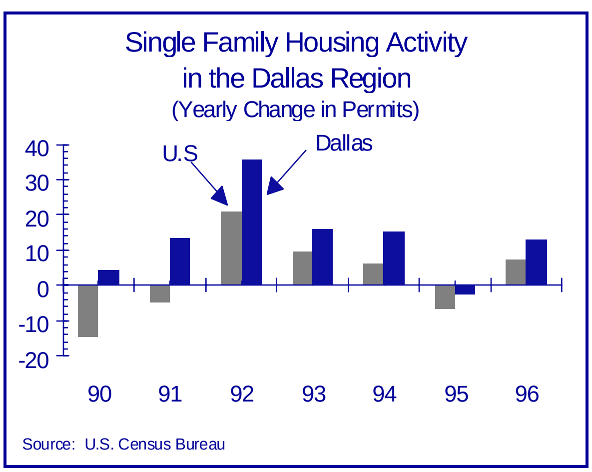
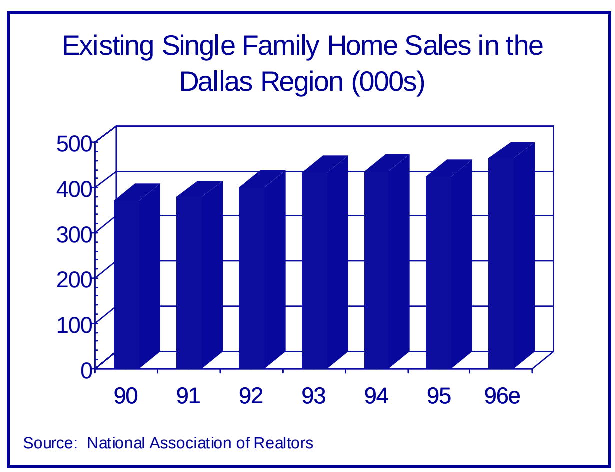


CHART 4



Existing Single-family Home Sales surge to record levels

The Dallas Region is on pace to finish 1996 with its highest total of existing single-family home sales since the ***National Association of Realtors*** began keeping records in 1980. Based on data for the first three quarters of 1996, the volume of home sales in the Region is showing a 10.7 percent increase over the same period in 1995. If sustained for the entire year, approximately 465,000 homes will have been sold last year (see Chart 4 previous page).

Overbuilding in Residential Housing?

Concerns have been raised about whether the Region may be heading toward another period of overbuilding as in the early 1980s, that subsequently led to a sharp fall-off in homebuilding activity in the latter half of that decade. For example, during the period 1980-1986, the Region averaged 235,000 residential building permits annually. Over the next five years (1987-1991), the bottom fell out of the homebuilding market, with residential building permits averaging only 72,300 per year, a decline of over two-thirds from the previous period.

The downturn in residential construction during the late 1980s was prompted by a number of factors, including a collapse in oil prices that contributed to a recession in the Region. Beginning in 1983, annual nonfarm employment fell during three of the next five years and led to an out-migration of residents looking for work. Moreover, the savings and loan crisis disproportionately affected the Region, leading to a tightening of credit and an exacerbation of already weak economic conditions in the Region. Finally, the Tax Reform Act of 1986 removed generous tax incentives on apartment buildings and condominium investments that were a significant portion of total residential construction during that earlier period. For example, the number of permits for buildings with 5 units or more fell from about 34,000 in 1986 to less than 4,000 in 1988 -- an 89 percent decline in just two years.

Today's situation may not be analogous to that of the 1980s, however, because there are a number of factors that would seem to make a sharp and sustained downturn in residential construction unlikely. Employment growth has moderated but remains above the national average, with corporate expansions and relocations attracting residents from other parts of the country. The Region's achievement of increased diversification has lessened its dependence on oil and gas today as compared to ten years ago. Additionally, housing affordability is still a plus for the Region, with above average income growth and below average housing prices. *Nevertheless, given the rapid growth of residential construction in some parts of this Region, close monitoring of economic fundamentals by lenders is warranted to ensure that demand keeps pace with supply.*

Commercial Real Estate Markets

Office vacancy rates continued to decline in most major

Table 1

Downtown Office Vacancy Rates (Percent)

	Sep 96	Jun 96	Sep 95	Sep 94
Albuquerque	13.6	12.4	10.6	14.3
Austin	16.0	16.6	19.5	22.6
Dallas	35.5	33.7	34.9	35.2
Denver	15.8	15.7	14.5	14.5
Ft. Worth/ Arlington	21.3	19.6	19.0	18.4
Houston	22.4	21.9	21.8	23.5
Oklahoma City	26.8	28.9	31.2	29.1
National	14.4	14.6	16.1	16.3

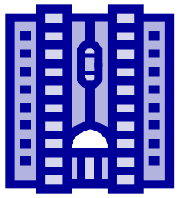
Source: CB Commercial/Torto Wheaton Research

Table 2

Suburban Office Vacancy Rates (Percent)

	Sep 96	Jun 96	Sep 95	Sep 94
Albuquerque	5.7	5.1	5.0	8.2
Austin	6.2	6.4	7.0	9.9
Dallas	11.3	12.5	14.5	18.6
Denver	10.7	10.7	10.7	12.5
Ft. Worth/ Arlington	12.3	13.7	17.0	15.9
Houston	18.5	18.8	19.4	20.6
Oklahoma City	8.4	10.1	14.2	19.0
National	11.7	12.2	13.8	15.6

Source: CB Commercial/Torto Wheaton Research suburban markets within the Dallas Region, while remaining stubbornly high in a number of downtown areas, according to ***CB Commercial/Torto Wheaton*** real estate data. In every case, vacancy rates in suburban markets were much lower than in the central business districts around the Region.



This difference in vacancy rates between downtown and suburban office markets can be seen clearly by examining Tables 1 and 2 (previous page). Businesses continue to seek areas with an ample supply of land, easy access, better amenities, and an abundant labor force. Often, it is the suburban office markets that better meet these criteria. As a consequence, Dallas-Ft. Worth, Houston and Oklahoma City continue to be plagued by high downtown vacancy rates.

Recent purchases and lease transactions in Dallas and Houston are stimulating commercial real estate prices and lease rates, but they still remain at a substantial discount compared to markets outside the central business district. Meanwhile, Albuquerque, Austin, Dallas, Denver, and Oklahoma City are enjoying suburban office vacancy rates that are below the national average. Banks in the Dallas Region have been taking advantage of the increased commercial real estate activity by expanding their portfolios in that sector. While each market is different and FDIC surveys have not signaled underwriting deterioration, the growing exposures could leave portfolios vulnerable if an overbuilding situation occurs.

Summary: Although the Dallas Region continued to exhibit faster growth in employment and income than the U.S. in 1996, area forecasters are calling for growth in the Region to moderate in 1997. Nevertheless, these forecasters expect the Region to continue to outpace the U.S. in growth in jobs and income once again in 1997.

Adrian R. Sanchez, Regional Economist

Financial and Commodity Markets

- **The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.**
- **The Dallas Region's bank stock index has outperformed the S&P 500 so far this year, but it has underperformed the S&P Composite Bank Index.**
- **Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.**
- **New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.**
- **Favorable forecasts and a drop in exports have driven grain prices lower.**

Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost nearly 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the Dallas Region's banks fared slightly better. The value of securities holdings for all Call Report filers in the Region declined by only 1.42 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition

CHART 1

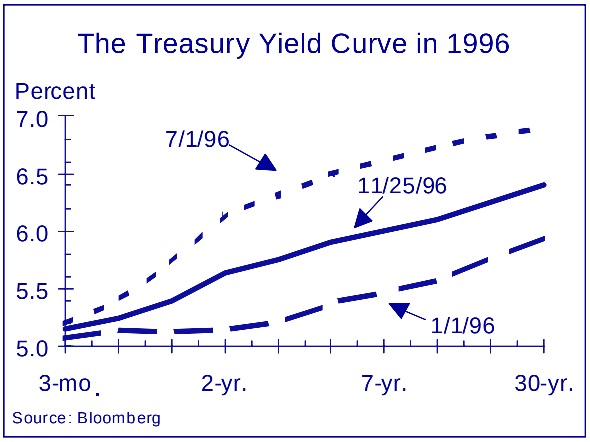


TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE								
	US Treasury 30-year bond $100,000 Par 7.25% Coupon 7.75 yrs until maturity		FNMA Mortgage pass-through $100,000 Par 7.5% Coupon 7.59 yrs WAL		FNMA Callable Agency bond $100,000 Par 7.55% Coupon 7.58 yrs until maturity		TOTAL	
Date	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period
11/25/96	$107,375	3.84%	$100,280	2.19%	$102,240	2.14%	$309,895	2.74%
7/1/96	$103,406	(7.08%)	$98,130	(3.90%)	$100,100	(4.68%)	$301,636	(5.27%)
1/1/96	$111,281		$102,110		$105,020		$318,411	

SOURCE: Bloomberg

PROTOTYPE

price of each instrument.

The Dallas Region's Bank Stock Performance

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the Dallas Region's banks. The Dallas Regional Bank Index (DRBI), created by the Division of Insurance (DOI), consists of the Dallas Region's 8 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The DRBI, which is weighted by total market value of shares outstanding, has gained 34 percent on the year but has underperformed the S&P Bank Index* (see Chart 2). The DRBI does not share any institutions with the S&P Bank Index.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 (next page) plots this concept through 1995.

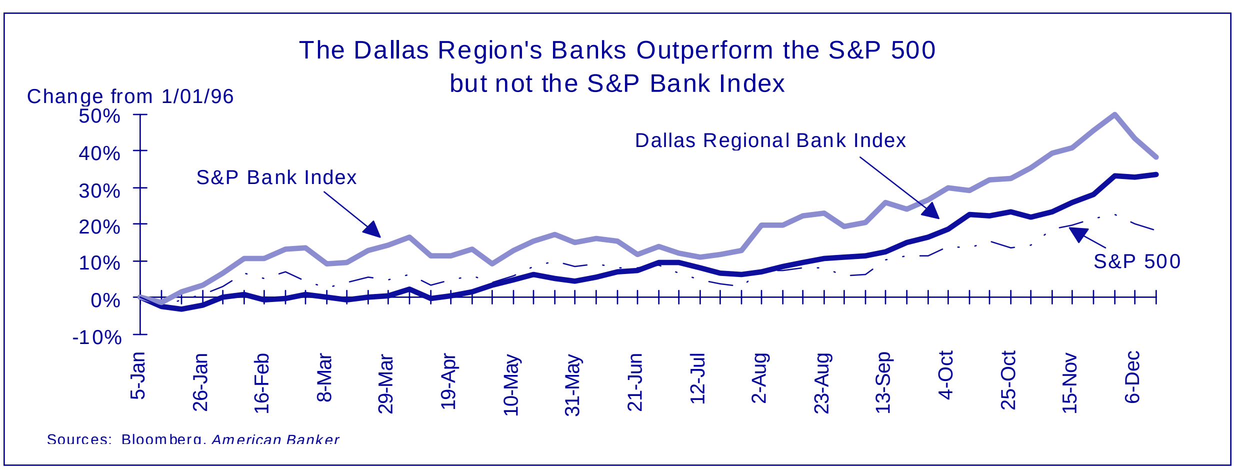
The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield

CHART 2



Curve Twists

Managing earnings exposures to changes in the yield curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. *Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).*

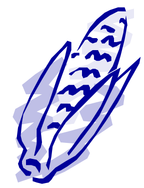
YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.

Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversified with most volume being derived from speculators and traders for proprietary accounts.

Favorable Forecasts, Fewer Exports Drive Grain Prices Lower

Many market observers were surprised by a mid-November USDA report that projected near-record corn and soybean crops this year. Favorable weather during the late harvest pushed estimated corn production for the 1996/1997 crop year to 9.27 billion bushels -- the third best harvest behind those of 1992 and 1994. *The USDA expects strong corn yields over much of the Corn Belt and record yields in Nebraska, Kansas, and Missouri*. Likewise, soybean production is forecast to total 2.4 billion bushels -- second only to the 1994 harvest.



As expected, prices for corn continued to slide from their summer highs, which were driven by fears of supply shortages, late planting, and late harvest risks. Weaker corn and soybean prices, the second largest spring wheat harvest on record, and favorable weather conditions for the recently planted winter wheat crop also have softened wheat prices (see Chart 4 next page). Further compounding price declines has been a drop in demand from abroad as global competition heightens. *Domestic corn and wheat producers are facing increased production, aggressive marketing, and foreign export subsidies from competitors including Argentina and the European Union*. Soybean exports appear more favorable as Pacific Rim purchases of soybean meal to feed expanding livestock herds accelerate and as South American competitors face lower than expected production.

CHART 3

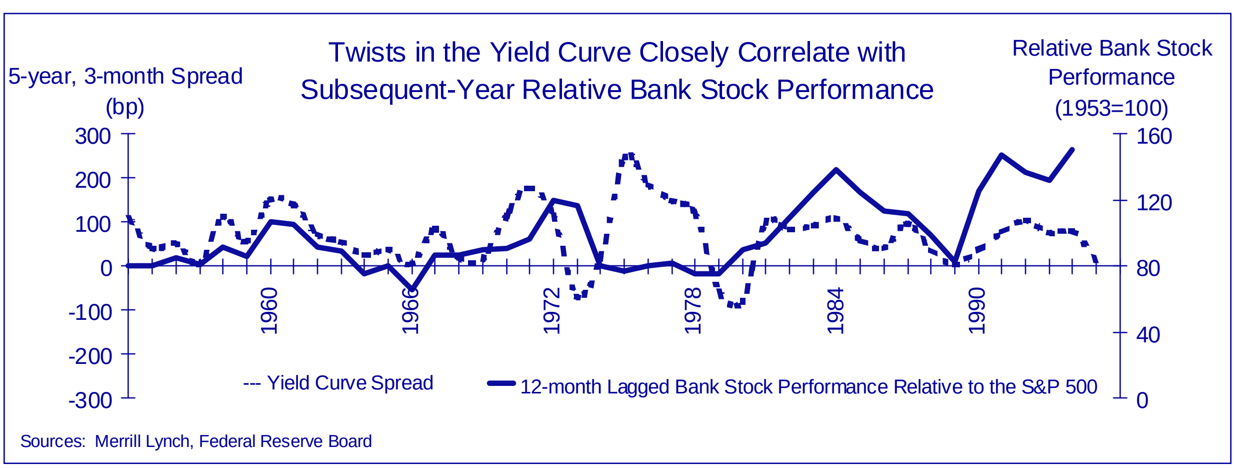


CHART 4

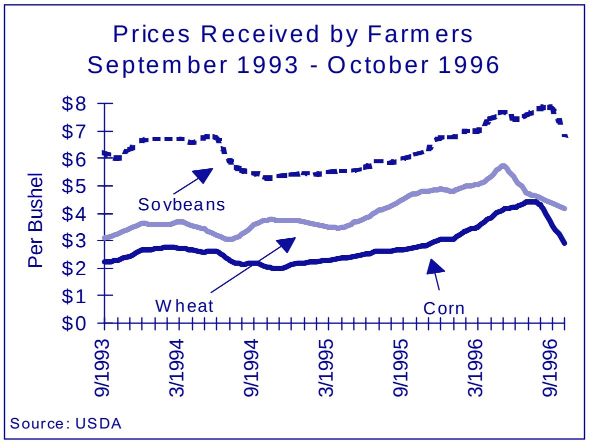


TABLE 2

MAJOR COMMODITY RANKINGS BASED ON 1994 CASH RECEIPTS

	CO	NM	OK	TX
CATTLE	1	1	1	1
DAIRY	4	2	5	3
NURSERY		5	4	4
WHEAT	2		2	
BROILERS			3	5
HAY	5	3		
COTTON				2
CORN	3			
CHILI PEPPERS		4		

SOURCE: USDA

According to the USDA, average prices for all three crops for the current marketing year are expected to fall from the average of the previous year, but should remain favorable relative to the average price received over the previous five marketing years. Futures markets generally agree with these predictions with some contracts that mature over the 1996/1997 marketing year recently trading approximately 30 percent below their respective contract highs reached earlier in the year.

Provided livestock and milk prices continue their recent ascent or stabilize, declines in feed costs should improve profit margins for livestock and dairy farmers. This is especially good news for cattle operators who faced falling cattle prices and rising feed costs earlier in 1996. Table 2 shows the major agricultural commodities for states in the Dallas Region.

The prospect for timely repayment of production loans to the Region's agriculture banks appears good based on the current expectations for operating income. Cash flows for many crop producers also should be supported by the first of seven fixed-support payments under the 1996 Farm Bill.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

Current Regional Banking Conditions

- **Earnings performance for the Dallas Region continues to be favorable even with rising provision and overhead costs. Third quarter year-to-date return on assets (ROA) of 1.26 percent improved modestly over the year-end 1995 ROA of 1.21 percent.**
- **Noncurrent loan increases outpace provision expenses since 1994, reducing reserve coverage on noncurrent loans from 182 percent at year-end 1994 to 142 percent as of the third quarter.**
- **The 1996 "Freedom to Farm" Bill phases out the government safety net and will require focused attention to risk management by producers and their lenders as the government transfers risk back to the private sector.**

Banking in the Dallas Region continues to be robust during the third quarter of 1996. Operating performance is favorable, capital levels are strong, and asset quality appears satisfactory despite recent signs of modest deterioration. Advancing net interest margins and modest improvement in noninterest income continue to bolster the Region's earnings performance despite rises in noninterest expense and loan loss provisions. The rise in noninterest expense was driven primarily by the one-time SAIF special assessment (see ***Saif Capitalized***.) Increased provision expenses reflect a modest but continuing trend of rising loan delinquencies.

There are some hints of modest deterioration in asset quality which may warrant attention. Past due and nonaccrual volumes have risen slowly but steadily since year end 1994, when they registered 2.0 percent, to their current level of just under 2.5 percent. More recently, past due loans and nonaccrual loans increased in virtually every lending type during the quarter. Similarly, the volume of charged off loans, now at 0.33 percent as compared to 0.18 percent at year-end 1994, is rising as well. Commercial loans, which are growing fastest, have the largest growth in past due and noncurrent loans.

Deteriorating consumer credit quality in the Region is consistent with national trends. Credit card delinquencies in the Dallas Region were at 2.2 percent, and charge-offs were 2.4 percent at year-end 1994; by the end of the third quarter, these figures had grown to 3.0 percent and 3.2 percent, respectively. It should be noted, however, that the Region's $4.6 billion in credit card loans amount to only 2.9 percent of total loans in the Region and represent only 2.1 percent of credit card loans nationwide. Although the full extent of the consumer credit problem remains yet to be seen, modest participation in credit card lending should help insulate this Region's banks from the adversity other parts of the country may face.

A subtle but evident shift from residential real estate and consumer loans to commercial and commercial real estate (including construction and land development loans) continues. Since 1994, consumer and residential loans have declined from 44.7 percent of total loans to 42.0 percent at the end of the third quarter of 1996. During the same period, commercial and commercial real estate loans have increased from 42.2 percent to 45.7 percent.

Growth trends vary considerably for banks in different asset size categories. *The fastest growth was in banks with assets between $500 million and $1 billion, where loans grew at an annualized pace of 26 percent during the third quarter of 1996*, apparently fueled by strong middle-market loan demand, especially construction and land development.

Commercial Real Estate Activity

Commercial real estate markets have improved considerably from five years ago. Absorption rates are up, previously depressed or stagnant lease rates are escalating, and commercial real estate prices are moving higher. As a result, commercial real estate portfolios are expanding. Interestingly, banks with less than $500 million in assets have the largest share of commercial real estate loans. They also have put most new loans of this type on the books over the past 12 months. Real estate development based on above average economic activity (in some cases "booming" activity such as Denver and Austin) will need to be monitored carefully, if the economy cools off as many are predicting (see ***Regional Economy***). In fact, articles have appeared recently in the ***Wall Street Journal*** and the ***Denver Post*** questioning whether some sectors of the Denver real estate market are overbuilt or if the expected decline in job growth will jeopardize the heightened real estate activity that Denver is now enjoying. Bankers need to be aware of real estate market conditions so that they can appropriately assess and manage the risk in their portfolios. Many private sources, in addition to the FDIC and the Federal Reserve Banks, provide good information on market conditions, much of which can be found on the Internet

Ag Banks - Past the Drought and into the 1996 Farm Bill

Collectively, "farm banks" in the Dallas Region have favorable capital positions and operating results (see Table 1). These strengths played an important role in their ability to weather the effects of last summer's drought that was pervasive throughout most of the Region. Generally, these banks have better operating performance, capital protection, and underwriting disciplines than farm banks in the early to mid-1980s.

The 1996 Farm Bill could expose agricultural producers and consequently their lenders to new risks that will have to be managed. Increased price volatility for commodities is expected, given that all producers (with the exception of fruit and vegetable farmers) are now free to determine the type of crop they wish to grow and the amount of acreage they wish to allocate. A phase out of the federal price support safety net over seven years is expected to result in greater income volatility to farmers. Unlike years past, the transition payments are fixed amounts and do not depend on the type or amount of crop produced. Accordingly, farmers will need to employ disciplined risk management tools.

The need to employ newly developed risk management products will require additional time and resources for both the producer and their lenders. According to a ***Texas A&M University*** analysis entitled "New Farm Bill: Watershed Change in Policy," "[p]roducers' ability to manage risk will be a more important determinant of who survives. Futures markets, contract markets, cooperative pooling, and price insurance will become more important survival tools for farm managers. *This gives a definite advantage to farm units that can afford to allocate resources to specialize in risk management.*" Similar pressures facing the small producer could face small ag banks: additional risks and limited resources to manage them.

Since the average size of the farm bank in the Dallas Region is only $48 million, the growing complexity of successfully managing risk could prove taxing. Fortunately, the Farm Bill also includes development of an Office of Risk Management for the administration of crop insurance and educational programs for risk management. Nevertheless, the removal of the government safety net and transfer of risk may put small banks with fewer resources at a disadvantage compared to larger banks. These disadvantages could take the form of

Table 1

Banks with Ag Loans that Exceed 100% of Tier 1 & 25% of Gross Loans				
State	**# of Banks**	**Avg Tier 1%**	**Total Assets**	**AVG ROA**
Texas	159	9.94%	$8,190	1.18%
Oklahoma	106	10.45%	$4,203	1.11%
New Mexico	7	10.66%	$564	1.19%
Colorado	54	10.10%	$2,762	1.48%
Total	326	10.06%	$15,719	1.20%
Source: Bank Call Reports				

increasing overhead or greater credit risk.

Coupled with these increased risks is an increase in banks' exposure to farm debt, both in terms of loans outstanding and market share. According to the USDA, as of year-end 1995, the $60 billion of farm debt held by banks amounted to 40 percent of the nation's farm debt outstanding, as compared to $44.8 billion in 1990, or 33 percent of the total outstanding. This increased level of exposure, coupled with the additional risk potential bought on by the 1996 Farm Bill, underscores the importance of risk management for agricultural producers and lenders.

There are many sources of information available to those who wish to become more familiar with the key components of the 1996 Farm Bill. The USDA and Texas A&M University both provide excellent informational resources to learn more about the Farm bill and its economic implications. The USDA's Internet address is http://www.USDA.gov and Texas A&M's address is http://afpc1.tamu.gov.

Alan C. Bush, Senior Regional Analyst