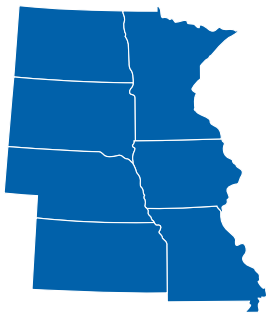

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

THIRD QUARTER 1997

In Focus This Quarter

FDIC KANSAS CITY REGION



◆ ***Subprime Lending: A Time for Caution***—The extent of subprime lending is increasing as strong competition for high-quality borrowers has some lenders moving down the credit quality spectrum. Subprime lending requires a commitment of resources and expertise beyond that required in more conservative lending, and the consequences of deficiencies in underwriting, servicing, and collection can be severe. *See page 3.*

By Kathy R. Kalsner, Debra L. Novak

◆ ***Retail Shakeout: Causes and Implications for Lenders***—Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions. *See page 6.*

By Richard A. Brown, Diane Ellis

Regular Features

DIVISION OF INSURANCE

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SENIOR REGIONAL
ANALYST

JEFFREY W. WALSER,
REGIONAL ECONOMIST

JOHN M. ANDERLIK,
FINANCIAL ANALYST

◆ ***Regional Economy***—Flooding in the Red River Valley affected a significant portion of North Dakota's economy . . . the aircraft industry is driving a boom in Wichita . . . cattle ranching is poised for improved profitability in 1997 . . . small independent hog farmers face stiff competition from larger operations. *See page 11.*

By Craig A. Rice, Jeffrey W. Walser

◆ ***Financial Markets***—Securitization of home equity loans is growing rapidly . . . consumer debt consolidation loans may be driving this growth . . . signs of relaxed underwriting have appeared . . . the arrival of FASITs could increase the appetite of community banks to enter the ABS market. *See page 16.*

By Allen Puwalski

◆ ***Regional Banking***—Banks in the Red River Valley may experience some credit quality problems . . . the Region's banks turn to alternatives to core deposits to fund loan growth . . . the year 2000 problem cannot be ignored. *See page 20.*

By John M. Anderlik, Craig A. Rice

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Subprime Lending: A Time for Caution

- **Subprime lenders specialize in lending to borrowers with blemished or limited credit histories.**
- **The consequences of deficiencies in underwriting, servicing, and collection can be severe with subprime lending. Lenders that fail to dedicate the necessary resources in these areas likely will have trouble succeeding in the increasingly competitive market for subprime loans.**
- **Some institutions insured by the FDIC have failed to properly assess and control the risks associated with their subprime lending programs.**

What Are Subprime Loans?

Faced with strong competition and shrinking margins on loans to high-quality borrowers, some lenders are moving down the credit quality spectrum. The strategy to extend loans to borrowers perceived as less credit-worthy is referred to as “subprime” lending. *Subprime lending is most commonly associated with auto, home equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories.* Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

Subprime loans also are referred to as marginal, non-prime, or below “A” quality loans. There are no established guidelines for determining the degree to which a borrower is considered subprime, so one lender’s “B” customer could be another lender’s “C” customer. Definitional variations aside, some general market parameters on ranking loans are presented in Table 1.

TABLE 1

CRITERIA FOR LOAN RANKINGS		
GRADE	PAYMENTS LATE 30 DAYS	BANKRUPTCY FILING
PRIME	NONE	NONE
A-	LESS THAN 2	NONE IN 5 YEARS
B	LESS THAN 4	NONE IN 3 YEARS
C	LESS THAN 6	NONE IN 2 YEARS
D	CONSTANTLY LATE	NONE IN 1 YEAR
SOURCES: DUFF & PHELPS, STANDARD & POOR'S, MORTGAGE MARKET INFORMATION SERVICES		

How Big Is the Market?

The lack of a standard definition for a subprime loan makes it difficult to accurately determine the extent of the market. However, some industry experts estimated that during 1996, subprime loans secured by residences, including both home equity and mortgage loans, amounted to between \$100 billion and \$150 billion compared to the estimated \$800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between \$75 billion and \$100 billion, or about 20 percent of total auto loans outstanding.

Who Makes Subprime Loans?

In the past, subprime lending was primarily the domain of a limited number of finance companies. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of subprime lenders, however, has surged in recent years as more companies have been attracted by the significantly higher rates and fees earned on subprime loans. In some cases, yields on these higher risk assets have been as high as 15 percent to 30 percent. The new subprime participants include finance companies that traditionally served prime borrowers, new specialized subprime lenders, and banks.

The increase in the number of subprime lenders has been fueled by strong demand from investors for asset-backed securities (ABS). This method of funding enables the lender to effectively raise cash at a lower rate to fund loan growth. In addition, the subprime ABS market has attracted lenders that previously refrained from making subprime loans because they did not want to maintain these high-risk loans or the associated reserves on their balance sheet. By issuing securities backed by subprime loans, lenders now have the ability to originate subprime loans and sell them to ABS investors.

Favorable stock market conditions also helped to fund the growth of subprime lenders. Approximately 30 subprime lenders raised nearly \$3 billion from stock offerings from January 1995 through April 1997, according to market watchers. This financing avenue may become less accessible, as investors’ concerns over financial

problems of several major market participants have caused stock prices of subprime lenders to decline significantly during the first part of 1997.

Financial Difficulties of Some Subprime Lenders

Market participants have observed that, as in credit card lending, *increasing competition may be compelling some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share.* Financial difficulties reported by major subprime auto lenders Jayhawk Acceptance Corporation and Mercury Finance Company highlight these concerns.



Problems in subprime lending are not limited to auto loans. Lenders that specialize in subprime home equity loans and mortgages also are showing signs of stress. In April 1997, Moody's Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home equity loans. The reason was concern over the increasing level of delinquencies in the issuer's loan portfolio and the highly competitive environment for subprime home equity loans (see *Financial Markets*).

Differences between Prime and Subprime Lending

There are key differences between the underwriting, servicing, and collection methods used for prime and subprime lending programs. The goal of the subprime underwriting process is to differentiate those subprime borrowers whose past credit problems were due to such temporary events as illness or job loss from the habitually bad credits. Subprime lenders often supplement a prospective borrower's credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. This process allows the lender to better determine the credit risk or "grade" of the borrower. If this determination is successful, the lender can better establish the price at which the loan will be profitable.

Servicing and collection of subprime loans tends to be more labor intensive and costly than in prime lending. Subprime lenders tend to monitor payments more close-

ly than prime lenders. Some purportedly call their borrowers regularly to remind them when a payment is due. In addition, while prime lenders may be willing to work with late borrowers by adjusting minimum amounts or payment schedules, subprime lenders generally pursue collections more aggressively and repossess collateral more quickly.

Insured Institutions and the Subprime Market

Bank involvement in subprime lending is difficult to quantify because subprime loans are not delineated in bank and thrift Call Reports. *However, both large and small banks reportedly are participating in credit card, auto, home equity, and mortgage subprime lending.* Insured institutions have used various strategies to establish a presence in the subprime market. Some have:

- acquired or formed joint ventures with companies specializing in subprime lending;
- built subprime lending programs internally, using existing resources; and
- tapped a network of loan brokers with access to subprime borrowers. Smaller banks entering the market for subprime mortgages may use this method more commonly.

Through these strategies, insured institutions have:

- extended loans directly to subprime borrowers or purchased subprime loans from loan brokers;
- lent to subprime specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines; and
- serviced subprime loans or invested in asset-backed securities secured by subprime loans.

Risks Associated with Subprime Lending Need to Be Considered Carefully

According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because of the relatively high default rates on such loans, the FIL indicates that this type of lending warrants particular caution and management attention.

In Focus This Quarter

Institutions need to be thoroughly aware of the increased risks and costs associated with lending to higher risk borrowers. Some of these risks include:

- *Delinquencies and defaults tend to be more frequent and occur sooner on lower quality loans* (see Chart 1).
- Loan loss reserves that would have been adequate for prime lending may not properly cover higher loss rates associated with subprime loans.
- Strains on underwriting and collection resources may emerge.
- Because selling collateral is more frequently the source of repayment on subprime loans, failure to accurately estimate recovery values could severely affect the profitability of subprime lenders. For example, several subprime auto lenders recently reported lower profits when the supply of better quality cars coming off leases depressed the prices they received on repossessed cars.

Insured institutions that rapidly increase subprime exposures also may need to reevaluate delinquency measurement methodologies. Rapid loan growth can make it more difficult to accurately track delinquency and default trends. Generally loans do not default immediately, but “season” or reach peak loss rates over a period of time. *Delinquency and default rates can be*

deceptively low if the proportion of new loans exceeds the proportion of seasoned loans in a lender’s portfolio. Calculating default rates over time for loans originated in a particular period or lending program, instead of as a percentage of total outstanding loan balances, helps reduce the distortion caused by rapid loan growth. This method of computing delinquency and default rates, known as “static pool” or “vintage analysis,” is a common measurement tool among investment analysts.

Banks involved in subprime lending also should realize that the recent increase in subprime lending has occurred during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be more susceptible to downturns in the economy, which could further exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

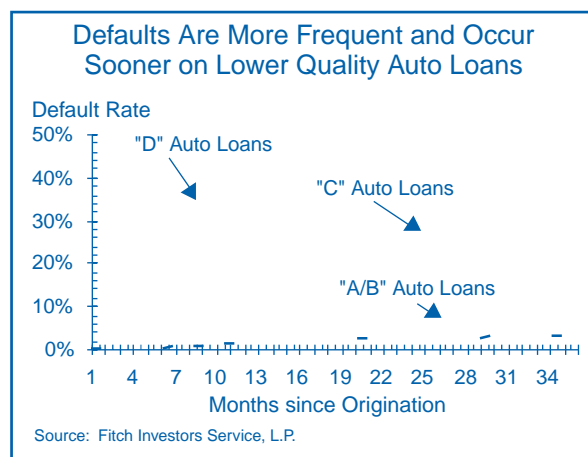
In addition, banks that lend to subprime specialty lenders, who rely heavily on securitization, should evaluate the accounting treatment of securitization and the effect securitization may have on earnings (see *Financial Markets*).

Conclusion

The extent of involvement by insured institutions in subprime lending is difficult to quantify. To be successful in subprime lending requires a commitment of resources and expertise. Conversely, deficiencies in assessing and controlling the risks of subprime lending can have serious consequences. Such deficiencies have surfaced at a number of FDIC-insured institutions. Striking an appropriate balance between the risks and rewards of subprime lending is a challenge for bankers and merits the continued attention of bank supervisors.

*Kathy R. Kalser, Chief
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Debra L. Novak,
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CHART 1



Retail Shakeout: Causes and Implications for Lenders

- Changes in the marketplace, technology, and finance are transforming retailing.
- These trends have given rise to rapid growth in the new “big box” store format.
- Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.
- The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.

For the past two decades, construction of retail space has outstripped many indicators of demand such as growth in retail sales, population, and income. The broadest measure of the industry’s health is sales per square foot, and, for shopping centers, it has fallen by around 35 percent in real terms since 1972. Chart 1 shows how growth in leasable shopping center space has exceeded growth in shopping centers’ sales since 1972.

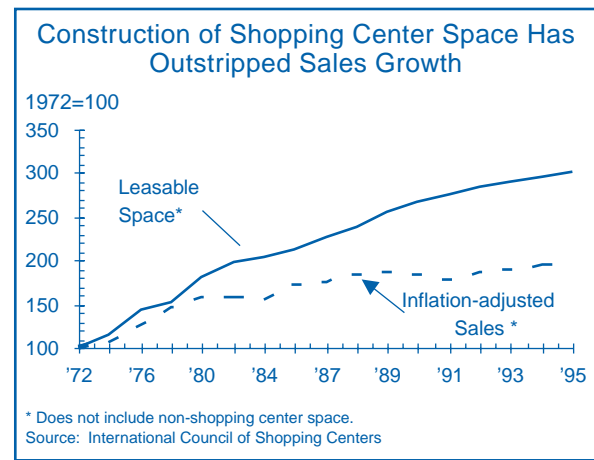
Based on signs of “overstoring,” a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate, they are exposed to heightened credit risk as the shakeout unfolds.

New Forces Are Reshaping the Retail Landscape

A combination of demographic and economic forces has reduced growth in demand for retail goods from the boom days of the 1970s and mid-1980s. Meanwhile, technology is reconfiguring the way retail goods are marketed and delivered, and a low cost of capital has stimulated investment in new retail space and new retailing concepts.

A retail industry boom began roughly in 1970 when baby boomers and women began entering the work force in record numbers. At the same time, proliferation in general-purpose credit cards facilitated an extension in consumer borrowing power. As a result, there was a

CHART 1



98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

To meet this demand and serve expanding suburban communities, developers built shopping centers at a rapid pace. The number of shopping centers, from small neighborhood strip centers to huge regional malls, grew from about 13,000 in 1972 to over 41,000 in 1995.

Despite economic conditions that seem favorable for the retail sector, revenue growth has been painfully slow in the 1990s. Payrolls have seen net growth of 13.4 million jobs since mid-1991, while real disposable personal incomes and consumer confidence have risen commensurately. An optimistic household sector has shown a willingness to take on debt under these favorable conditions and has done so with the benefit of lower interest rates compared to the 1980s.

Even with generally positive economic conditions, retail demand has grown slowly in the 1990s (see Chart 2, next page). Annual rates of increase in real expenditures on many durable and, especially, nondurable goods have lagged behind rates of the previous two decades.

Slow growth in retail revenues can be explained in part by the fact that retail goods overall have risen in price at only around two-thirds of the general rate of inflation during the 1990s, while the appliance, electronics, and personal computer sector has seen actual price deflation.

An aging consumer base is another factor holding down retail sales growth. The total number of households headed by persons age 20 to 35—the age at which families are getting established and acquiring household durable goods—is the same now as it was in 1980. The lack of growth in this key demographic group has limited growth in retail demand and should continue to do so for the foreseeable future. The total population in the 20 to 35 age bracket is projected to decline slightly by 2007.

Other broad trends have contributed to slower retail sales growth. Retail sales as a percentage of personal income fell from 46 percent to 38 percent between 1967 to 1996 as consumers shifted more of their disposable income to the purchase of personal services, housing, education, travel, and entertainment. A *Standard and Poor's Industry Survey* reports that consumers have reduced their number of trips to shopping malls by 35 percent since 1980, while total shopping hours are down 70 percent.

Looking ahead, mail-order retailing through electronic media, including cable television and the Internet, may be poised to gain significant market share at the expense of shopping centers. “Virtual shopping malls” such as Amazon.com, an Internet book-seller, have made headlines with their initial successes, although analysts caution that widespread adoption of high-tech shopping may be some years down the road.



Technology has become a key to distribution and marketing. Faced with slower revenue growth, retailers have been investing in technology to cut their expenses and boost their bottom lines. For example, point-of-sale scanning delivers a vast amount of information that can be used to target marketing efforts and manage and control inventories—providing a distinct competitive advantage for large retail chains with vast marketing and distribution networks.

A low cost of capital has fueled investment. Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise have been infeasible. Since 1991, around 1.13 billion square feet of new retail space has been added nationwide representing an

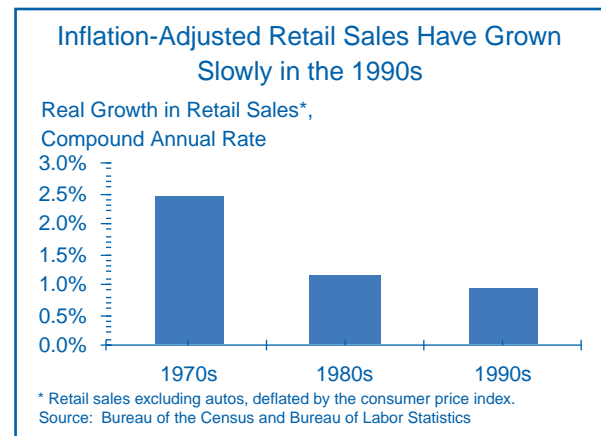
increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost \$33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although they are known to be sizeable.

Growth of the “Big Box” Format

Leading retailers have responded to these forces with aggressive expansion in the “big box” store format. Big box retailers are typically discount stores and super-stores, such as Circuit City, PetSmart, and The Home Depot, Inc., which tend to cluster in large strip malls called “power centers.” In many towns and cities, the arrival of big box stores has left smaller, local retail establishments with only a small fraction of their former share of the local market.

The big box format has a number of advantages. Among the most important is the ability to offer a large, diverse on-shelf selection. This approach enables a single location to dominate that retail category in the local market, which is why the big box chains are often referred to as “category killers.” Large retail chains also have more leverage over suppliers. They can negotiate more favorable prices and demand cooperative advertising from manufacturers. Large retailers typically have the financial resources to invest in the latest distribution methods and technology. Finally, unlike smaller traditional retailers, these large chains can obtain financing through the capital markets.

CHART 2



Industry Consolidation to Continue

Rapid expansion among the large retail chains has contributed to a highly competitive retail sector marked by intense battles for domination of the major retail categories. The result of this competition, analysts say, will be consolidation in the industry as weaker chains give way to market leaders.

One sign of this consolidation is in multibillion dollar acquisitions, such as Federated Department Stores' acquisition of R.H. Macy. The five largest department store chains (JC Penney, Federated, May, Dillard, and Nordstrom) now account for 87 percent of department store sales nationwide. The top three discount department store chains (Wal-Mart, K-Mart, and Target) account for 87 percent of full-line discount department store sales.

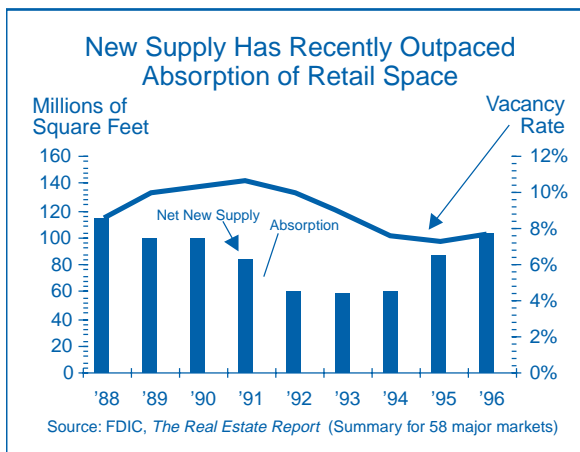
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more likely to be forced into bankruptcy. *Dun & Bradstreet* reports that domestic business failures among retail establishments rose in 1995 by 2.8 percent to 12,952. While most of these failures were individual stores and small chains, a number of larger chains also filed for bankruptcy during 1995, including Barney's, Bradlees Inc., Caldor, The Clotheshime Inc., Edison Brothers Stores, Elder-Beerman, Herman's Sporting Goods, Jamesway, and Today's Man.

As the retail shakeout moves forward, any credit losses on commercial and industrial loans to retailers are more likely to arise from bankruptcies and restructurings than from mergers and acquisitions. Unfortunately, it is difficult to say in advance exactly how consolidation in the industry is likely to take place.

Overbuilding Is a Risk for Retail Real Estate

Retail industry analysts are particularly concerned about the potential for overbuilding of retail space. Because of this concern, lenders and examiners should be alert to possible credit quality problems with commercial real estate loans secured by retail properties.

CHART 3



Although a vacancy rate of 7.7 percent does not suggest that the U.S. retail market is vastly overbuilt at present, there are warning signs. One is that the U.S. aggregate vacancy rate has begun to tick upward since 1995 as net completions of new retail space have caught up to and surpassed the absorption of that space by retailers (see Chart 3). Another frequently cited indicator of overbuilding is a falling ratio of sales per square foot in the industry, reflecting the fact that additions to retail space have outpaced sales growth for some time. In any case, local market conditions may be somewhat more volatile than the national figures would suggest, particularly in areas where a great deal of construction activity has recently taken place (see inset, *Retail Vacancy Rates Continue below the National Average*).

Besides market conditions, underwriting is the other major determinant of credit quality in retail real estate lending. Market analysts report that many of the problems resulting from local market downturns have been on loans with 1980s-vintage underwriting, particularly those with high loan-to-value ratios. Analysts also voice concern that the rapid expansion of space may be putting downward pressure on lease rates. *In light of an ample supply of space and a number of large chains continuing to add space, any valuations that assume future growth in lease rates should be closely reviewed.* The viability of rapid expansion on the part of the large retail chains would undergo a particularly severe test in the event of a recession.

*Richard A. Brown, Chief, Economic Analysis Section
Diane Ellis, Senior Financial Analyst*

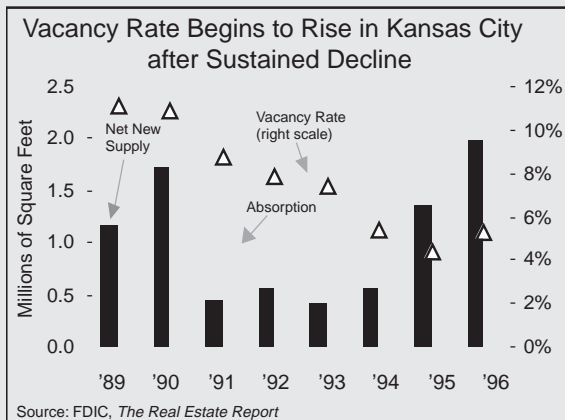
Retail Vacancy Rates Continue below the National Average

According to *F. W. Dodge Real Estate Analysis and Planning Service*, the vacancy rates for retail real estate in the Region's three major markets have been declining in the 1990s. As shown in Table 1, the vacancy rates in all three markets in 1995 and 1996 were below the average of the 58 major markets surveyed.

In the **Kansas City** metropolitan area, retail vacancy rates have been declining since 1990 and have been below the average of 58 major markets since 1991 (see Chart 4). Much of the growth in demand for retail space has occurred south of the city, especially **Johnson County, Kansas**. However, as shown in Table 1, vacancy rates increased in 1996, from 4.4 percent to 5.3 percent. In apparent response to the historically low vacancy rates of the previous year, newly built retail space outpaced absorption for the first time in six years (see Chart 4).

While the Kansas City market's vacancy was still below the 58 major market average of 7.7 percent in 1996, large projects planned for 1997 have the potential to push the vacancy rate higher. Construction of the Great Mall of the Great Plains began in **Olathe, Kansas**, in January. The outlet-based mall will have 1 million square feet of gross leasable space. In addition, a 648,000-square foot shopping center, including a 30-screen movie theater, is scheduled to open in suburban Kansas City in fall 1997.

CHART 4



The Twin Cities retail market continues to boom, with 1.5 million square feet of new development in 1996 and a number of major redevelopments. Chart 5, next page, shows that the **Minneapolis/St. Paul** area has experienced a steady tightening of retail vacancies since 1993. While industry experts expect some retail shakeout to occur among the older retail centers, this year's biggest new retail development, Tamarack Village in the **Woodbury** suburb of St. Paul, is proving to be a success. The Dayton Hudson Corporation also has agreed to enter two area regional malls by building Dayton's department stores there.

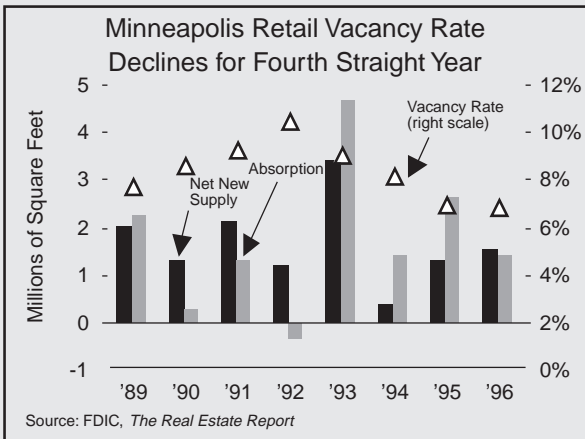
In **St. Louis**, there continue to be a number of major redevelopments at existing shopping centers, as well as new development in the outlying suburbs. However, the number of successful retailers in the area has dwindled. An example of the large retailers

TABLE 1

RETAIL VACANCY RATES IN KC REGION ARE BELOW THE NATIONAL AVERAGE				
	1993	1994	1995	1996
KANSAS CITY MSA*	7.4	5.4	4.4	5.3
MINNEAPOLIS MSA	9.0	8.1	6.9	6.8
ST. LOUIS MSA	8.8	8.4	7.3	7.6
AVERAGE OF 58 MAJOR U.S. MARKETS	9.0	7.6	7.4	7.7

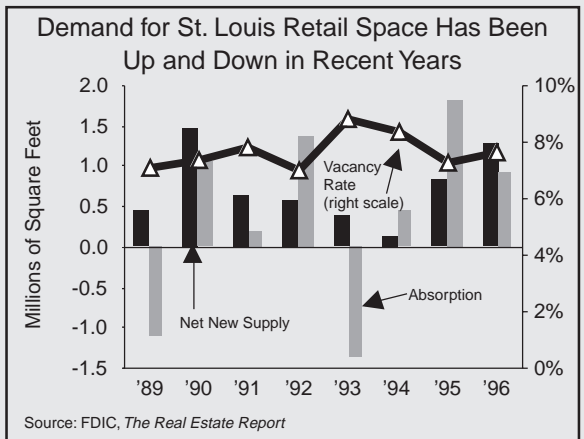
*MSA = METROPOLITAN STATISTICAL AREA
SOURCE: F. W. DODGE

CHART 5



leaving the market is the Central Hardware chain, which vacated a dozen large retail spaces varying in size from 50,000 square feet to 150,000 square feet in 1996. New retailers have been somewhat slow to

CHART 6



replace those leaving, as indicated in Chart 6 by a recent rise in the St. Louis retail vacancy rate.

Jeffrey W. Walser, Regional Economist

Kansas City Region: North Dakota Suffers from Spring Flooding

- **Flooding in the Red River Valley devastated private and public property and will strain North Dakota's resources.**
- **Wichita's booming aircraft industry should propel the city's economy in the near term but may increase the city's already heavy reliance on the industry.**
- **Declining inventories in 1997 should push up cattle prices, helping the Region's cattle ranchers.**
- **The hog industry continues to consolidate in the Region, but small operators in Iowa resist the trend.**

April Flood Hit North Dakota Hardest

Severe winter storms dumped record amounts of snow over parts of **North Dakota** and western **Minnesota**. The resultant spring thaw and flood may have serious consequences for the economy in the area known as the Red River Valley, especially for North Dakota. The Red River flows northward and forms the border between Minnesota and North Dakota. The Red River Valley, a very flat area, is the most fertile land in North Dakota and home to 35 percent of North Dakota's population. Table 1 shows the importance of the Red River Valley to North Dakota.

The Federal Reserve Bank of Minneapolis has made preliminary estimates of property damage, based on publicly available information, at \$1.2 billion to \$1.8 billion, with the greatest destruction in the **Grand Forks** and **East Grand Forks** area. Damage to residen-

tial and commercial buildings in that area may range from \$600 million to \$800 million, and damage to property in the buildings may range from \$375 million to \$525 million. State officials estimate that less than 10 percent of this damage to private property is covered by insurance. The Federal Reserve Bank also estimated that losses of net worth to independent businesses could range from \$150 million to \$400 million. A Grand Forks county commissioner estimated that the county had lost 30 percent of its tax base. Losses of public buildings, roads, and bridges may be in the range of \$120 million to \$200 million. These estimates represent only part of the total negative economic impact, as they do not include foregone output or employment income or costs incurred while building dikes, stacking sandbags, and evacuating residents.

At the height of the flood, 1.7 million acres of cropland were underwater, but the losses associated with this flooding should be less than previously estimated. When the water receded, farmers were able to plant in affected areas more quickly than they had expected. Because the flood occurred early enough in the season, planting was still possible in time to achieve reasonable crop maturities. Livestock producers were hard hit by the cold, snowy winter and the April snowstorm that occurred during the calving season. State officials estimate that more than 160,000 cattle died during the winter, two to three times the usual death rate. While individual ranchers suffered severe losses, the effects of the cattle deaths are expected to be short-term at worst.

Congress appropriated some \$500 million in federal aid to residents of the Red River Valley in June. While most such aid is in the form of low-interest loans, it should provide some businesses the means to reopen and some families assistance to rebuild their homes. The federal

TABLE 1

COUNTIES ON THE RED RIVER MAKE UP MUCH OF NORTH DAKOTA'S ECONOMY				
COUNTY	POPULATION	% OF STATE TOTAL	HOUSEHOLD INCOME (\$ MIL)	% OF STATE TOTAL
CASS	102,874	16.1%	1,085	19.0%
GRAND FORKS	70,683	11.1%	640	11.2%
RICHLAND	18,148	2.8%	159	2.8%
WALSH	13,840	2.2%	116	2.0%
PEMBINA	9,238	1.4%	83	1.5%
TRAILL	8,752	1.4%	74	1.3%
SIX-COUNTY TOTALS	223,535	35.0%	2,157	37.8%

SOURCE: 1990 U.S. CENSUS

assistance will fall far short of repairing all the flood damage, however. *The flood damage is very large compared to the size of North Dakota's economy.* As a point of comparison, North Dakota's 1995 to 1997 biannual general revenue budget was only \$1.4 billion.

Implications: The flooding could have the following effects:

- Taxpayers could pay significantly higher taxes to replace damaged infrastructure.
- The direct victims of the flood could require many years to pay off the debts incurred after the flooding.
- Many residents of North Dakota who lost much of what they had might move elsewhere. The city tax assessor of Grand Forks, as quoted in the *New York Times*, estimated that "as many as 7,500 people may leave town."
- As discussed in *Regional Banking Conditions*, 53 banks in the Red River Valley, with total assets of more than \$2.8 billion, face risks from flood-damaged real estate and agricultural losses.

The Aircraft Industry Is Booming in Wichita

Because of the concentration of aircraft manufacturing in **Wichita**, the area has been vulnerable to changes in the health of the industry. For example, over the past two decades, Boeing's fortunes have been subject to booms and busts caused by fluctuating demand in the commercial and military markets. In fact, Boeing laid off more than one-third of its Wichita employees in the early 1990s as sales lagged expectations. Another example is Cessna, which halted production of small piston-engine planes by 1986 because of soaring product liability costs. It decided to reenter that segment of the business after Congress passed the General Aviation Revitalization Act of 1994, which limited manufacturers' liability in airplane accidents.



The aircraft industry in Wichita sustained strong growth in 1996, with Boeing Wichita, Cessna Aircraft, Raytheon Aircraft, and Learjet adding more than 5,300 jobs. The four manufacturers had a substantial econom-

TABLE 2

THE AIRCRAFT INDUSTRY HAS FUELED THE MANUFACTURING BOOM IN WICHITA			
COMPANY	1995 EMPLOYMENT	1996 EMPLOYMENT	INCREASE
BOEING	14,800	18,000	3,200
CESSNA	6,740	7,600	860
RAYTHEON AIRCRAFT	6,500	7,500	1,000
LEARJET	2,836	3,084	248
AIRCRAFT TOTAL	30,876	36,184	5,308
TOTAL WICHITA MSA MFG. EMPLOYMENT	57,100	62,100	5,000
AIRCRAFT AS % OF TOTAL MFG.	54%	58%	—

SOURCE: WICHITA EAGLE AND BUREAU OF LABOR STATISTICS

ic presence in the area in 1996, as reported in Table 2. In 1996, Boeing began advertising for positions such as draftsmen, engineers, numerical control programmers, and manufacturing analysts. Boeing recalled some of the nearly 9,000 employees it downsized earlier in the decade. Cessna opened a new plant to build piston-engine planes in mid-1996, using \$40 million in Kansas industrial revenue bonds. The plant is expected employ more than 1,000 workers by the end of 1997.

As Table 2 shows, all of Wichita's net increase in manufacturing employment in 1996 was due to the aircraft industry. As a result of increased hiring by the aircraft producers, Wichita was second among U.S. cities in manufacturing employment growth from October 1995 to October 1996, with an 8.1 percent increase.

According to local business analysts, the industry expansion has exerted direct pressure on the market for skilled labor and pushed up wages throughout the local economy. Due to the shortage of skilled workers, it has been reported that Cessna has recruited inexperienced workers with good work records to train in its manufacturing process. Boeing has resorted to hiring away experienced workers from some of its own vendors and subcontractors.

Implications: In the near term, indicators point to Wichita's continued economic health as the industry expands. One industry analyst estimates that recent

investment and hiring by the aircraft industry will result in three to five years of sustained growth in Wichita. *However, this growth will increase the demand for labor, possibly restraining growth in service and small manufacturing businesses not related to the aircraft industry.* Higher wages paid in aircraft plants should eventually pull up other wages in the local market, as workers at each level of skill and experience migrate to higher paying jobs. Smaller businesses usually struggle to find and retain productive workers, and the rising wages could make their task more difficult. At the same time, however, higher wages and income growth may result in a general increase in demand for the goods and services they provide.

In the longer term, since more than 58 percent of its manufacturing jobs are in the aircraft industry, Wichita's fortunes will continue to be dependent on the health of that industry, which has been subject to significant variability. Manufacturing accounts for 23.4 percent of total employment in Wichita compared with 15.4 percent nationwide, according to the *Bureau of Labor Statistics*.

The upswing in manufacturing employment in Wichita has led to increased sales of new and existing homes and startups of businesses supplying the aircraft industry and its workers. Demand for mortgage and business loans is strong and growing in the current environment, but observers of the Wichita economy are mindful of the risks that the heavy concentration of the aircraft industry implies.

Cattle Cycle Turns and Ranchers' Prospects Improve

As discussed in the second quarter 1997 *Regional Outlook*, the Region's cattle ranchers have experienced several difficult years. However, recent results from a government estimate of the U.S. cattle population suggest that ranchers' chances for profitability will improve in 1997 and 1998.

The semiannual *Cattle* report, released by the U.S. Department of Agriculture (USDA) in January, indicated a population of 101.21 million head of cattle and calves nationwide as of January 1, 1997. This inventory is 2.2 percent less than the January 1, 1996, number, and represents the largest annual decline since 1988. The report also indicated 34.28 million beef cows (the mothers of feeder cattle) at the beginning of 1997, or

2.7 percent less than the prior year's number. The total number of calves born in 1996 was reported at 39.59 million head, or 1.6 percent below the 1995 level. Chart 1 shows the cyclical pattern of cattle inventories and returns to ranchers over the current cattle cycle.

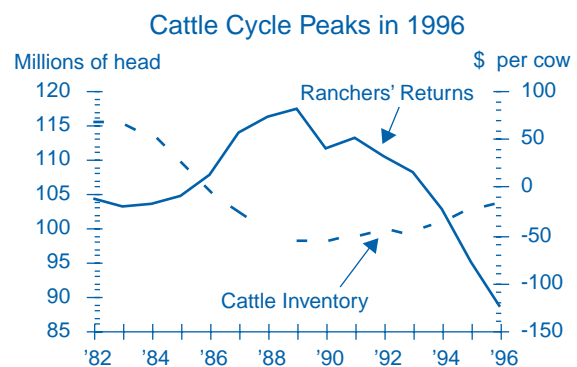
The cyclical pattern of cattle inventories occurs as ranchers respond to the market price of feeder cattle. Ranchers maintain herds of cows to produce calves, which they grow for about one year and then sell to feedlots, where they are fed grain intensively and sold to slaughterhouses after about another six months. The young cattle sold by the ranchers are known as feeder cattle, while the finished cattle sold to slaughterhouses are known as fed cattle.

The price of feeder cattle is affected on the demand side by the price of fed cattle. When feedlot operators are receiving high prices for their fed cattle, they are willing to bid higher for feeder cattle to fill their feedlots. On the supply side, the price of feeder cattle is affected by the population of young cattle, which is in turn determined by the population of cows.

The cattle cycle occurs because of significant lags as ranchers adjust their inventories to market prices. Small-scale ranchers predominate in the industry, with 80 percent of the ranches in the United States having fewer than 50 cows. Because cattle raising is a secondary source of income for these ranchers and requires only modest cash outlays, ranchers are typically slow to respond to downturns in market prices.

The biology of the cattle also causes lags, as the time from the conception of a calf until it is ready for market is typically 21 months.

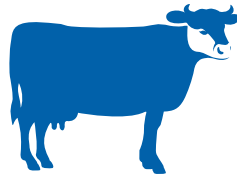
CHART 1



Source: U.S. Department of Agriculture

In 1995, for example, enough ranchers had been earning negative returns for more than one year that many of them sent some of their cows to slaughter, rather than breeding them to produce more calves. Continued slaughter of cows in 1996 slowed the growth of the cow herd, ultimately leading to a reduction in cattle inventory in 1997.

In 1997, prices of feeder cattle have increased substantially. The price of a 600- to 650-pound feeder steer in the Oklahoma City market has increased from \$61 per hundred pounds in late October 1996 to more than \$85 in mid-June 1997. This is the price ranchers, also known as cow-calf operators, receive when they sell young cattle to feedlots for finishing. Chart 2 shows the paths of feeder cattle prices and fed cattle prices in 1996 and 1997. The relative prices of fed and feeder cattle were unusual in 1996, with feeder cattle prices lower than fed cattle prices most of the year.



Implications: Cattle industry analysts expect that ranchers in the Kansas City Region, who have 28 percent of the nation's beef cows, can look forward to improved returns in 1997 and 1998.

The Hog Sector Continues to Consolidate While Iowa Producers Battle for Turf

The seven states of the Kansas City Region are home to a significant share of the U.S. swine industry. According to the March 27, 1997, *Hogs and Pigs* report, 47.7 percent of the nation's hogs are located in the Region. **Iowa**

has been the nation's leading hog-producing state since early in the century, and currently controls more than 21 percent of the national inventory. **Minnesota, Missouri, Kansas, and Nebraska** also rank among the top ten hog-producing states.

Over the past three decades, the hog industry has been continuing a trend of consolidation. The number of hog-producing operations nationwide has declined from 871,000 in 1970 to 157,000 in 1996. By the late 1970s, larger hog operations were able to achieve lower average costs of production with investments in specialized facilities such as confined hoghouses. Many small or part-time growers became unable to compete and exited the industry. The trend of consolidation has accelerated in the 1990s because new techniques in hog raising have required even larger investments in physical and human capital. The smaller operator does not produce enough hogs to justify large fixed expenditures for the facilities and training needed to remain competitive. Table 3 presents the decline in the number hog operations in the states of the Kansas City Region.

While the number of hog operations has declined by almost one-half in Iowa, the state still has the largest number of hog farmers in the nation. Thanks to their numbers and associated political clout, smaller Iowa hog farmers have been largely successful in discouraging investment by large hog operators from outside the state.

CHART 2

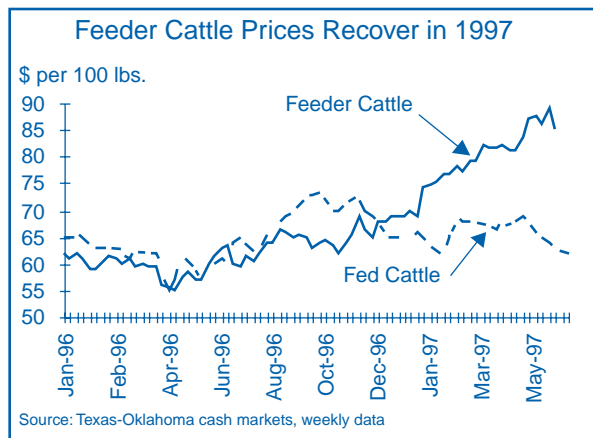


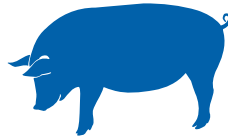
TABLE 3

THE REGION'S PIG FARMS HAVE CONSOLIDATED SIGNIFICANTLY SINCE 1988				
	1988	1992	1996	1996 AS % OF 1988
IOWA	41	35	21	51%
KANSAS	7	6	4	63%
MINNESOTA	17	14	11	67%
MISSOURI	17	13	7	41%
NEBRASKA	13	12	8	64%
NORTH DAKOTA	3	2	1	29%
SOUTH DAKOTA	8	7	4	44%
KC REGION TOTALS	104	89	56	54%
UNITED STATES	323	240	157	49%

NOTE: FIGURES ARE IN THOUSANDS OF FARMS
SOURCE: U.S. DEPARTMENT OF AGRICULTURE

In the mid-1990s, alliances of environmental activists and family farm organizations used court injunctions to stop a number of planned pork production projects from locating in Iowa. In 1996, the Iowa legislature passed a law that exempted livestock farmers from such lawsuits, provided they met environmental standards. This law has not entirely stopped litigation between large and small hog operators, however.

There are signs that Iowa's hog industry is in a long-run decline. Two large hog packers downsized some of their Iowa operations in February and March 1997. The companies cited difficulties in obtaining the hogs needed to slaughter at capacity levels. According to Glen Grimes, agricultural economist at the University of Missouri, in an interview in *Feedstuffs* magazine, the Midwest packing sector will suffer permanent erosion as midwestern packing plants are replaced by those in the South and the Southwest. Dr. Grimes noted, "Hogs usually move first, and the packing plants follow."



Implications: Iowa's political leaders continue to look for solutions to the conflict, but the persistence of the small hog farmers and their allies will not be denied in the short run. In a year such as 1997, when strong hog prices and moderate feed costs are expected, many smaller operators will be able to enjoy profits. For the longer term, however, the number of small producers should continue to decline.

The industry's consolidation has potential effects on the banking industry. Loans to smaller hog producers may begin to pose additional risks as such operations become less competitive with larger, more technologically sophisticated producers. In addition, community banks could face additional competition as larger hog producers begin to seek alternative sources of financing from larger banks or investors.

Corn and Soybeans in 1997: Stocks to Be Replenished

The USDA, in its June 1997 *World Agricultural Demand and Supply Estimates*, forecasted corn production of 9.84 billion bushels for this fall harvest, an increase of 5.9 percent over the 1996 harvest. If the forecast is realized, it will be the second largest harvest in U.S. history. Larger planted acreage for corn and soybeans is the result of the above-average prices that have prevailed over the past two years. Corn planted acreage also has likely been affected by the 1996 Federal Agriculture Improvement and Reform Act, which decoupled payments to farmers from specific production requirements. The USDA forecast implies that pre-harvest stocks will increase from 426 million bushels in August 1997 to 909 million bushels in August 1998, as domestic and export demand will not grow as much as supply. The USDA projects that prices paid for the corn crop just being planted will be 5 to 20 percent lower than for this year's crop.

The *World Agricultural Demand and Supply Estimates* forecasts a similar story for soybean production, with a record 2.6 billion bushels, an increase of 9.2 percent over last year. Ending stocks would more than double to 260 million bushels. Given production and stocks buildup, the USDA projects next year's soybean prices to be 10 to 30 percent lower than this year's prices.

Implications: The USDA forecasts farm cash receipts from corn and soybeans to be lower in 1997, implying lower incomes for farmers who market these crops.

*Craig A. Rice, Senior Regional Analyst
Jeffrey W. Walser, Regional Economist*

Financial Markets

- Deteriorating credit quality trends in the rapidly growing home-equity backed securities market could portend trends in bank residential mortgage lending.
- Financial asset securitization investment trusts, known as FASITs, promise to change the asset-backed securities market significantly and could make securitization more accessible to community banks.
- The Treasury yield curve is steeper and higher than it was at year-end 1996.
- During the first quarter of 1997, the Kansas City Regional Bank Index outperformed the S&P 500 but not the S&P Composite Bank Index.

Trends in the Home-Equity Asset-Backed Market Are Important to Banks

The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over \$20 billion or 251 percent since 1993, with total issuance of HEL ABS topping \$27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has been accompanied by abnormally early and high levels of delinquencies. Banks that are investing in HEL ABS, considering securitizing HELs, or lending significantly for debt consolidation should be aware of credit quality developments in the HEL ABS market.

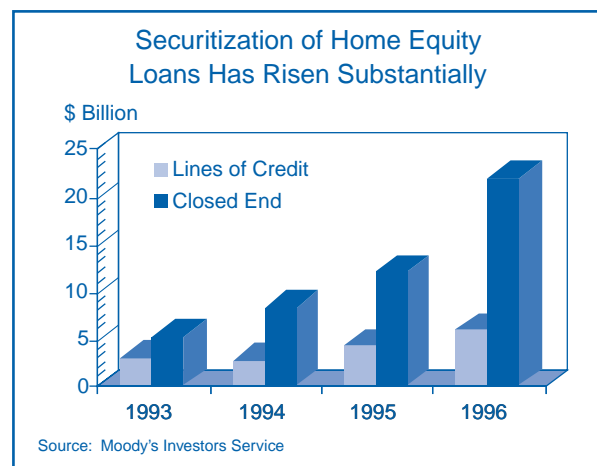
The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market. The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, known as cash-out refinancing, grew substantially when home-equity borrowers were motivated by lower rates to refinance their first mortgages for amounts greater than the remaining principal balance instead of adding a second mortgage.

Debt consolidation is the primary reason for home-equity borrowing. Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens. According to the *Consumer Bankers Association 1997 Home-Equity Loan Study*, debt consolidation accounted for 36 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior

to 1992, home improvement was the primary reason for home-equity borrowing. This trend toward debt consolidation as the reason for home-equity borrowing has significant risk implications because, unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance the lender's collateral value.

The rapid growth of the HEL securitization market has been attended by signs of relaxed underwriting. Adverse credit quality trends have been particularly prominent for loans that were originated in 1995. Chart 2 (next page) shows the total delinquency rates for closed-end loan pools originated in 1995 versus 1994. The sharp upward path of delinquency rates for loan pools originated in 1995 raises concern that aggressive competition for volume, and apparently relaxed underwriting standards, could lead to unprecedented default levels. *Furthermore, HEL originations in 1996 more than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.*

CHART 1



The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The trends would be obscured because banks report all first mortgage lending on 1 to 4 family residential properties without distinguishing between purchase mortgages and cash-out refinancings. The unfavorable trends in the HEL ABS market suggest that banks that engage in significant cash-out refinancing and other forms of home-equity lending should be able to monitor trends in the credit quality of these loans separate from purchase mortgage loans.

A Combination of Several Factors Could Induce More Banks to Securitize HELs

Although the present volume of bank-originated HEL securitizations is relatively small, banks have recently entered this finance company-dominated market, and a combination of several factors is likely to cause more to follow. First, home equity lines of credit are currently growing at rates exceeding total consumer lending, and, by and large, the deposit growth to fund this lending is less than robust. In addition, according to *Moody's Investors Service*, investor demand is high for bank-originated home-equity line of credit securitizations because bank-originated lines are perceived to have lower credit risk. The funding benefits and profitability of securitizing bank-originated home-equity lines of credit could entice more banks into the securitization market. Finally, the combination of these factors with the potential cost savings provided by using the new financial asset securitization investment trust (FASIT)

structure (see discussion below) could produce momentum that will result in banks, large and small, securitizing home equity loans in significantly increased amounts.

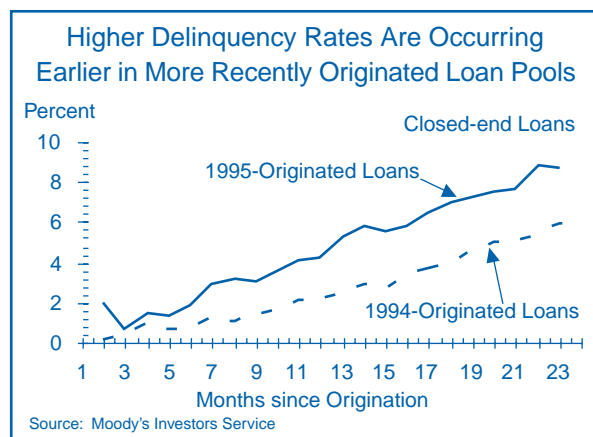
Securitizing HELs can change the balance sheet and income statement of the securitizer significantly, resulting in significant servicing assets and gains on sale.

Beginning in 1997, when a company sells loans, it must comply with the requirements of Financial Accounting Standard (FAS) 125. If the company retains servicing rights on the assets sold, FAS 125 requires the seller to book an asset related to the gain on sale that represents the future income derived from servicing the loans. This asset is similar to mortgage servicing rights in that it represents the present value of future expected cash flows derived from loan servicing. One major home-equity securitizer, which indicated that FAS 125 would not materially affect its financial statements, reported servicing assets at almost 90 percent of equity, and gains associated with the sale of serviced assets at 71 percent of total revenue.



The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results in charge-offs or early repayment through foreclosure of serviced assets, could require the adjustment of the valuation assumptions and the write-down of the servicing assets.

CHART 2



FASITs Promise to Change the ABS Market

The Small Business Job Protection Act of 1996 created two new sections of the Internal Revenue Code that create and govern FASITs. The FASIT provisions, patterned in part on the real estate mortgage investment conduit (REMIC) rules issued in 1986, are intended to provide tax certainty for ABS issuers and purchasers and enhance the flexibility of asset securitizations. The FASIT provisions take effect on September 1, 1997.

The advent of the FASIT is likely to change the ABS market in important ways. First, the FASIT will clarify

the tax treatment of securitizations. Because of the current tax ambiguity, designing ABS structures to avoid taxation is administratively costly, and it restricts the forms that securitizations can take. The higher administrative cost associated with current securitization techniques establishes a practical minimum size for asset pools that can be feasibly securitized. With FASITs and the reduced costs associated with tax clarity, the economically feasible pool size may be significantly smaller. *The lowering of this threshold could result in more community banks entering the securitization market.*

ABS issuers believe that the market for their product has been hampered by the restrictive nature of current asset-backed tax ambiguity, which prevents them from responding to investor preferences for varying maturities, coupon types, and prepayment and credit risk profiles. FASITs allow sponsors the flexibility to create multiple-class securities that satisfy these preferences with the certainty that the securities will count as debt and that the FASIT will not be treated as a taxable corporation. This combination of flexibility and tax certainty could lead to the kind of innovations in ABS structures that followed the 1986 REMIC legislation, which brought analogous benefits to the mortgage-backed market.



FASITs will bring to the ABS market the ability to add and remove assets throughout the life of a securitization. This feature could be applied by securitizing revolving construction loans and then replacing the revolving loans with permanent financing when construction is completed. A FASIT also will be able to contain a mixed pool of assets such as real estate, non-real estate assets, and unsecured credit, allowing exposures to very different markets from the same security. Finally, a FASIT can hold swaps and other hedging instruments. Using this feature, an issuer could combine a mortgage passthrough security with a hedging instrument that is designed to offset mortgage prepayment risk, such as a reverse-index amortizing swap.

The increased flexibility that the FASIT promises to bring the ABS market comes with the potential for greatly increased complexity and risk. Banks that invest in FASIT securities will need to understand fully not only the risk characteristics existing at the outset of

security but also the risk that could arise throughout the security's life if assets are to be removed and replaced.

Changes in Interest Rates and Bond Values

The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained there for the next 23 days. The FOMC met again on May 20, 1997, and left the target rate unchanged.

The model portfolio responded to the rise in rates, but only modestly (see Table 1). The relatively short weighted average maturity of the portfolio served to moderate the effect of the 54 basis point rise in the five-year Treasury between December 31, 1996, and March 31, 1997. As discussed in **Regional Outlook**, Second Quarter 1997, changes in the value of the model portfolio correlate more with changes in the five-year Treasury rate than with the 30-year bond rate.

The yields along the April 30, 1997, yield curve imply that the market expects the curve to continue to flatten through the remainder of the year with short rates rising somewhat. In order to gauge what affect a 25 basis point rise in the yield curve could have on bank fixed-income portfolios, the model portfolio has been "shocked" to simulate the effect of an instantaneous 25 basis point shift in the yield curve on May 28, 1997.

CHART 3

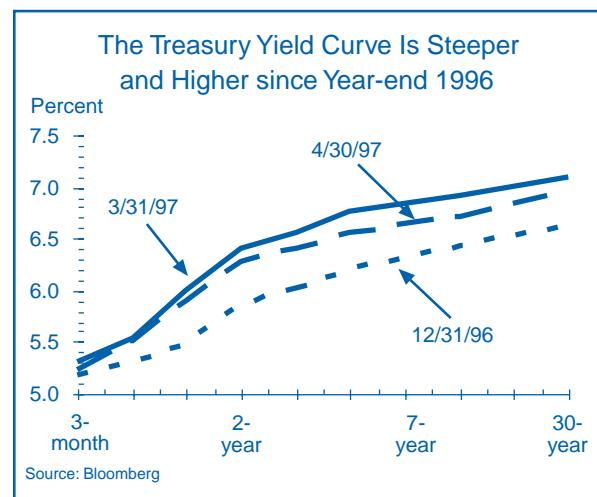


TABLE 1

TYPE OF SECURITY	PAR VALUE	PERCENT OF PORTFOLIO	MATURITY OR WAL AS OF 12/31/96	PERCENT CHANGE FROM 12/31/96 TO 3/31/97	CHANGE RESULTING FROM A 25 BP RATE INCREASE ON 5/28/97
U.S. TREASURY 5.6%	2,000	20%	1 YR	-0.30%	-0.16%
FNMA AGENCY 5.8% CALLABLE	1,200	12%	2 YR	-0.50%	-0.38%
STATE COUNTY MUNICIPAL GO 4.8%	800	8%	11 YR	-2.05%	-2.03%
FNMA MORTGAGE PASSTHROUGH 7.5%	3,000	30%	8 YR	-1.78%	-1.44%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5 YR	-1.27%	-0.50%
CREDIT CARD ASSET-BACKED SECURITY	1,000	10%	5 YR	-0.09%	0.00%
TOTAL	10,000	100%	4.85 YR	-1.08%	-0.77%

NOTE: PORTFOLIO COMPOSITION BASED ON ESTIMATES DERIVED FROM AGGREGATED BANK CALL REPORT INFORMATION.

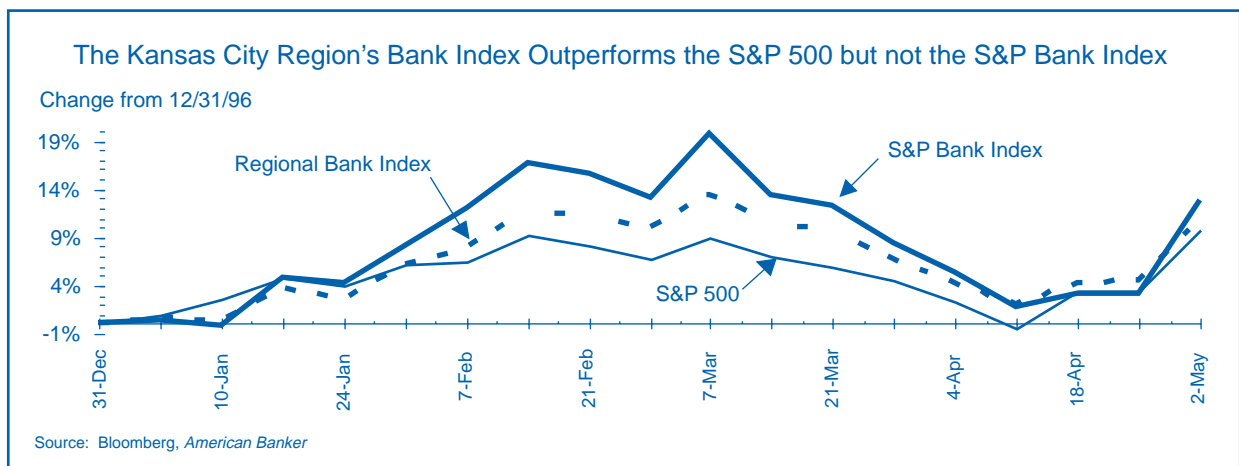
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate changes owing to its longer maturity. The mortgage passthrough security also is more sensitive to rising rates because its weighted-average life (WAL) extends as rising rates discourage the underlying mortgage holders from prepaying their loans. The decline in prepayment rates results in extending the maturity of the security while rates are rising, a combination unfavorable to the security's value.

The Kansas City Regional Bank Index Outperformed the S&P 500, but Not the S&P Composite Bank Index during the First Quarter of 1997

Both the S&P Composite Bank Index and the Kansas City Regional Bank Index have been subject to similar performance swings this year (see Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The Kansas City Regional Bank Index was up almost 11 percent through May 2, 1997.

Allen Puwalski, Banking Analyst

CHART 4



Regional Banking Conditions

- The harsh winter and subsequent flooding in the Red River Valley may have a detrimental effect on the loan portfolios of some banks.
- Large institutions are increasingly turning to borrowed funds to support loan growth. Community institutions also appear to be steadily increasing their reliance on less traditional deposit funding in the form of large-denomination time deposits (CDs).
- Viewed by many as an inconsequential issue, the year 2000 problem deserves close attention by the Region's banks and thrifts.

Red River Valley Banks and Thrifts Are Sure to Feel the Effects of the Spring Flooding

Flood-related damages and losses sustained by bank customers who are property owners and farmers may result in increased loan delinquencies and possible charge-offs. Smaller community banks and thrifts with offices only in the Red River Valley may be particularly affected, since their entire lending area may have been hit by the flood.

The majority of damage caused by the flood was felt by real estate owners, most of whom carried no flood insurance on these properties (see *Kansas City Region—North Dakota Suffers from Spring Flooding*). In **Grand Forks**, for example, fewer than 1,000 flood insurance policies were in force, while nearly 10,000 properties sustained damages. Lenders may be at risk in cases where borrowers lack the means or the motive to rebuild or repair mortgaged properties. While many lenders have granted loan payment deferrals to assist distressed borrowers with their difficult

situations, loan performance problems may surface once these grace periods are lifted.

In addition to credit risk, some mortgage lenders may be exposed to liability to the extent that they failed to fulfill their obligations as required by federal law for properties mortgaged in the floodplain. For example, if a lender failed to require flood insurance when such insurance was mandated, or failed to provide necessary flood hazard notifications, that lender could be exposed to some liability from customers whose property sustained flood damage.

As shown in Table 1, 53 small community banks and thrifts with combined assets of almost \$3 billion are headquartered in the Red River Valley. These institutions have \$940 million in loans secured by real estate. More than two-thirds of this figure represents loans secured by 1 to 4 family residences. Table 1 provides further information on the real estate exposure of these insured institutions relative to equity capital.

TABLE 1

COMMUNITY BANKS AND SAVINGS AND LOANS IN THE RED RIVER VALLEY ARE HEAVILY EXPOSED TO REAL ESTATE AND AGRICULTURE (AS OF DECEMBER 31, 1996)						
STATE	# OF INST.	TOTAL ASSETS (000s)	# OF INSTITUTIONS WITH REAL ESTATE LOANS AS A % OF EQUITY		# OF INSTITUTIONS WITH AGRICULTURAL LOANS AS A % OF EQUITY	
			GREATER THAN 300%	100% TO 299%	GREATER THAN 300%	100% TO 299%
MN	29	1,079,000	7	13	2	21
ND	24	1,797,000	4	16	5	12
TOTAL	53	\$2,876,000	11	29	7	33

SOURCE: BANK AND THRIFT CALL REPORTS

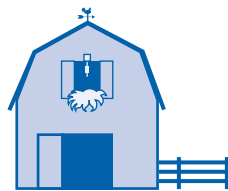
Although flood-damaged real estate poses the greatest risk to lenders, agricultural loan portfolios also may show some deterioration caused by the combined effects of a harsh winter and spring flooding. Farm lenders most likely will see an increase in borrowing by their customers to repair and replace equipment and buildings damaged by the flood. Since these new loans will increase the volume of debt serviced for a number of borrowers, cash flows may become strained, particularly for highly leveraged customers. Reduced crop yields also may result in carryover debt, which will further constrain future cash flow.

The institutions profiled in Table 1 hold over \$300 million in loans to farm producers. Of these 53 institutions, 40 have significant concentrations of credit to farm borrowers relative to equity capital. Those institutions having the highest concentrations of farm loans (more than 300 percent of equity) have remained profitable during the past three years, and levels of nonperforming assets reported on December 31, 1996, remained manageable.

The Midwest flood of 1993 may provide some insight into what can be expected for banks and thrifts in the Red River Valley. The 1993 flood caused an estimated \$10 billion in damage, primarily to farmers. However, no banks failed as a result of that flood, and in the aggregate, most indicators of bank performance exhibited little deviation from trends existing just prior to the flood. It appears that banks did increase loan loss reserves in anticipation of loan quality problems, but overall earnings did not seem to be significantly affected.

While some lessons can be learned from the experiences of the 1993 flood, there are several major differences that make it difficult to project how institutions may be affected by the Red River flood. Among the differences are:

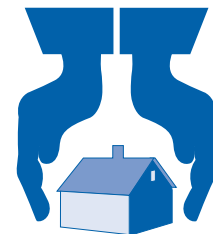
- The majority of the damages in the 1993 flood were incurred by farmers who were at least partially indemnified by crop insurance. The most significant damage from the Red River Valley flood appears to be centered in the real estate of uninsured homeowners and businesses.
- The 1993 flood caused a significant increase in prices for commodities such as corn and soybeans. While yields were reduced, farmers in 1993 mitigat-



ed losses by selling salvaged crops at higher prices. Currently, however, there has been no significant increase in commodity prices to help Red River Valley farmers with their projected decrease in crop yields.

- Unlike the 1993 flood, the devastation in the Red River Valley is geographically highly concentrated. Thus, community banks in the Red River Valley will probably have few loan customers who were not adversely affected by the flood.

There are several factors that could lessen the financial suffering by loan customers and consequently reduce the negative implications for insured institutions. For example, the federal government, through a number of programs, provides low-cost loans to individuals and businesses to encourage the replacement and repair of damaged properties. In addition, some properties in frequently flooded areas may be purchased at preflood fair market values by programs administered by the federal government and the state of **Minnesota**. Farmers may be partially indemnified by crop insurance and could find some relief in several emergency low-cost loan programs administered by the U.S. Department of Agriculture. Few individuals or businesses, however, are likely to be immune to the financial consequences of the flood.



Funding Strategies Are Changing to Meet Continued Loan Demand

During the national economic expansion, now into its seventh year, loan demand has been vigorous in the Region. Not unexpectedly, this demand has put some strain on insured institutions' liquid funds. Since 1992, the aggregate loan-to-deposit ratio for the Region's insured institutions increased from 68.4 percent at year-end 1992 to 83.2 percent at year-end 1996.

The trend in this key liquidity ratio is widespread: By year-end 1996, one-third of the institutions had loan-to-deposit ratios exceeding 75 percent, and almost three-quarters of those were community institutions (those with under \$100 million in total assets). In contrast, only one-eighth of the Region's institutions had loan-to-

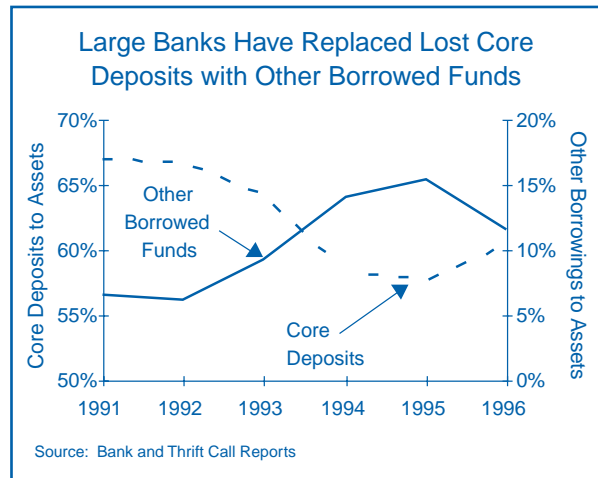
deposit ratios exceeding 75 percent in 1992. While the increase is significant, examiners have identified only a few isolated instances of liquidity problems in the Region.

More important is how institutions have funded the recent loan growth. Traditionally, institutions have funded loan growth with core deposits (defined in the *User's Guide for the Uniform Bank Performance Report* as savings, checking, and money market accounts, as well as CDs under \$100,000) because of the stability and cost-effectiveness of these instruments compared to other funding sources. However, since 1992, the Region's loan growth has far outstripped core deposit growth, as illustrated in Chart 1.

Weak core deposit growth appears to be due, in part, to stiff competition from other types of financial service companies. These entities have made numerous alternative products, such as mutual funds, available to consumers who traditionally invested in insured deposits. In addition, credit unions actively compete for consumer deposits and generally offer higher interest rates than banks. As a result of these competitive factors, the Region's institutions appear to have altered their funding strategies.

Large institutions (those with over \$1 billion in assets) have turned to nondeposit sources of funds. Large institutions have the Region's highest aggregate loan-to-deposit ratio, at 96.3 percent as of year-end 1996, up from 77.5 percent in 1991. More important, large institutions have experienced the most significant shift in funding. As shown in Chart 2, from 1992 to 1995, large

CHART 2



institutions' ratio of core deposits to total assets dropped from 66.8 percent to 57.6 percent. Over the same period, these institutions increased their use of borrowed funds from 6.2 percent of assets to 15.4 percent of assets. Greater bank participation in the Federal Home Loan Bank System, which offers member institutions relatively stable term funding on a cost-effective basis, accounts, at least in part, for much of this growth.

Unlike large institutions, which have expanded their use of other borrowings, community institutions have increased noncore deposit accounts, mainly through the issuance of large-denomination (over \$100,000) Certificates of Deposit (CDs). Because many of these institutions are located in rural areas that have traditionally had relatively fewer competitors, their core deposit bases have tended to be quite stable. However, these institutions also have experienced a shift in funding composition as large banks and nonbank entities continue to expand into rural areas, thereby providing increased competition for consumer deposits.

Chart 3 (next page), which illustrates funding trends of core deposits and large CDs relative to total assets, shows a steady increase in the proportion of community institution assets funded by large CDs since 1992. Over the same period, core deposits decreased relative to assets.

Implications: Although loan-to-deposit ratios have risen with the economic cycle, FDIC examiners report only isolated liquidity problems at small institutions. In the long term, however, reliance on large CDs by community banks has two potential adverse consequences. First, liquidity risk increases because these funds are

CHART 1

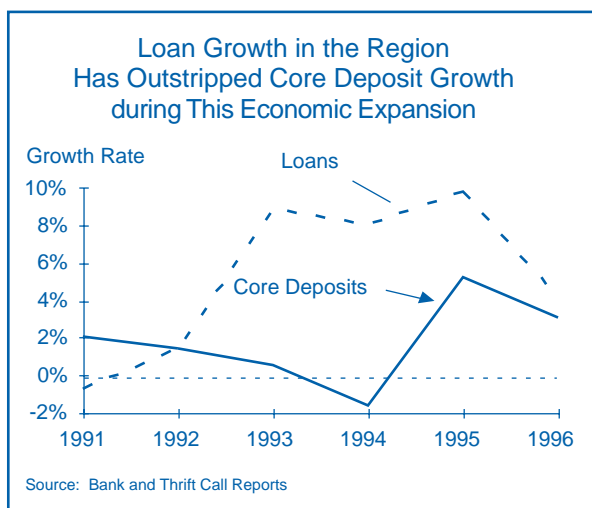
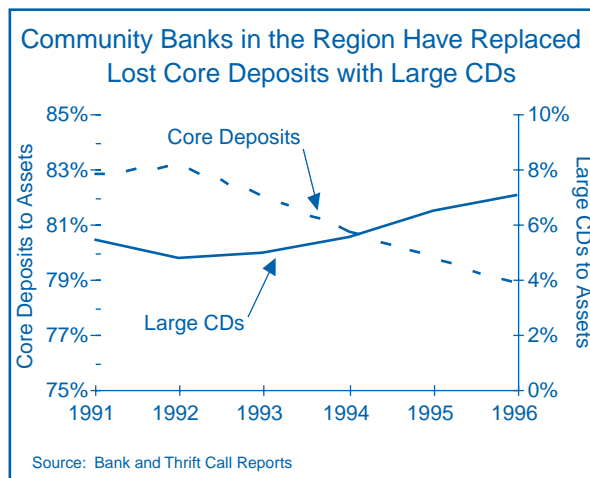


CHART 3



more interest-rate sensitive, and therefore less stable, than core deposits. Second, large CDs are usually more costly than core deposits. Increased reliance on such funds could ultimately affect community banks' net interest margins and overall profitability.

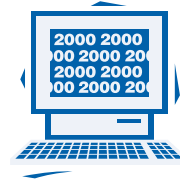
The Year 2000 Problem Cannot Be Ignored

Significant concern has been registered over the potential impact of the year 2000 on computer systems. This concern primarily relates to the fact that the year portion of dates in many computer systems is represented by just two digits (i.e., 96 for 1996). Therefore, some systems may interpret the date 01/01/00 as January 1, 1900, rather than January 1, 2000.

The year 2000 effect on financial institutions may be especially significant because of their heavy use of computer systems. For example, deposit records, loan records, and management reports may be inaccurate if this flaw is not corrected. In addition, bank customers

may experience similar problems that have the potential to disrupt their ability to conduct business or repay their debt. For financial institutions, the potential problems may reside with in-house systems and with the systems of their servicers.

Fixing the problem is a relatively straightforward task but could involve an enormous amount of computer programmer time reviewing voluminous lines of computer code. Other approaches to fixing the problem could include replacing computer software and hardware. *While these costs may be significant, lack of attention to this issue may be much more costly in terms of business disruption, potential computer systems failures, and degradation of financial control systems.*



A recent survey of community bankers by **Grant Thornton**, an accounting and management consulting firm, found that most community banks consider the year 2000 problem a nonissue. According to the survey, only 7 percent of respondents indicated that it is a major concern. When asked what steps they have taken to fix the problem, 26 percent said they did not have a problem. While indeed many institutions may not have the problem, prudent bankers will have a plan to thoroughly audit their systems and the systems of their servicers to ensure that they are in fact year 2000 compliant.

The FDIC's Division of Supervision recently issued Year 2000 Workprogram Procedures to assist examiners in raising the awareness of insured institutions to the potential problems surrounding this issue.

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