Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FOURTH QUARTER 1997

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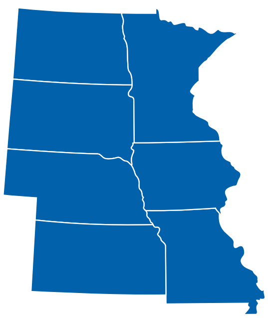

In Focus This Quarter

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

By Ronald Spieker, Steve Linehan, George French

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

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◆ ***Regional Banking***—**Strong banking conditions continue…however, some weaknesses are noted in South Dakota and North Dakota…strong loan growth for community banks is concentrated in real estate…institutions in some rural counties may be more susceptible to economic downturns.** *See page 23.*

By John M. Anderlik, Craig A. Rice

DIVISION OF
INSURANCE

CRAIG A. RICE,
REGIONAL MANAGER

JEFFREY W. WALSER,
REGIONAL ECONOMIST

JOHN M. ANDERLIK,
FINANCIAL ANALYST

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Bank Earnings: Competitive Pressures and Cyclical Risks

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

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

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

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

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

Credit Quality

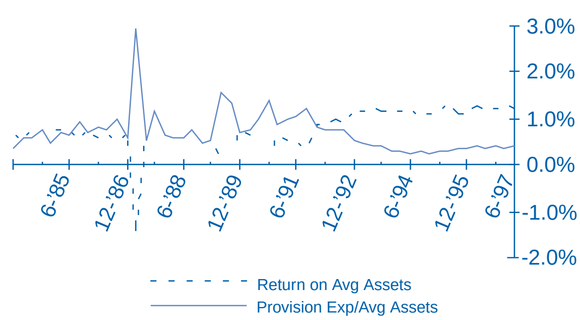
Variations in credit quality have been and are likely to remain for some time the primary source of large swings in bank earnings (see Chart 1). Banks manage the risks of large swings in credit quality by adjusting underwriting standards and loan terms, by diversifying loan portfolio exposures, and by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

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

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

CHART 1

Earnings Results Are Largely Driven by Provision Expenses



Source: Commercial Bank Call Reports

CHART 2

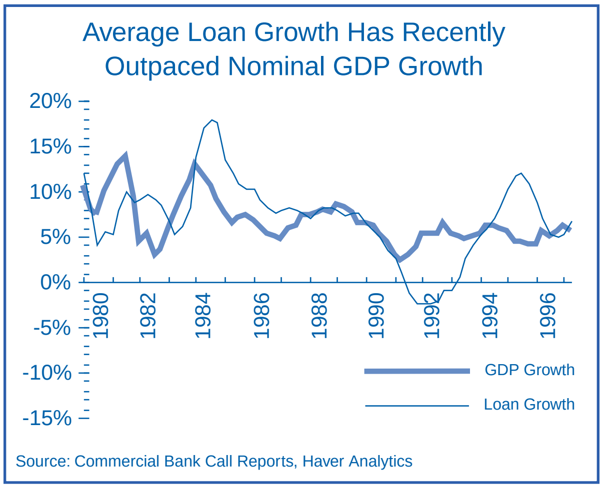
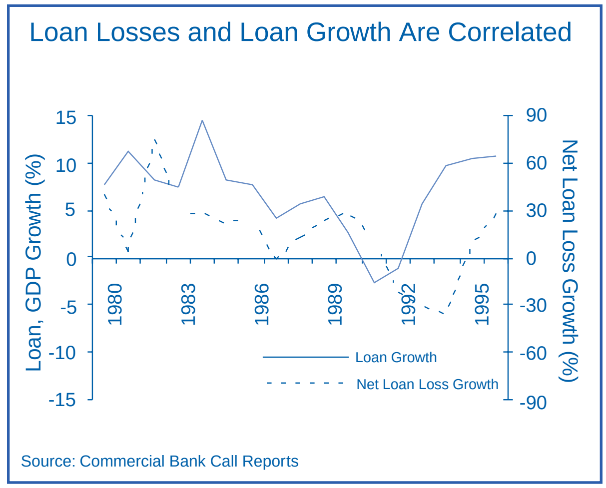


CHART 3



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

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

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

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

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

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

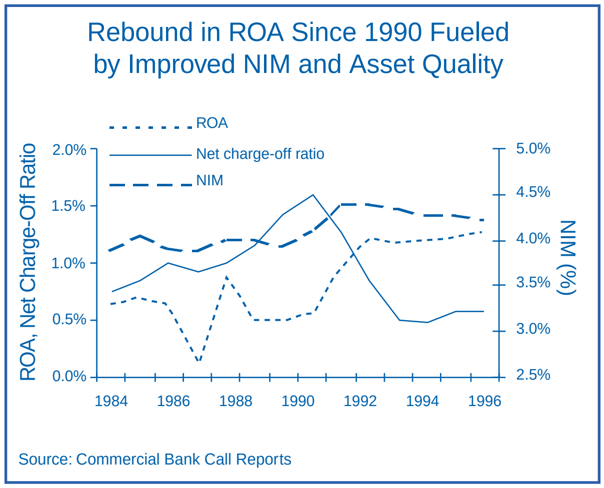
consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to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

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

Net Interest Margin

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

Chart 4



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

Table 1

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

Source: Bank & Thrift Call Reports

TABLE 2

1997 COMMERCIAL BANK PERFORMANCE COMPARED WITH HISTORICAL AVERAGES			
	6/30/97	INDUSTRY AVERAGES 1984-1996	
	ANNUALIZED (%)	LOW (%)	HIGH (%)
NET INTEREST INCOME/AVERAGE EARNING ASSETS	4.23	3.89	4.36
X AVERAGE EARNING ASSETS/AVERAGE ASSETS	86.50	86.21	88.42
= NET INTEREST INCOME/AVERAGE ASSETS	3.66	3.36	3.89
+ NONINTEREST INCOME/AVERAGE ASSETS	2.13	1.10	2.13
– NONINTEREST EXPENSE/AVERAGE ASSETS	3.50	3.05	3.90
– PROVISION EXPENSE/AVERAGE ASSETS	0.40	0.28	1.28
+ OTHER ITEMS/AVERAGE ASSETS	0.03	–0.02	0.15
– TAXES/AVERAGE ASSETS	0.68	0.18	0.64
= NET INCOME/AVERAGE ASSETS (ROA)	1.25	0.10	1.20

SOURCE: BANK & THRIFT CALL REPORTS

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

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

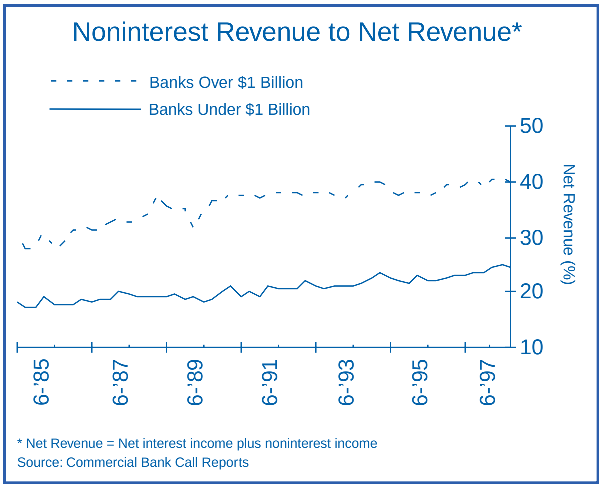
On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads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

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

Growth in Noninterest Income

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

CHART 5



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

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

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

The Effect of Expense Control on Earnings Performance

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

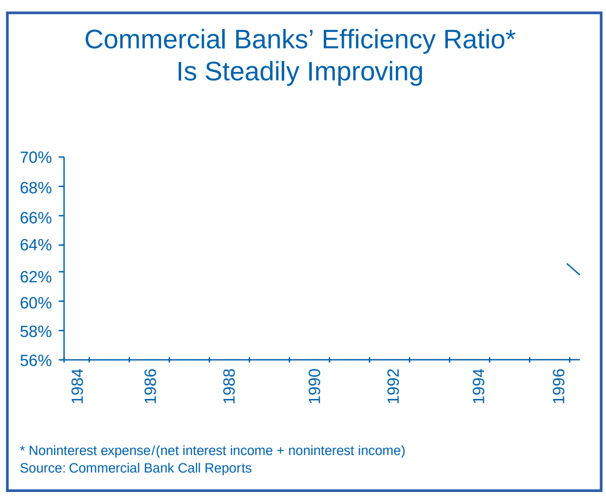
[2] The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

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

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

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

CHART 6



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

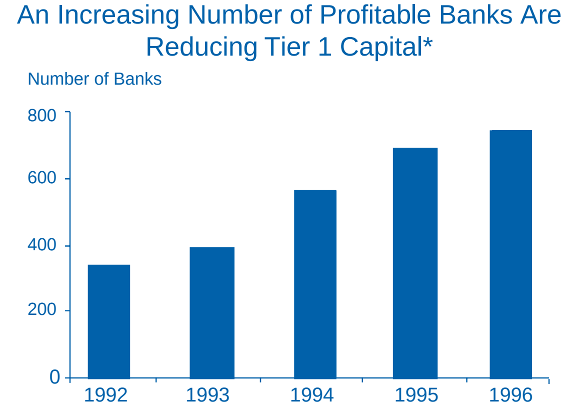
The Role of Capital in the Management of Earnings

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

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

While the book value of equity and other capital ratios has increased at the aggregate industry level, a number of banks are reporting declines in equity capital and leverage capital ratios despite positive earnings (see Chart 7). For all institutions, the ability to actively man-

CHART 7



* Both Tier 1 dollar amount and ratio
Source: Commercial Bank Call Reports

age capital accounts going forward will depend largely on having earnings available above the levels needed to fund dividends and growth, after assuming capital protection adequate for the level of business risk. Bankers and examiners will need to carefully review strategies that increase bank leverage or increase business risk without considering the potential effects of a downturn in credit quality or other weakening in the economy.

Summary

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

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

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

[3] Salomon Brothers.

Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets

- **Commercial banks are leading a resurgence in commercial real estate financing; many metropolitan markets are experiencing rapidly rising rents and single-digit vacancy rates, suggesting the likelihood of further development.**

- **New funds directed toward commercial real estate are being increasingly supported by commercial mortgage-backed securities and real estate investment trusts.**

- **Some analysts have expressed concern that these financing vehicles may serve to heighten competitive pressures that will lead to more aggressive loan pricing.**

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

Commercial Banks Show Renewed Interest in Commercial Real Estate

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

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

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

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

Table 1

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

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

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

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

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

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

Borrowers' Financing Options Expanding

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

CHART 1

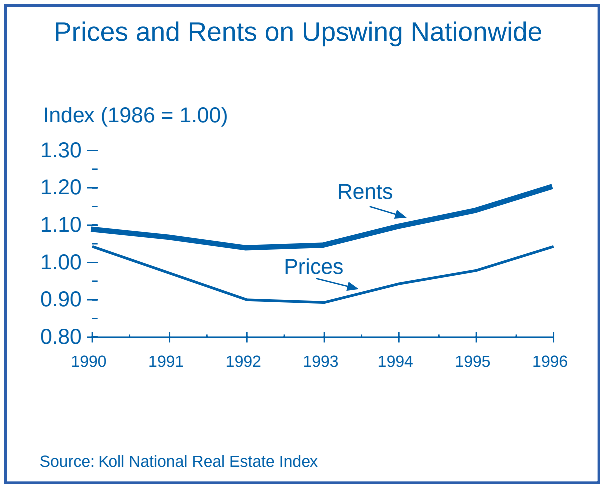


CHART 2

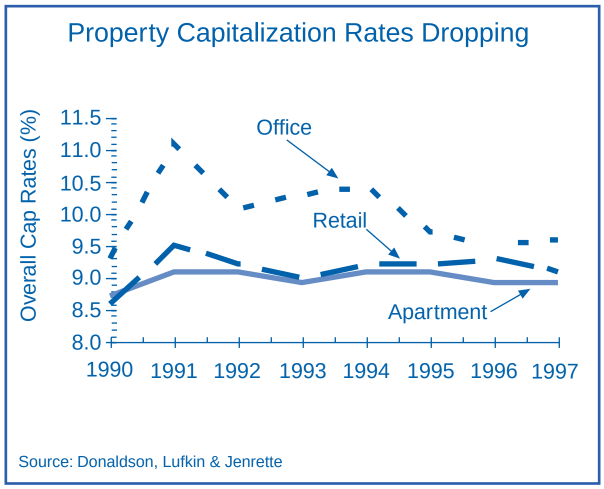
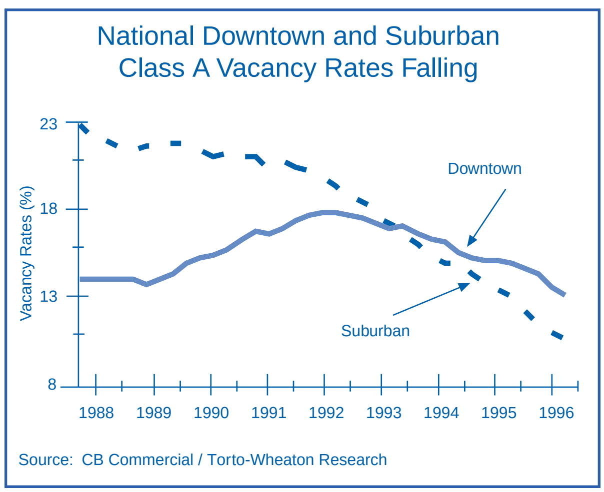


CHART 3



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

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

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

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

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

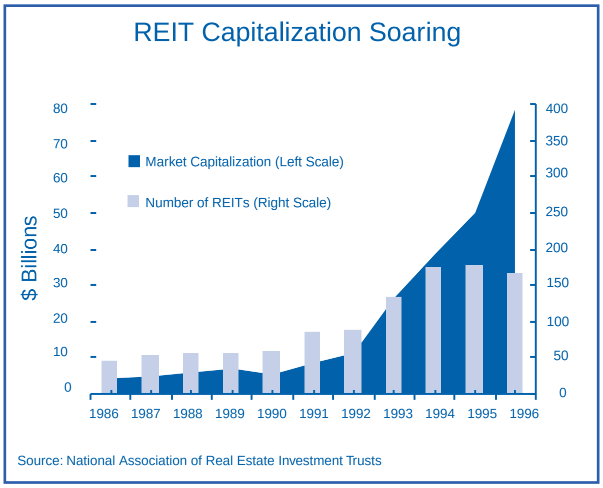
REITs: An Alternative to Traditional Capital Sources

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

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

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

CHART 4



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

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

Commercial Real Estate Securitization: Some Broader Implications

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

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

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estatebased instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose how best to compete against—or participate in—these new real estate financing strategies.

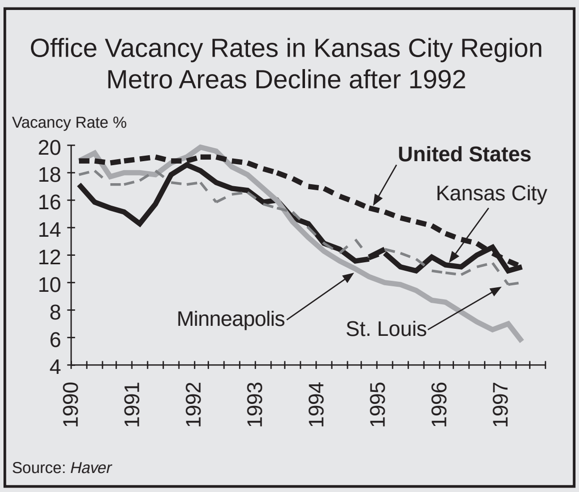
Steven Burton, Senior Banking Analyst
sburton@fdic.gov
Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

Demand for Commercial Real Estate Remains Strong in Region's Largest Metropolitan Areas

Office vacancy rates have been declining steadily since 1992 in Minneapolis, St. Louis, and Kansas City, the largest metropolitan areas in the region. As seen in Chart 5, office vacancy in all three markets has been below the national average since that time.

In **Minneapolis**, office vacancy rates declined to 5.7 percent in the second quarter of 1997, the lowest level recorded in 14 years. The low vacancy rates have led to rising rents and intense competition among prospective tenants. In Minneapolis, rental rates for Class A offices have been rising consistently in both the downtown and suburban parts of the market. Strong employment growth and continued interest in downtown locations have contributed to strong demand in the Minneapolis–St. Paul metropolitan area. According to data provided by ***FW Dodge***, more than 5.6 million square feet of office space has been absorbed in the two cities since 1993, with negligible new construction during the same period. Responding to the present situation, plans for more than 8 million square feet of new office space have been announced for completion over the next five years. Vacancy rates in the industrial market have increased to 8 percent in the second quarter of 1997, up from 6 percent in 1995, following construction of 8.3 million square feet in the last half of 1996. Demand for retail space remains strong, as almost all of the 2.1 million square feet built in 1996 has been rented.

CHART 5



Office vacancy rates in **St. Louis** have declined to 10 percent in 1997, down from nearly 20 percent in 1990. Growing demand and insignificant added space over the period have worked to tighten the market. Demand in the suburban market has strengthened consistently, and the downtown market has revived in 1997, after some weakness in 1996. The industrial vacancy rate has declined to 2 percent in the second quarter of 1997, as new demand outstripped the 2.3 million square feet built in 1996. In the retail market, continued construction of "big-box" retail stores continues to augment supply in both city and suburban markets.

Office vacancy rates in **Kansas City** reached 11.2 percent in the second quarter of 1997, somewhat above those in Minneapolis–St. Paul and St. Louis, but still tight enough to drive rent increases. One industry observer noted that single-year increases in office rents in 1997 were the highest in his experience. A number of new construction projects scheduled for 1998 and 1999 will add more capacity to the stretched market. Industrial vacancy rates reached 8 percent in the second quarter of 1997, with a number of large warehouses in the planning stages.

Jeffrey W. Walser, Regional Economist

Kansas City Region: Rural Counties Pursue Widely Divergent Growth Paths

- **The economic performance of the Region's rural counties has improved substantially from the 1980s, but wide inequality in the counties' growth persists in the 1990s.**

- **Branson, Missouri, enjoyed a significant tourist-driven boom but it shows signs of slowing.**

- **The increasing average age of farmers may pose new challenges to agricultural banks.**

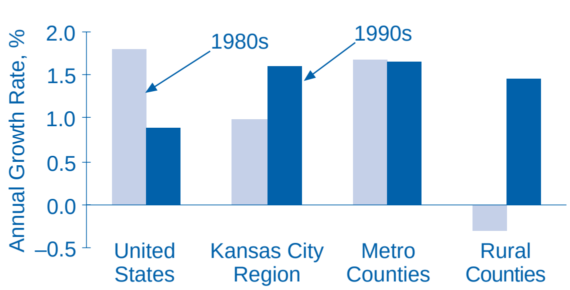
Growth Record of Rural Counties: A Mixed Bag in the 1990s

Employment growth in the Kansas City Region lagged that of the United States in the 1980s but has been stronger in the 1990s. Chart 1 compares growth during the period 1980 to 1994 for the United States, the Region, and rural and urban counties of the Region. As the graph suggests, employment growth in the 72 metropolitan counties was essentially the same in both decades: an annual average of 1.68 percent in the 1980s and 1.66 percent in the 1990s. The Region's improved record in employment growth can be attributed to the turnaround in growth in the 546 rural counties, from –0.30 percent in the 1980s to 1.45 percent in the 1990s. These rural counties accounted for 41 percent of the Region's population of 18.2 million in 1994.

During the 1980s, many rural counties were hurt by structural changes in agriculture and rural retail trade, resulting in declining employment and population throughout the decade. The 1980s were a period of continuing consolidation in agriculture, as advances in technology allowed farmers to farm more land at less cost. Between the 1982 and 1992 ***Censuses of Agriculture***, the number of farms in the seven states of the Region declined by 76,000, or more than 14 percent of the total. Improved agricultural technology, and the fewer, larger farms that followed, reduced employment both on the farm and in the industries that support agriculture, such as machinery dealerships, feed mills, and lumberyards. Importantly, larger farms tend to rely less on the local economy for financing and other inputs.

CHART 1

Rural Counties Do Their Share for Employment Growth in the 1990s



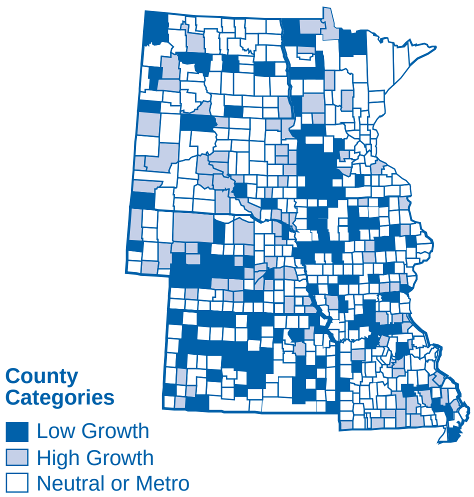
Source: Bureau of Labor Statistics

The 1980s also saw substantial consolidation in the rural retail sector, at the expense of merchants in smaller communities. Large national retailers built a number of stores in rural areas, using superior management and distribution to underprice their Main Street competitors. In a study of **Iowa**'s rural counties from 1983 to 1993, ***Dr. Kenneth Stone*** of Iowa State University found the introduction of national discount retail stores into 34 of Iowa's larger rural towns caused a decline of 46 percent in retail sales in nearby towns with populations of less than 1,000. The consolidation of rural retail trade often led shoppers to cross county lines, to the detriment of their home counties.

While structural transformation was widespread across the Region, not all areas were affected equally. A closer examination confirms that the performance of the rural counties was far from uniform. The 546 rural counties were ranked by average annual employment and per capita income growth during the 1980 to 1994 period. The 103 counties that were above average in both employment and income growth were classified as high-growth counties, while those that were below average in both statistics were classified as low-growth counties. The remainder of the counties, those with above-average performance in one category but not the other, were defined as neutral counties. Chart 2 shows

CHART 2

ECONOMIC GROWTH VARIES WIDELY ACROSS REGION'S COUNTIES



the distribution of high-growth and low-growth rural counties in the Region.

Table 1 displays annual rates of growth in employment and per capita income for the categories of counties and in the two decades under consideration. The table shows the marked divergence between the 103 high-growth counties and 164 low-growth counties in the 1980s. Both employment and population were declining strongly enough in the low-growth counties to result in declines for the total of rural counties. As suggested in the opening paragraph, rural counties have improved considerably in employment and population growth in the 1990s, but it is important to recognize the considerable variation in economic performance across the rural counties. Per capita incomes in the low-growth counties have grown at about the same rate in both decades, and more slowly than in the high-growth and metropolitan counties.

TABLE 1

LOW-GROWTH COUNTIES IMPROVE IN THE 1990S BUT CONTINUE TO LAG

GROWTH RATE	1980S	1990S	1980–1994
EMPLOYMENT:			
METRO	1.68%	1.66%	1.67%
RURAL	–0.03%	1.54%	0.41%
HIGH GROWTH	1.15%	2.55%	1.55%
LOW GROWTH	–1.13%	0.77%	–0.59%
PER CAPITA INCOME:			
METRO	1.47%	1.25%	1.41%
RURAL	1.97%	1.19%	1.74%
HIGH GROWTH	3.07%	1.64%	2.66%
LOW GROWTH	1.06%	1.08%	1.07%

SOURCE: BUREAU OF LABOR STATISTICS, BUREAU OF ECONOMIC ANALYSIS

A 1996 study by the ***Federal Reserve Bank of Kansas City***[1] included a similar analysis of the counties of the Region's seven states, plus those of Montana, Wyoming, Colorado, Oklahoma, and New Mexico. This investigation found that low-growth counties were twice as likely to have farming as their principal industry as the high-growth counties and 75 percent more likely to have retail trade as their principal industry.

Our study of just the Kansas City Region's seven states does not find such clear-cut differences in the industrial structures of the high-growth and low-growth counties. Approximately half of both sets of counties have farming as their most important industry, and the prevalence of retail trade is nearly equal in both sets. This difference in results likely occurs because of important differences in the populations examined by the Federal Reserve study and the present analysis. The rural counties of the Kansas City Region significantly underperformed those of Montana, Wyoming, Colorado, Oklahoma, and New Mexico, the additional five states in the Federal Reserve study. Average annual employment growth in the Region's rural counties was 0.41 percent during the 1990 to 1994 period, while it was 1.85 percent in the other five states.

The rural counties studied in the Kansas City Region were less varied in performance and industrial structure than the larger set of counties studied in the 12 states, so broad measures of industry concentration were less likely to show clear-cut patterns. The Federal Reserve study tends to support the suggestion that consolidation in farming and rural retail trade contributed to poor performance by some rural counties. The present study suggests that while such an association may be true on average, performance varies significantly within the set of farm-based and retail-trade-based counties. Further research is needed for a more complete explanation of the variation in rural counties' performance. Measures of the degree and speed of consolidation in the farming and retail industries would likely lead to a more com-

[1] M. Drabenstott and T. Smith. "The Changing Economy of the Rural Heartland." *Economic Forces Shaping the Rural Heartland*. Federal Reserve Bank of Kansas City, April 1996: 1–11.

plete understanding of the rural counties' economic growth.

In ***Regional Banking Conditions*** (see page 23), the performances of banks in the high-growth and low-growth counties, as defined above, are compared. The analysis shows that institutions headquartered in low-growth counties were less likely to grow between 1984 and 1996. Additionally, institutions in the low-growth counties experienced lower earnings during the difficult 1980s but converged with institutions in the high-growth counties in the 1990s.

Branson: Small Town, Big Growth

When rapid growth in a small rural town is supported by a single industry, that area may be quite vulnerable to changes in that industry. With such vulnerability, are there implications for the local economy and banking in the local economy? A look at **Branson, Missouri**, may provide answers.

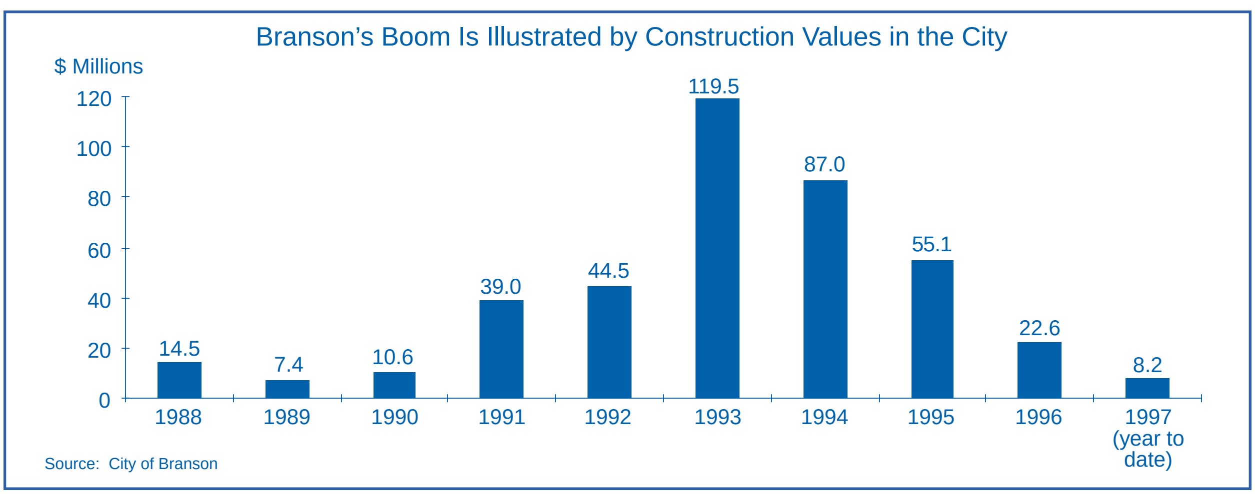
Before Branson was mentioned on national television in 1991 as the "country music capital of the universe," the town was characterized as a rather sleepy community of about 3,700 residents in the Ozark Mountain region of southern Missouri. It was known regionally for the recreational offerings of Silver Dollar City, a history-themed entertainment park, and Table Rock Lake, which attracted 3 million visitors in 1986.

With the influx of country music stars who built their own theaters, Branson boomed as few places have boomed before. It is now the most popular destination for motor coach tours in America and the second most popular holiday destination for motorists. While annual visitor counts are no longer provided by the ***Branson Convention and Visitor's Bureau***, the last publication shows more than 6.5 million visitors for 1995. According to figures published in the ***Springfield Business Journal***, the city now has 38 theaters with more than 51,000 seats, 199 lodging facilities with more than 17,000 rooms, and 163 sit-down restaurants with some 25,000 seats. Annual visitor projections once ran as high as 10 million visitors by 2000.

However, there are signs that Branson's boom has lost most of its momentum. Annual visitor counts have hovered in the range of 5.5 million to 6.5 million for four years, making the attainment of the projected 10 million visitors improbable. The city has recorded no major construction projects in two years. As Chart 3 shows, the value of new construction has steadily declined from a high of $119.5 million in 1993 to only $8.2 million through midyear 1997. The employment growth rate, which increased greatly during the years of highest construction activity to just over 26 percent in 1993, is sharply down since then, with a rate of just over 1 percent in 1996. In addition, in July 1997, a major commercial bankruptcy filing was made by the owners of Branson's Yellow Ribbon Theater.

Implications: Banks in high-growth areas face a unique dilemma. Boom years offer opportunities to grow balance sheets and shareholder wealth. But such rewards are not without commensurate risk. To take advantage of such opportunities, banks may increase staff levels and fixed overhead expenses and, most important, con-

CHART 3



centrate their loan portfolios in real estate construction and commercial loans to businesses driven by the boom. Such concentrations could possibly leave banks with high overhead costs and problematic loans should the boom suddenly quit. As in any high-growth area like Branson, the banks most at risk are those with little opportunity to diversify their portfolios during the boom years.

Aging of Farmers May Pose New Challenges to Agricultural Banks

The average age of farm operators in the United States has risen significantly since the World War II period. According to ***U.S. Census of Agriculture*** data as presented in Table 2, the average age of farm operators reached a record high of 53 years by 1992. In the 1992 census, 47 percent of all farm operators were more than 55 years old, compared with 42 percent reported in 1982. For farmers less than 35 years old, the proportions were 10 percent in 1992 and 16 percent in 1982.

During the 1950s and 1960s the average age of farmers increased sharply as the expanding economy drew larger proportions of farm children into urban employment. The level of new entrants into farming remained low during this period, until the average age reached a then high level of 51.7 years in 1974. In the 1970s the decline in farm numbers slowed as the number of new entrants increased for the first time since the postwar years. The increase in new entrants can be explained by a pair of "booms" in the 1970s. Baby boomers in the farm community came of age in the 1970s, resulting in a bulge in the number of people with the interest and inclination to pursue farming. At the same time, the 1970s were marked by a boom in the farm sector, driven by strong export demand and easily available credit.

The census data indicate, however, that the average age of farmers has increased sharply in the 1980s and 1990s as the number of new entrants has again fallen. For the same reasons as for its temporary decline in the 1970s, the average age of farmers will probably continue to increase in the future. The combination of off-farm migration and the declining size of farm families during the past several decades means the number of people raised on farms is shrinking rapidly. According to estimates by ***Fred Gale***, an economist at the U.S. Department of Agriculture, the pool of potential farm entrants continues to shrink, as shown in Table 3.

In addition to the demographic trend, farming has become a less attractive career for the prospective entrant since the booming 1970s. The increasing size of farms, which have grown from an average of 297 acres in 1960 to 469 acres in 1996, has led to increased capital requirements to enter farming. Young farmers typically have little equity and often have difficulty obtaining sufficient financing, because they have a short track record in farm management for prospective lenders to evaluate.

With fewer new farmers able to buy out those who retire, the practice of leasing land from absentee landlords has increased. According to a July 25, 1995, article in the ***American Banker***, the proportion of farmland held by absentees has been increasing over the past 15 years and is approaching half of all farmland.

Table 2

Average Age of Farmers Resumes Upward Trend

Year	Average Age	Number of Farms (in thousands)
1940	46.5	6,350
1959	50.5	4,105
1964	51.3	3,457
1974	51.7	2,795
1978	50.3	2,436
1982	50.0	2,407
1987	52.0	2,213
1992	53.0	2,108

Source: U.S. Census of Agriculture, various years

Table 3

Number of Potential Farm Entrants Is in Steep Decline

Year	20 to 29-Year-Olds Raised on Farms (in thousands)
1980	1,443
1985	917
1990	671
1995	454
2000 (projected)	375

Source: Fred Gale, U.S. Department of Agriculture, in "The New Generation of American Farmers," 1994

Implications: The increasing average age of farmers may affect agricultural banks in at least three ways:

- New entrants into farming are more likely to rent their farmland for longer periods. Tenant farmers who lack equity in the form of landholdings will tend to be a riskier class of borrowers. As tenant farming has become more prevalent, more complex rental agreements have begun to appear that are tailored to the risk profiles of the landlord and tenant. Agricultural lenders will have to gain experience in evaluating the risk of tenant enterprises.

- Agricultural banks may face a declining pool of loan candidates. The declining number of new entrants into farming implies that retiring farmers are more likely to sell their land to established farmers, speeding the consolidation of the industry. Larger-scale farms are more likely to look outside the local community for financing, decreasing both the size and the quality of the market in which community banks compete.

- The increasing age of farmers may also negatively affect agricultural banks' source of funding. As an increasing proportion of farmland is owned by retired farmers or their widows, who are likely to move away in retirement, community banks may lose important depositors. Similarly, when farmers die without passing on the land to their children, the land will likely be sold and the wealth distributed outside the community to the heirs.

Jeffrey W. Walser, Regional Economist
Marsha Martin, Regional Manager,
Division of Resolutions and Receiverships

Financial Markets

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

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

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

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

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

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

Trust Preferred Structure Provides a Tax-Advantaged Capital Funding Alternative

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

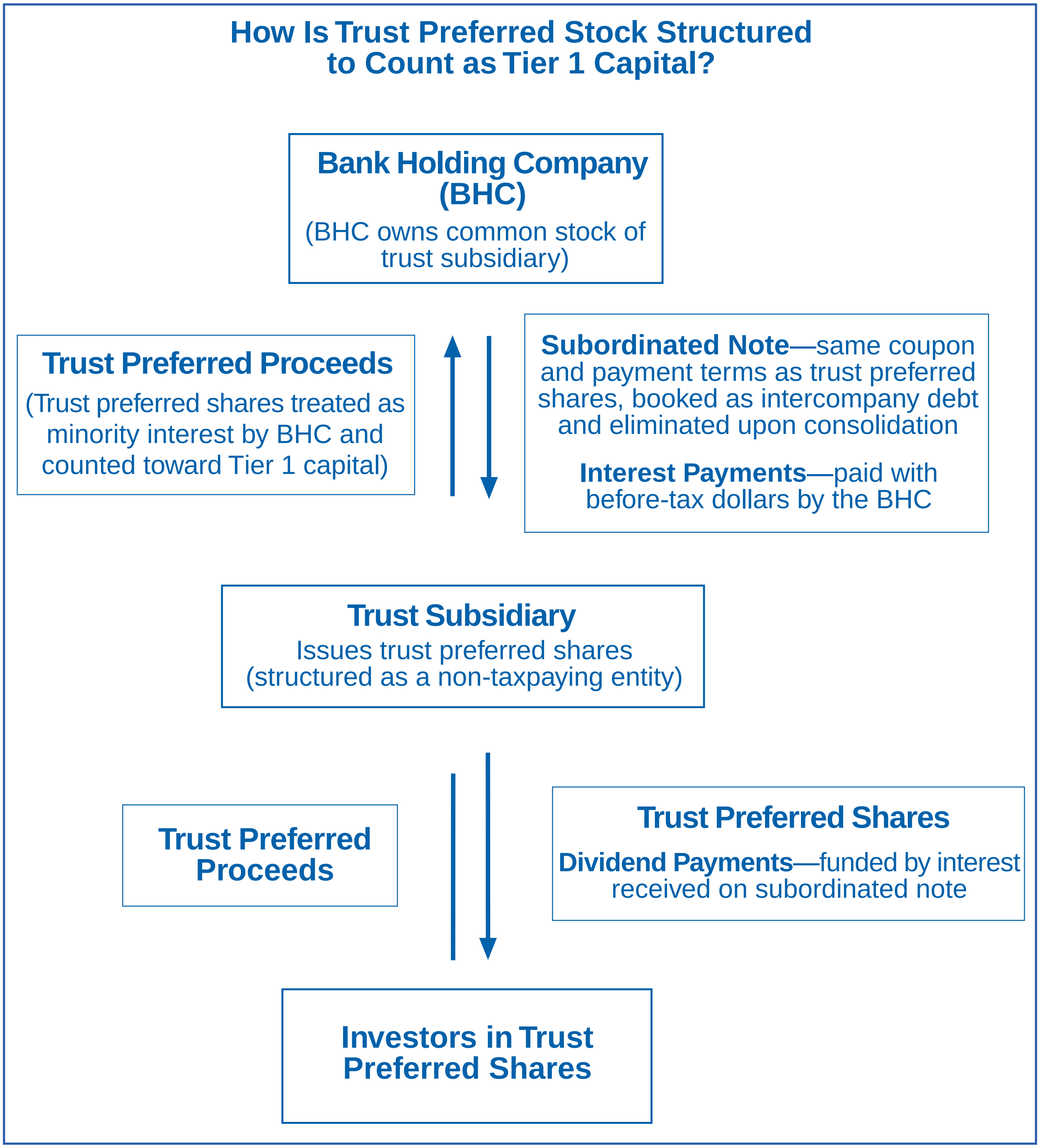
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary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

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

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

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

CHART 1


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

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

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

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

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

Bank Holding Companies of All Sizes Have Issued Trust Preferred Stock

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

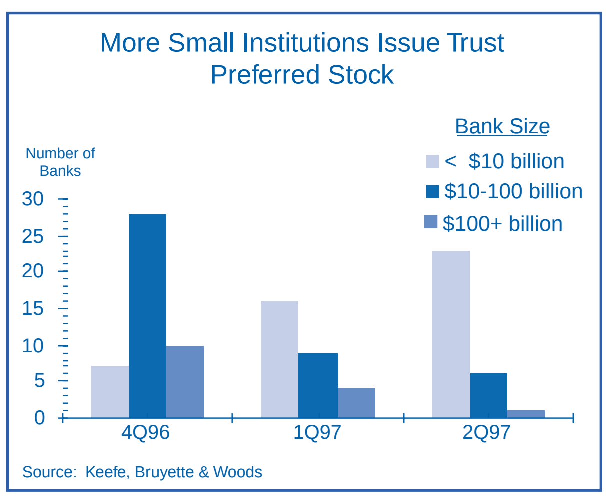
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated $4.3 billion in the first quarter of 1997 to just under $2.5 billion in the second quarter. Trust preferred issuance by larger banks declined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

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

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

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

CHART 2



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

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

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

Issues and Concerns

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

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

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

Kathy R. Kalser, Chief
Financial Sector Analysis Section

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

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

Regional Banking Conditions

- **The overall condition of the Region's commercial banks remains sound, with capital and earnings providing considerable financial strength.**
- **Asset quality remains solid, but some weaknesses are noted in North Dakota and South Dakota.**
- **Community banks continue to show strong loan growth concentrated in real estate and small business loans.**
- **A review of bank performance in rural counties suggests that institutions in certain counties are less likely to grow and that they may be more susceptible to economic downturns.**

The Region's Banks Remain Sound

On an aggregate basis, the Region's commercial banks continue to reflect sound financial conditions. As Chart 1 indicates, during the second quarter of 1997 the Region's banks:

- maintained their return-on-assets ratio at 1.4 percent, compared with the national average of 1.3 percent;
- widened their net interest margin to 4.8 percent, compared with the national average of 4.2 percent; and
- increased their leverage capital ratio to 8.8 percent, compared with the national average of 7.8 percent.

However, the Dakotas Are Showing Some Loan Problems

Region-wide asset quality remains favorable despite a slight upswing in loan delinquency over the past two years. Nonperforming assets remain moderate, at 0.7 percent of total assets, and delinquent loans represent a manageable 2.3 percent of total loans. However, not all institutions in the Region are enjoying such sound asset quality; in particular, community banks with less than $100 million in assets in North Dakota and South Dakota report levels of past-due loans much higher than the average for the Region.

North Dakota's community banks reported their third consecutive June-over-June increase in loan delinquencies, reaching levels not reported since June 30, 1991. Chart 2 shows the trend over the past seven years.

CHART 1

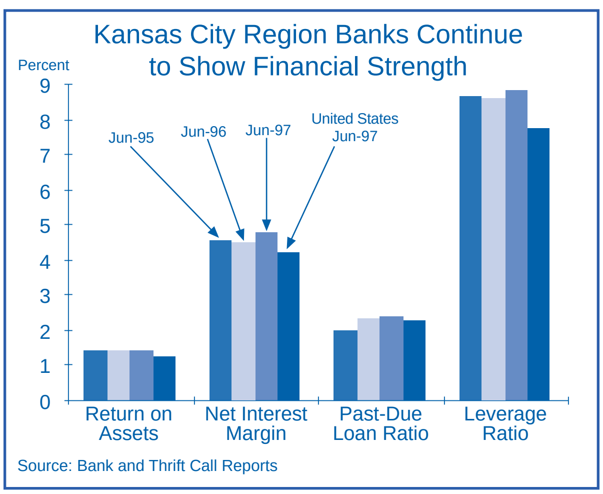
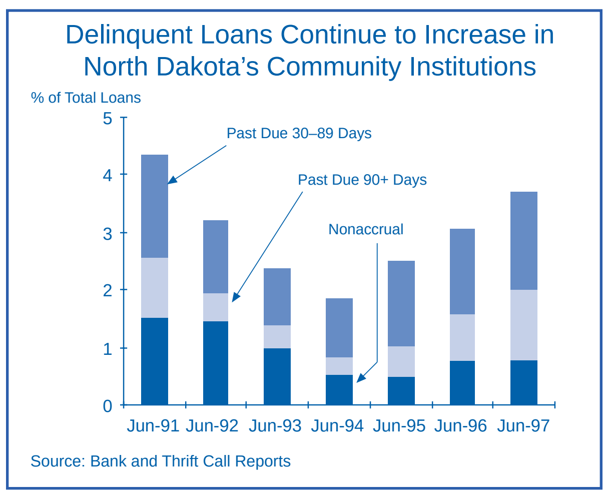


CHART 2



Several below-average years for farm producers most likely are the cause of this adverse trend. Farm loans exceed 25 percent of the total loan portfolios in 95 of the 101 community banks in the state.

The current ***FDIC Underwriting Survey*** noted a "moderate or sharp" increase in carryover debt in half of the North Dakota banks actively making agricultural loans examined by the FDIC in the second quarter of 1997. Surveys for the two quarters ending March 31, 1997, showed similar trends, with 42.9 percent of examiners noting the increase in carryover debt. Coupled with the most recent data from the ***U.S. Department of Agriculture,*** which shows that North Dakota farmers exceed the national average in their debt-to-equity ratios, such increases in carryover debt may further compound problems for highly leveraged farm borrowers.

This year does not appear to be any more favorable to North Dakota's farmers and, consequently, banks in the state. Farmers' fortunes depend heavily on income from wheat production, which represents approximately 44 percent of North Dakota's total agricultural cash receipts. This year the wheat crop yield was reduced by early dry conditions and later by disease and insects. Indications are that yields were down by nearly 17 percent from 1996. In addition, although cattle prices have improved significantly in 1997, poor pasture conditions and higher hay prices have limited ranchers' profitability.

Also of continuing concern are the effects of the flooding on businesses and residents in the Red River Valley, many of whom were devastated by the spring flooding. As noted in the third-quarter issue of the ***Regional Outlook***, most businesses and residents did not carry flood insurance. An analysis of quarterly banking data for banks and thrifts in the Red River Valley[1] as of June 30, 1997, did not yet indicate any higher loan delinquency resulting from flooding. However, increases in loan delinquency may lag because of payment deferrals and other cooperative arrangements between banks and affected borrowers.

In **South Dakota**, the 90 community banks reported past-due loans of 4.1 percent as of June 30, 1997, which compares unfavorably with the 3.6 percent shown a year earlier. Several poor years for cattlemen and the harsh winter of 1996/97 may be partly responsible for the high levels. However, average core capital of 12 percent mitigates most concerns about the condition of community banks in South Dakota. In addition, improved profitability for cattlemen in a state where livestock is the number one commodity should improve debt repayment capabilities for many bank loan customers.

Community Institutions Maintain Strong Loan Growth

Community institutions[2] continued to show strong loan growth in the 12 months ending June 30, 1997. Data indicate that such institutions posted annual loan growth of 13.1 percent, which exceeded asset growth for the third consecutive June-over-June period. Table 1 shows selected loan figures for the Region's community institutions. Following is a closer look at those figures:

- Real estate loans, which comprise almost half of total loans, led the growth and marked the third consecutive June-over-June period that such loans grew faster than loans in general. Single-family residence loans grew by the largest dollar amount, $1.7 billion, while real estate construction and land development loans continued to post large percentage gains.

- Agricultural loans (not secured by real estate), which at $10.1 billion represent more than one-fifth of total loans, grew at an 8.9 percent pace—slower than total loans, but a significant increase over the 1.7 percent and 1.8 percent growth rates posted in the 12 months ending June 30, 1995, and June 30, 1996, respectively.

[1] Delinquency rates were compared with those for the previous quarter and one year earlier for 53 banks and thrifts headquartered in counties bordering the Red River. The institutions were in Minnesota and North Dakota. Large institutions with branches outside the Red River Valley were excluded from the analysis.

[2] Community institutions are defined here as FDIC-insured banks and savings and loans that had less than $100 million in assets as of June 30, 1997. There are 2,039 such community institutions in the Kansas City Region.

Table 1

Community Institutions Show Strong Growth across Many Loan Categories	6/30/97 Level (millions)	Change from 6/30/96	Change from 6/30/93
Total Assets	77,968	8.3%	24.4%
Total Loans	46,821	13.1	46.0
RE Loans	23,338	15.2	56.4
RE Agriculture	5,131	10.6	44.3
RE Construction	1,168	20.3	154.9
RE Residential	11,990	16.3	54.1
RE Nonresidential	4,586	16.9	61.6
Agricultural Loans	10,114	8.9	28.1
Small-Bus. Loans	6,770	12.9	52.5
Under $100,000	4,920	10.8	33.7
$100,000–$250,000	823	17.7	115.7
$250,000–$1 Million	1,027	20.1	172.0
Consumer Loans	5,573	9.9	33.1
Credit Cards	281	–4.4	–3.9

Note: Does Not Include All Categories of Loans;
RE = Real Estate
Source: Bank and Thrift Call Reports

- Despite the advent of credit-scoring models at larger institutions that are expected to increase competition for small-business loans[3] (SBLs), community institutions continue to grow SBLs at a strong pace. SBLs under $100,000 grew at the slowest pace of the three SBL categories shown on Table 1, but the 10.8 percent pace was faster than it had been each of the three previous June-over-June periods. Larger SBLs continued their rapid growth and have more than doubled over the past four years.

- Community institutions appear to have responded to record consumer bankruptcy rates and high credit card delinquency by reducing their levels of credit card loans outstanding. Credit card loans shrank by 4.4 percent, following a 16.5 percent drop in the previous 12-month period.

Implications: Strong loan growth is likely the product of the strong expansionary economy in the Region. On the positive side, since loan interest income generally represents community institutions' largest revenue source, this growth has contributed to community institutions' strong earnings in recent years. On the negative side, rapid loan growth could lead to future problems if underwriting procedures were relaxed to attain such growth. However, current underwriting practices appear prudent; the second quarter 1997 ***FDIC Underwriting Survey*** from 167 Kansas City Region bank examinations found that 8.8 percent of state nonmember banks displayed tighter underwriting practices, while none had looser practices.

'Low-Growth County' Institutions Grow Slower and May Be More Susceptible to Economic Downturns

The article ***Growth Record of Rural Counties: A Mixed Bag in the 1990s*** has several implications for the Region's banks. It describes how rural counties have grown at widely different rates. This was particularly true in the 1980s, which were marked by farm and retail consolidation, as well as several devastating years for farmers. However, the article also shows that in the 1990s, rural counties of all types in the Region have shown a strong resurgence. An analysis of banking data[4] for financial institutions in the Region mirrors the article's findings. The data indicate that institutions in low-growth counties (LGC institutions) tend to grow slower than institutions in high-growth counties (HGC institutions) despite improvement in the overall economic climate. In addition, the data suggest that LGC institutions perform similarly to HGC institutions in strong economic periods but may be more susceptible to economic downturns. The key findings are discussed below.

LGC institutions are less likely to grow than HGC institutions in both strong and weak economic periods. Chart 3 (next page) illustrates that in every year between 1985 and 1995, LGC institutions were less likely to increase in asset size than their HGC counterparts. As a result of these yearly differences, LGC institutions grew their aggregate assets at an annual 1.5

[3] Small-business loans are defined here as loans categorized as commercial and industrial loans with original amounts of $1 million or less reported on the June Call Reports.

[4] To analyze banking trends in the Region's rural counties, we gathered banking information for all FDIC-insured financial institutions headquartered in those counties from 1984 through 1996. Institutions headquartered in low-growth counties were segregated from those located in high-growth counties. In addition, four very large savings and loans that were located in low-growth counties and failed or merged during the analysis period were excluded because of their overwhelming influence on the average results.

CHART 3

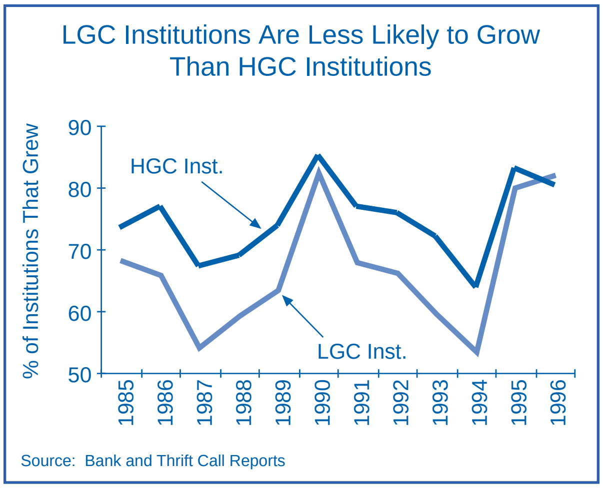
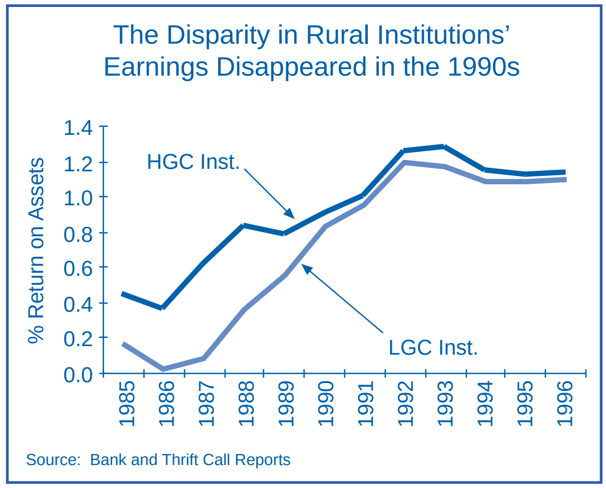


CHART 4



percent pace from 1984 through 1996, while HGC institutions grew by 2.5 percent.

LGC institutions and HGC institutions have performed very similarly since 1990 in terms of earnings, capital levels, and problem asset levels. As shown in Chart 4 (next page), both LGC and HGC institutions have posted strong earnings in the 1990s. In addition, both have similar and strong capital bases, as well as low levels of nonperforming assets. This convergence in banking performance despite a substantial difference in the counties' economic growth rates suggests that bankers in the low-growth counties have adapted to their environments.

While it is clear that LGC and HGC institutions perform similarly well in good times, LGC institutions may be more susceptible to economic downturns. *In fact, LGC institutions were more than twice as likely to fail during the last banking crisis as HGC institutions.* Since 1984, 5.9 percent of LGC institutions have failed, compared with only 2.6 percent of HGC institutions. In total, 56 LGC institutions and 12 HGC institutions have failed during that period. In addition to failures, LGC institutions performed more poorly as a group and were slower to recover. As shown in Chart 3, poor farming conditions caused rural banking income to be quite weak in the 1980s, and LGC institutions were more affected than HGC institutions. Rural counties bottomed out in 1986 at the height of the crisis, but LGC institutions barely broke even while HGC institutions posted a modest return on assets of 36 basis points. HGC institutions then improved their earnings faster than LGC institutions. By 1990, the crisis had ended and the differences were minimal.

The point here is not to be ominous, since rural institutions as a whole have performed quite well in the 1990s, whether their counties were low growth or high growth. However, because LGC institutions may be more vulnerable to the onset of adverse economic factors, bankers in low-growth counties should be especially prepared for the next, inevitable downturn.

John M. Anderlik, Financial Analyst
Craig Rice, Regional Manager

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