Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FIRST QUARTER 1997

In Focus This Quarter

FDIC NEW YORK REGION

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

■ ***Section 936 Repealed* - The tax reform provisions contained in the "minimum wage" bill (H.R. 3448) repealed Section 936 of the Internal Revenue Code. Section 936 provided significant tax incentives to U.S. businesses operating in Puerto Rico.** *See page 6.*

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

DIVISION OF INSURANCE

SUZANNAH L. SUSSER, SENIOR REGIONAL ANALYST

NORMAN GERTNER, REGIONAL ECONOMIST

Regular Features

Dear Reader,

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

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

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

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

Sincerely,

Arthur J. Murton
Director

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Visit the Division of Insurance online at http://fdic01/division/doi/. For more information on this publication, please call Suzannah Susser at (212) 704-1482 or email her at Suzannah L. Susser@DOI@New York.

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

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the New York Region.**
- **The New York Region's per capita bankruptcy rates are favorable compared to the national average. Maryland, with the highest rate in the Region, is ranked a relatively low twenty-first in the country.**
- **Credit card charge-offs are approaching recession levels.**

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

What Is Occurring in the New York Region?

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

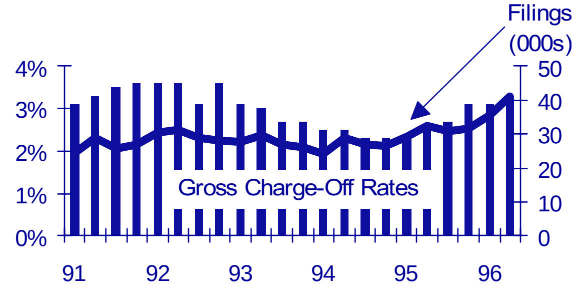
Table 1 (next page) shows that personal bankruptcy rates are rising throughout the Region. Current levels are fairly moderate compared to other states in the country. Maryland has the twenty-first highest per capita filing rate in the nation. Other states in the Region and Puerto Rico all have per capita filings below the national average. Nevertheless, there has recently been rapid growth in filings. Second quarter bankruptcy rates in the Region grew an average 24 percent from year-end 1995 levels. Pennsylvania reported the highest percentage growth rate but still has one of the lowest bankruptcy rates in the Region.

Why Are Consumer Credit Losses Rising in an Expanding Economy?

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

CHART 1

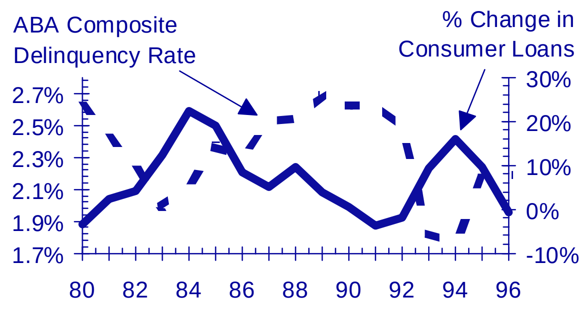
Personal Bankruptcies Correlate with Consumer Loan Charge-Offs in the Region



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

CHART 2

U.S. Consumer Delinquency Rate Tends to Rise After Credit Growth Accelerates



Sources: American Bankers Association and Federal Reserve Flow of Funds

PROTOTYPE

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

Why Are Bankruptcy Rates Rising?

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

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

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

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. For example, divorce is often a financial calamity leading people to bankruptcy court and is associated with high personal filing rates throughout the country. Other catastrophic events, such as automobile accidents and medical emergencies, affect people in different states differently (in financial terms) because of varying state laws. The report identifies other factors driving up bankruptcy rates such as:

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

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

The New York Region measures up fairly well based on this study. The Region has a lower than average divorce rate, and a lower percent of the population lacks health insurance. All of the states in the Region require no-fault automobile insurance. The study concludes that if these types of conditions are generally favorable, consumer debt levels will play a more significant role in per capita bankruptcy rates. Maryland, for example, is average in the catastrophic events categories but has a lower than average ratio of disposable income as a percentage of debt. This weakness affects Maryland's bankruptcy rate, but it does not affect it as strongly as the other factors. In Pennsylvania, unemployment is above the national average, but the catastrophic events measures are all very strong. Pennsylvania has one of the lowest bankruptcy rates in the country.

Puerto Rico's personal bankruptcy filings are at record highs, surpassing the previous record set in 1991. Puerto Rico may be an exception to the SMR study.

Table 1

Bankruptcy Rates Per Thousand Persons

	1991	1992	1993	1994	1995	3rd Qtr 1996 Annual.	3rd Q 96 State Ranking
Delaware	1.66	1.97	1.90	1.56	1.95	2.41	46
Washington, DC	2.00	2.24	2.02	2.24	2.53	3.15	32
Maryland	2.65	3.09	2.87	2.82	3.26	4.08	21
New Jersey	2.71	3.05	2.85	2.83	3.35	4.05	23
New York	2.28	2.62	2.53	2.41	2.64	3.18	30
Pennsylvania	1.72	1.87	1.59	1.53	1.88	2.49	44
Puerto Rico	2.39	1.96	1.79	NA	1.99	2.59	43
United States	3.46	3.52	3.15	3.00	3.33	4.15	NA

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

Bankruptcies are attributed to high debt to income ratios (exceeding 40 percent); ease of access to credit cards and loans, which has increased consumer debt; and poor personal financial management. Also, Puerto Rico's economy has been sluggish, and the unemployment rate is approximately 14 percent.

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

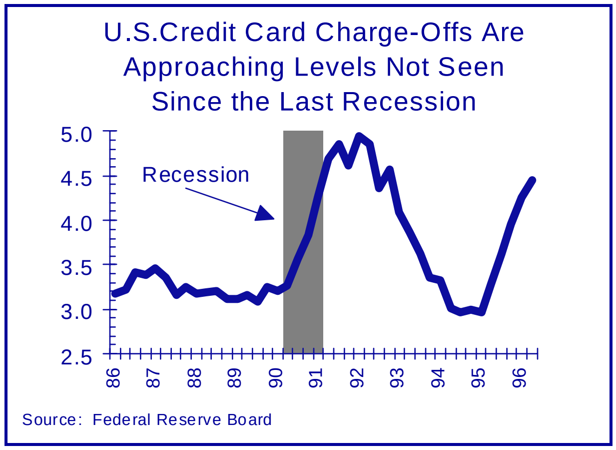
Implications for Insured Institutions

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

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

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in

Chart 3



both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions. Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst
Suzannah L. Susser, Senior Regional Analyst

Section 936 Repealed

- **A provision of the tax code which provided significant tax incentives to U.S. businesses operating in Puerto Rico has been repealed.**

- **The repeal of Section 936 has both short- and long-term implications for insured banks in Puerto Rico.**

- **Section 936 also played a much larger role in the Puerto Rican economy.**

Tax reform provisions contained in the "minimum wage" bill (H.R. 3448) repealed Section 936 of the Internal Revenue Code. Section 936 provided significant tax incentives to U.S. businesses operating in Puerto Rico. These incentives essentially came in two forms: tax credits against earnings derived from a U.S. company's Puerto Rican operations (active income) and a tax-free investment vehicle for profits retained in Puerto Rico.

The repeal of Section 936 has both short- and long-term implications for insured banks in Puerto Rico. In the short-term, bank liquidity will be threatened to the extent U.S. companies reduce their Section 936 passive income investments, most of which are held with banks in the form of deposits or securities repurchase agreements. The profitability of some institutions also could suffer as banks replace Section 936 funding with higher cost alternative funding sources. Over the long-term, Puerto Rico's banks may be affected by any adverse economic effects from the repeal of Section 936. These effects could be particularly severe if the repeal prompts U.S. firms to reduce or eliminate their business operations in Puerto Rico.

The Demise of Section 936

In 1993, President Clinton began to phase out the incentives by limiting the tax credit to one of two alternatives: a 60 percent credit for wages and some fringe benefits paid to Puerto Rican employees (wage credits); or a percentage credit, subject to a phase-out schedule, against qualifying income (income credit). Section 936 continued to allow U.S. companies to invest profits generated by their Puerto Rican operations into certain qualified investments that earned interest free of any federal taxes (Qualified Possession Source Investment Income Provisions or QPSII).

On August 20, President Clinton repealed Section 936

Table 1

Selected Financial Information for Puerto Rico's Insured Commercial Banks

Institution Name	Sept 936 Dep/TA	9/30/96 Assets	T1 Lev Ratio	YTD 3Q ROA	YTD 3Q NIM
Oriental Bank & Trust	30.46	926,770	8.54	1.65	4.13
The Bank & Trust of Puerto Rico	27.72	341,026	5.49	0.37	1.96
Roig Commercial Bank	21.62	934,403	7.17	0.74	3.94
Scotiabank de Puerto Rico	28.46	856,143	13.66	1.30	5.54
Banco Central Hispano-Puerto Rico	27.95	1,626,346	15.62	0.57	3.01
Banco Santander Puerto Rico	22.07	4,179,900	9.72	1.04	4.01
Banco Bilbao Vizcaya Puerto Rico	23.50	1,236,129	6.11	0.69	4.23
Eurobank & Trust Company	18.11	202,074	7.02	0.41	3.34
PonceBank	14.75	1,141,036	7.51	0.98	4.98
Westernbank Puerto Rico	12.53	1,209,134	5.34	1.42	4.09
Banco Popular de Puerto Rico	16.66	13,618,000	6.43	1.18	4.49
FirstBank of Puerto Rico	11.65	2,760,285	6.49	1.36	5.84
R-G Premier Bank of Puerto Rico	17.08	804,758	8.25	0.57	3.78
Banco Financiero de Puerto Rico	0.00	69,433	8.41	1.51	7.27
Banco del Comercio de Puerto Rico	0.00	80,930	5.17	-0.36	4.98

Sources: Financial Institutions Commissioner's Office September Report and Bank Call Reports.

by signing H.R. 3448. Under the new law, no tax credits will be available to companies not already claiming the credits, retroactive to December 31, 1995. For businesses presently using the credits, the law phases out the income credit over ten years. The law retains the 60 percent wage credit until January 1, 2002, at which time the available credit percentage is reduced to 40 percent. The wage credit is completely eliminated after 2005. Finally, the law eliminates the tax exemption on QPSII interest income retroactive to July 1, 1996.

Because of their prior tax-free status, QPSII funds have historically provided Puerto Rico's banks with a significant source of relatively inexpensive funding. As of September 30, 1996, QPSII funds invested in insured commercial banks totaled $7.9 billion and represented approximately 27 percent of these banks' total funding. Another $3.8 billion in QPSII funds are held in brokerages, foreign banks, and nonbanks. The Puerto Rico Bankers' Association estimates that 69 percent of QPSII bank deposits carry maturities of six months or less. Given the elimination of the tax exemption, many fear that a massive repatriation of QPSII funds to the U.S. is inevitable. As shown in Table 1 (previous page), a number of Puerto Rican banks rely heavily on QPSII funding to support their operations. Accordingly, the threat of repatriation causes earnings concerns since some banks may be forced to pay substantially higher rates to replace any lost QPSII funding. Puerto Rico's Treasury Secretary Manuel Diaz Saldana estimates that without QPSII funding, banks would pay approximately $100 million in additional interest expenses annually, which translates into a drop in net interest margins of 30 to 40 basis points.[1]

Mitigating Factors in the Near Term

Short-term liquidity and earnings concerns are substantially mitigated by the following factors:

- *Repatriated funds are subject to a tollgate tax imposed by the Commonwealth of Puerto Rico.* The tax on repatriated QPSII funds is set at 10 percent. The rate is lowered to 5 percent for companies that invest at least half of their earnings in Puerto Rico for a five-year period. Approximately $3.5 billion out of a total $17 billion in QPSII funds held with banks, brokerages, and the government are subject to the lower tollgate tax rate.

- A number of Puerto Rico's banks with significant QPSII funding concentrations are owned by large foreign parents and therefore have *ready access to alternate funding sources*. Among the independent banks, most have sufficient profitability to absorb a moderate rise in funding costs (see Table 1 on previous page).

- Since the repeal of Section 936 was widely expected, *most institution managers have adopted contingency plans for the potential loss of Section 936 funding.*

- *Spreads earned on QPSII funding have been diminished in recent years* by Commonwealth rules regulating the investment of 936 funds. In 1993, institutions were required to retain a portion of their Section 936 funds in low-yielding investments of two government development banks. Rules adopted in the early 1990s also prohibited the investment of Section 936 funds in higher yielding auto loans.

Despite the significant disincentives presented by tollgate taxes, many industry officials estimate that as much as $10 billion or nearly 60 percent of QPSII funding will eventually leave Puerto Rico. The primary determinant of how much QPSII funding ultimately leaves the island will depend on alternative investment yields available to companies outside of Puerto Rico.

Longer-term Impact on the Island's Economy

Besides the benefits provided to banks by QPSII funding, *Section 936 plays a much broader role in Puerto Rico's economy*. Economists estimate that businesses using Section 936 tax credits provide two-thirds of the island's manufacturing jobs and one in ten of all island jobs. The manufacturing sector accounts for 39 percent of the island's gross product. This sector also supports the island's growing service sector (see Chart 1 on next page). For example, numerous hotel and condominium accommodations are rented to business executives who travel to the island in connection with 936 companies. Puerto Rico's Treasury Department reports that in 1995, 936 companies accounted for an estimated $869 million or 16 percent of General Fund Revenues. These

[1] On October 1, the Puerto Rican government implemented new rules that effectively cap the rate banks will pay on existing QPSII deposits. The new rules were in response to banks "bidding up" the price of 936 funding. While the higher bids for QPSII funds may have been a rational pricing response meant to compensate depositors for the loss of tax benefits, the aggressive bidding also may be indicative of the heavy reliance banks have placed on this funding source. Ironically, the government's new rules may make it more difficult for banks to retain these

amounts are exclusive of taxes paid by employees of 936 companies.

QPSII funds held with financial institutions and government development banks also play a significant role in financing mortgages and local construction projects. Many fear that the loss of cheaper QPSII funding will lead to higher mortgage interest rates as banks pass on their higher funding costs to consumers. Obviously, any significant rise in unemployment or deterioration in business conditions prompted by the repeal of Section 936 could pose a threat to the soundness of insured Puerto Rico institutions.

Mitigating Factors in the Longer Term

There are several arguments downplaying the significance of the repeal of Section 936 on Puerto Rico's economic fortunes. For example, following the percentage reduction of the Section 936 credit in 1993, Puerto Rico's economy continued to grow. Real gross product was 2.6 percent in fiscal year 1994 and 3.3 percent in fiscal year 1995, while the number of jobs rose 1.8 percent in 1994 and 2.1 percent in 1995. Moreover, the current wage credit will be retained through the year 2002, giving the local government ample time to implement incentives and/or tax credits to facilitate a favorable business climate and promote new business development. In this context, the new law might be viewed as simply continuing the gradual phase out of Section 936 tax benefits that began in 1993. Finally, there may be other advantages to doing business in Puerto Rico besides previously available tax incentives; namely, the availability of affordable skilled labor and the island's close proximity to Latin American markets.

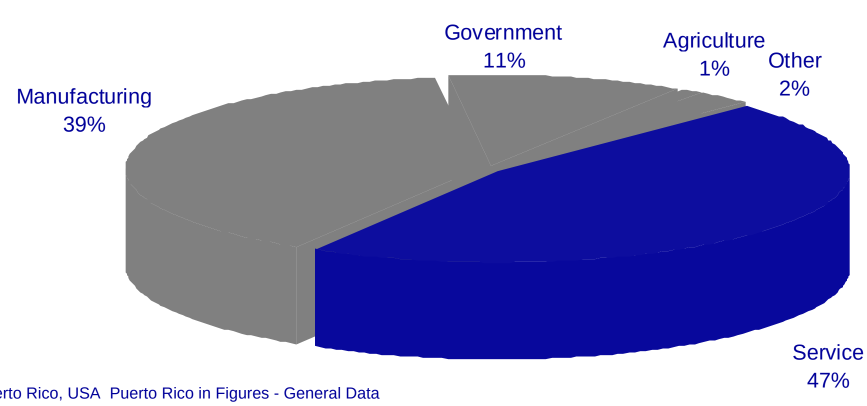
Implications for Insured Institutions

The threat of a near-term loss of inexpensive QPSII funding argues for close monitoring of liquidity conditions for insured Puerto Rican banks. Earnings levels also must be reviewed closely in the near term to gauge the impact of any replacement of repatriated funds. The near-term impact of the repeal on local interest rates, particularly consumer mortgage rates, also should be measured. In addition, the impact of actions taken by Puerto Rico to moderate the impact of the repeal should be assessed. The reaction of U.S. companies to actions also should be monitored.

Steven Burton, Senior Financial Analyst
Suzannah L. Susser, Senior Regional Analyst

CHART 1

The Manufacturing Sector Accounts for a Significant Segment of Puerto Rico's Gross Product and has Contributed to Growth in the Service Sector



Source: Puerto Rico, USA Puerto Rico in Figures - General Data

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Almost 400 banks and thrifts in the New York Region paid $753 million of this total.**

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

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

Why Was Action Needed?

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

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

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

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

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

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

What Significant Actions Were Taken?

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

Table 1

New York Region Institutions Affected by SAIF Special Assessment

Number of Institutions Affected and Total Assessment by Type	Mutual	Savings Banks	S&L	State Member	National	Non-Member	Total
Delaware	0	2	1	0	1	0	4
District of Columbia	0	1	0	0	2	0	3
Maryland	1	42	28	6	6	9	92
New Jersey	24	31	29	3	7	6	100
New York	6	24	32	5	5	9	81
Pennsylvania	41	28	46	2	15	11	143
Puerto Rico & VI	0	3	0	0	0	6	9
Total	72	131	136	16	36	0	391
Assessment ($000s)	108,165	294,562	171,295	25,671	100,619	53,043	753,355

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

deposits effective October 1, 1996. In determining the amount, the Board:

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

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

Early estimates are that there will be fewer than ten exempted institutions in the New York Region. This number of exempted institutions is small compared with the estimated 391 institutions in the Region that paid about $753 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

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

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

TABLE 2

SUMMARY OF 1997 ASSESSMENT RATES *

1997 ADJUSTED BIF & SAIF SCHEDULE			
CAPITAL GROUP	SUPERVISORY SUBGROUP A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
EXEMPT INSTITUTION SAIF SCHEDULE			
1	23	26	29
2	26	29	30
3	29	30	31
FICO ANNUAL RATES			
BIF INSTITUTIONS		SAIF INSTITUTIONS	
1.30		6.48	

* CENTS PER $100 OF DOMESTIC DEPOSITS

SOURCE: FDIC'S DIVISION OF INSURANCE

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

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

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

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. As a result, many such institutions will reflect much lower operating earning this year.

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

John D. Weier, Chicago Senior Regional Analyst

For More Information

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

Region's Economy Improves Modestly, But Still Lags the Nation

- **The Region's economy is expanding at a moderate pace but lags the nation in employment and personal income growth. A study links high business costs of large cities to stifled job growth.**
- **The stock market is soaring to record levels providing a boost to Wall Street employment.**
- **Real estate markets continue to rebound.**

In general, economic growth in the New York Region has not kept pace with the nation's rate of economic expansion. *Measures of employment and income indicate that the Region has not benefited from the economic recovery to the same degree as the rest of the nation.*

Regional Economy Lags Nation in Employment and Personal Income Growth

Table 1 compares employment growth in the states comprising the New York Region to the nation. The nation's economy has added over 2 million jobs during the past year and its employment base has grown by 2 percent. In contrast, none of the states in the Region (with the exception of Delaware) have kept pace.

Table 2 compares personal income growth for states in the Region to the nation over the past year. Personal income consists mainly of wages, salaries and interest income, but excludes capital gains. The table illustrates that, with the exception of Delaware, national growth in personal income exceeded growth in personal income in the states in the Region.

The main reason for this disparity has been slower employment growth in the Region. Over the years, the Region has lost a large number of manufacturing jobs to the South and overseas. While this trend has abated somewhat, much of the new economic growth taking place in the nation has been in the Southeast and Rocky Mountain states where land, labor, energy and taxes cost less.

While job growth has stabilized or improved somewhat, the Region has been hurt by waves of corporate downsizing over the past several years. This situation was particularly true in the securities, banking and retailing industries during the early stages of the last recession. Downsizing has since spread to local governments, the defense industry, and health care sectors.

Table 1

New York Region Lags the Nation in Job Growth (in Millions)

	1995	1996	% Chg
Delaware	3.67	3.75	2.2
Maryland	2.18	2.19	0.5
New Jersey	3.80	3.83	0.8
New York	7.96	8.04	1.0
Pennsylvania	5.25	5.27	0.4
Puerto Rico	0.92	0.93	1.1
U.S.	117.04	119.33	2.0

Source: Bureau of Labor Statistics. Data have been rounded. Employment statistics for 1995 and 1996 reflect percentage change on year-to-date averages through October.

Table 2

Most States in the New York Region Lag the Nation in Personal Income Growth (in Billions)

State	1995	1996	% Chg
Delaware	$18.5	$19.7	6.5
Maryland	131.7	136.6	3.7
New Jersey	235.0	245.3	4.4
New York	498.5	520.5	4.4
Pennsylvania	281.5	293.8	4.4
Puerto Rico	NA	NA	NA
U.S.	$6,023.6	$6,341.1	5.3

Source: National Income and Product Accounts. Data have been rounded. Personal Income statistics for 1995 and 1996 reflect percentage change on year-to-date averages through July.

Implications: *The Region continues to exhibit a slower growth pattern than the rest of the nation. Historically, it has proven more vulnerable to a national recession.* This condition was evident during the most recent economic downturn in the early 1990s, when large parts of the Region entered the recession sooner and recovered later. Certain states in the Region, particularly New York and New Jersey, were hit extremely hard by that recession, which was relatively mild nationwide. Another recession would seriously hinder loan demand, force bankruptcies and otherwise jeopardize the still tenuous economic gains the Region has made since the last recession.

Why Has the Mid-Atlantic Region Lagged the Nation?

A study conducted by ***Regional Financial Associates, Inc. (RFA)*** tried to answer that question by studying the relationship between business costs and job growth. Using a business cost index that incorporates labor and energy costs, local taxes, and office rents, *RFA showed that most low cost cities boom, while high cost cities either grow slowly or contract.*

The New York Region's economy is tied to a number of high cost cities. The economies of these cities, measured by job growth, have either shown anemic growth or, in some cases, actually contracted during the past five years (see Table 3).

State taxes vary widely and tend to correlate with job creation and destruction. Delaware, the only state in

TABLE 3

CITY	COST INDEX*	FIVE-YEAR JOB GROWTH (%)**
NEWARK, NJ	107	1
TRENTON, NJ	106	2
NEW YORK, NY	142	-1
LONG ISLAND, NY	117	2
PHILADELPHIA, PA	110	-6
PITTSBURGH, PA	103	4

* 100 = U.S. AVERAGE BUSINESS COST. THE INDEX INCORPORATES LABOR AND ENERGY COSTS, LOCAL TAXES AND OFFICE RENTS.

** FROM JULY 1991 TO JULY 1996. RESULTS NOT ANNUALIZED. SOURCE: REGIONAL FINANCIAL ASSOCIATES, INC.

TABLE 4

CORRELATION?
STATE AND LOCAL TAXES AND PERCENT CHANGE IN NUMBER OF JOBS (1990 TO 1996)

STATE	TAXES AS % OF INCOME	FIVE-YEAR JOB GROWTH (90-96)
DELAWARE	6.4	9.4
MARYLAND	11.5	1.0
NEW JERSEY	12.9	-1.1
NEW YORK	16.1	-4.0
PENNSYLVANIA	12.3	1.8
U.S. AVERAGE	11.5	9.3

SOURCE: REGIONAL FINANCIAL ASSOCIATES, INC.

the Region with taxes lower than the national average, is the only state which has shown any meaningful job growth (see Table 4). On the other hand, New York State, with the highest taxes in the Region, had a 4 percent loss of jobs over the past five years. Furthermore, some cities like New York and Philadelphia impose their own tax burden, over and above those levied by their states. *RFA surmises that the principal reason behind the correlation is that young startup companies cannot afford to operate in cities with high business costs.* With advances in information technology making physical location less important for many industries, the forces binding businesses to high-cost cities become even more tenuous.

RFA found that the usual state or city government tactics, such as granting businesses one-time tax breaks, do not improve an area's climate for nurturing young companies. In fact, granting one-time tax breaks encourages established companies to leave, or at least threaten to leave, in an attempt to obtain tax breaks, too.

Implications: With its heavy concentration of large high cost cities and without significant changes to tax structures, the RFA study suggests that the Region will struggle to remain competitive with lower cost cities located in other areas of the country.

Regional Industrial Sectors -- Dependency and Diversity

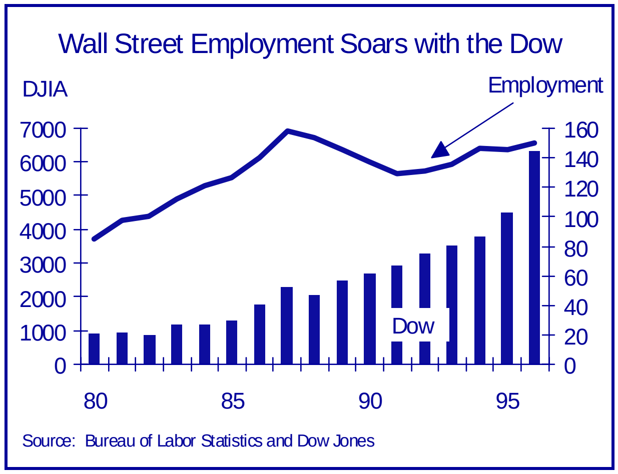
Selected industries that are important to the Region are displayed in Table 5 (next page), which depicts the share of labor income from an industry relative to the U.S. share. Industries such as finance, insurance, and real estate, as well as legal and educational services, are more influential to the Region than to the nation as a whole.

The Region's dependence on the security and commodity brokers sector is heavily skewed by New York's dependence on that sector, which is five times higher than the national average. Likewise, dependence on the legal services sector is skewed by Washington, D.C.'s reliance on that sector. Industries that are vital to Pennsylvania's economy, such as the primary metals, chemicals, and coal-related products sectors, are not reflected as important to the Region as a whole. A similar example is Delaware, where the share of labor income from the chemical industry is over nine times the national average.

Stock Market Activity Booms to Record Levels

The recent rally in the stock market has driven the Dow Industrials to over 6,800, with some predicting a Dow of 10,000 or even higher by the end of the decade. The equity markets have benefited over the past two years from a rare combination of strong company earnings, low interest rates, and little threat of inflationary pressures. Baby boomers, who see their retirement portfolios enhanced by exposure to the markets, have

Chart 1



been placing greater and greater shares of their personal wealth in the stock market, hoping that Wall Street will fund their children's college education and their own retirement needs.

The stock market's strong performance has generated significant employment opportunities for stock brokers, money managers and other financial specialists. With salaries and bonuses among the highest in the nation,

Table 5

Selected Industry Sectors That Dominate The New York Region Economy Relative to the U.S.
The New York Region is One and a Half Times More Dependent on the Financial Sector than the U.S. Economy

	Regional Share of Labor Income as a Ratio to the U.S. Share						
	Region	DC	DE	MD	NJ	NY	PA
Finance, Insurance and Real Estate	1.51	0.64	1.49	1.01	1.05	2.24	0.93
Dep. and Non-dep. Credit Institutions	1.31	0.81	3.19	1.00	0.84	1.78	0.92
Security and commodity brokers	2.79	0.60	0.64	0.77	1.08	5.55	0.49
Real estate	1.30	0.90	0.59	1.63	0.96	1.71	0.78
Services	1.12	1.45	0.81	1.16	1.08	1.15	1.05
Legal	1.48	4.68	0.99	1.08	0.90	1.79	1.01
Educational	1.57	3.10	0.68	1.16	0.81	1.64	2.01
Social services	1.42	1.38	1.11	1.15	0.77	1.83	1.34
Museums, botanical, zoological gardens	1.49	1.33	3.35	0.80	0.40	2.35	1.00
Other Industries							
Chemicals	1.38	0.05	9.22	0.56	3.01	0.68	1.40
Coal-Related Products	0.87	0.07	1.86	0.24	1.78	0.33	1.49
Primary Metals	0.96	0.01	0.58	0.68	0.53	0.35	2.76

Source: Bureau of Labor Statistics

Table 6

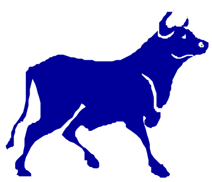
Commercial Vacancy Rates in the New York Region Have Improved Over the Decade							
Metro Areas	1990	1991	1992	1993	1994	1995	1996*
Baltimore	17.3	19.0	21.6	16.7	14.4	13.9	12.7
Long Island	22.2	18.8	16.3	14.3	13.6	13.8	13.0
New York City	15.4	16.6	16.4	15.2	16.1	14.9	14.2
Philadelphia	16.7	16.5	17.7	16.7	15.2	13.2	13.5
Washington, D.C.	16.8	15.0	13.5	11.4	10.4	9.6	9.0
Wilmington	27.3	24.4	22.5	19.3	17.8	12.8	14.5
31 Major US Markets	18.5	18.9	18.5	17.1	15.3	13.8	13.1

* Data for 1996 represent the first half of the year only.
Source: *FDIC Real Estate Report*, FDIC Division of Research and Statistics, October 1996.

Wall Street employees generate large multiplier effects in the Region. A strong Wall Street supports many peripheral industries such as accounting, computer programming, printing and restaurants.

Wall Street employment consists primarily of stock and commodity brokers in New York City. Chart 1 (previous page) tracks the relationship between the Dow Industrials and employment on Wall Street. The two are clearly associated. *Most recently, employment on Wall Street surpassed its previous record which was established just prior to the 1987 stock market crash.*

Implications: *Wall Street is a major engine of economic growth in the New York Region, particularly in New York City and its immediate surrounding areas.* While the Dow has continued to reach record levels almost every month, a significant correction would almost certainly negatively affect Wall Street employment and the peripheral industries it supports. A prolonged downturn in the markets could pose serious risks to the economic health of these areas. This sensitivity to the financial markets may be becoming more pronounced as manufacturing industries continue to relocate to lower cost areas.



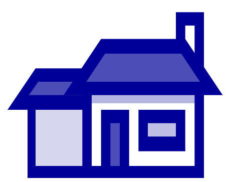
A major correction in the stock market would put severe stress on banks that engage in equity market-related activities. It also could be the harbinger of another wave of loan and credit card defaults reminiscent of the late 1980s, early 1990s.

Real Estate Markets Rebound

Commercial Real Estate: *The Region's commercial real estate markets, which were battered by a glut of speculative commercial real estate construction in the late 1980s, have made substantial progress in reducing excess space* (see Table 6). A scarcity of building in the early 1990s has reduced vacancies in the commercial markets.

Construction markets in New York City, Baltimore, and Philadelphia are experiencing new activity. New York's downtown and Times Square sections are being revitalized. Baltimore is benefiting from a new "enterprise zone." Philadelphia is capitalizing on a general improvement in its local economy. The I-78 corridor of New Jersey also is experiencing some building activity, but the rest of New Jersey is generally softer than the Region as a whole.

Residential Real Estate: *Demand for both existing single- and multi-family homes firmed in the third quarter of 1996.* For example, in New York State and New Jersey, existing home sales for single-family houses, condominiums and co-ops were up over 6 percent between the third quarter of 1995 and 1996. Sales were up about 1 percent in Maryland, but fell 2.6 percent in Pennsylvania over the same time frame. In general, demand continues to be strongest at the lower end of the market and should be strongly influenced by the future course of mortgage interest rates. In the new housing sector, the mid-Atlantic Region has had the slowest activity in the nation for many years.



The Region also lags in price increases of existing homes. During the twelve months ended June 30, 1996, prices on existing homes in New York, New Jersey, and Pennsylvania rose by 2.9 percent, the weakest price appreciation in the U.S. Nationally, prices rose an average of 4.7 percent.

Implications: *The current economic environment, which is characterized by low inflation rates and relatively stable interest rates, is favorable to the Region's real estate markets.* Higher interest rates could adversely affect the recovery in these markets, which have made substantial, albeit gradual, improvement. Higher interest rates also would pose a threat to mortgage loan activity, by making it more difficult for the average purchaser to afford a house. Such conditions would have a negative impact on the lenders providing credit to this sector.

Norman Gertner, Regional Economist
Karen A. Denu, Division of Supervision

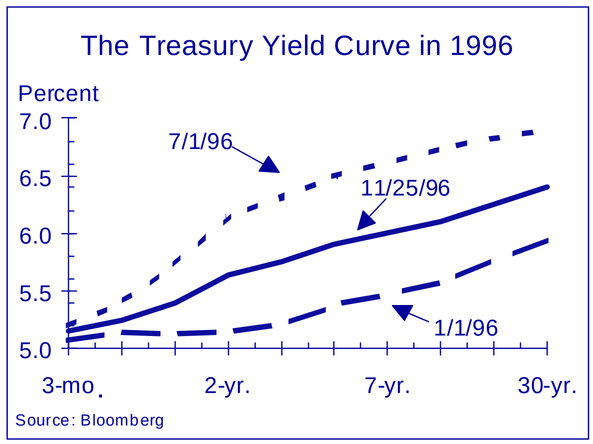
Financial Markets

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

Changes in Interest Rates and Bond Values

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

CHART 1



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

Together, the bonds lost 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the New York Region's banks fared better. The value of securities holdings for all Call Report filers in the Region declined by 0.93 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition price of each instrument.

The New York Region's Bank Stock Perfor-

TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE

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

SOURCE: Bloomberg

mance

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

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused both the S&P Bank Index and the New York Regional Bank Index (NYRBI) to outperform the S&P 500. The NYRBI, created by the Division of Insurance (DOI), consists of the New York Region's 60 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The NYRBI, which is weighted by total market value of shares outstanding, has gained 39 percent on the year, with performance mimicking the S&P Bank Index*. The close relationship of the two indexes results from the NYRBI sharing its nine largest (and heaviest weighted) institutions with the S&P Bank Index: Bank of New York, Bankers Trust, Citicorp, Corestates Financial, Chase Manhattan, J.P. Morgan, Mellon Bank, and PNC Bank, and Republic New York.

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

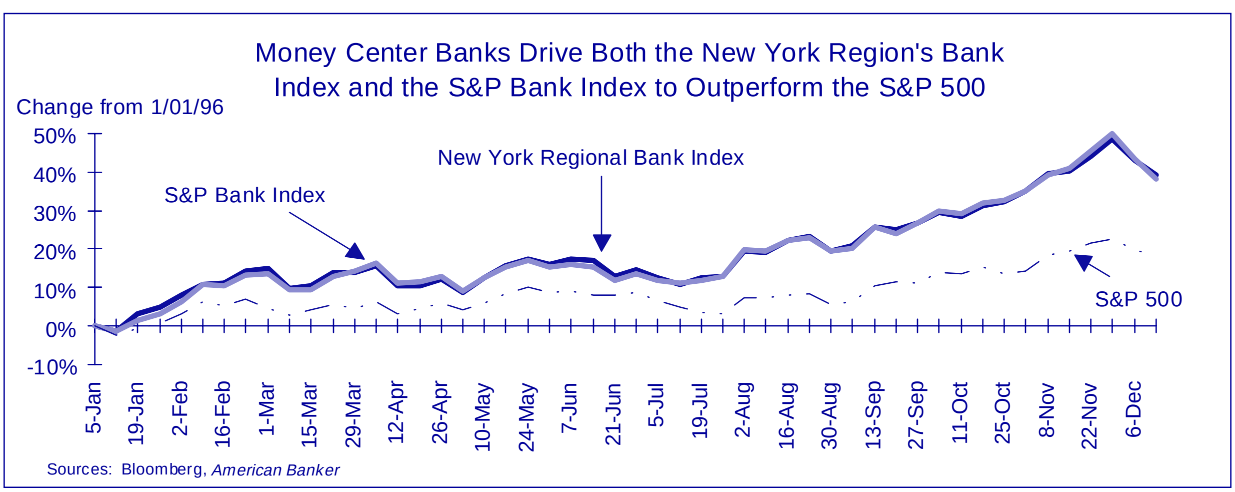
A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader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

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

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

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

CHART 2



A New Product for Managing Exposures to Yield Curve Twists

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

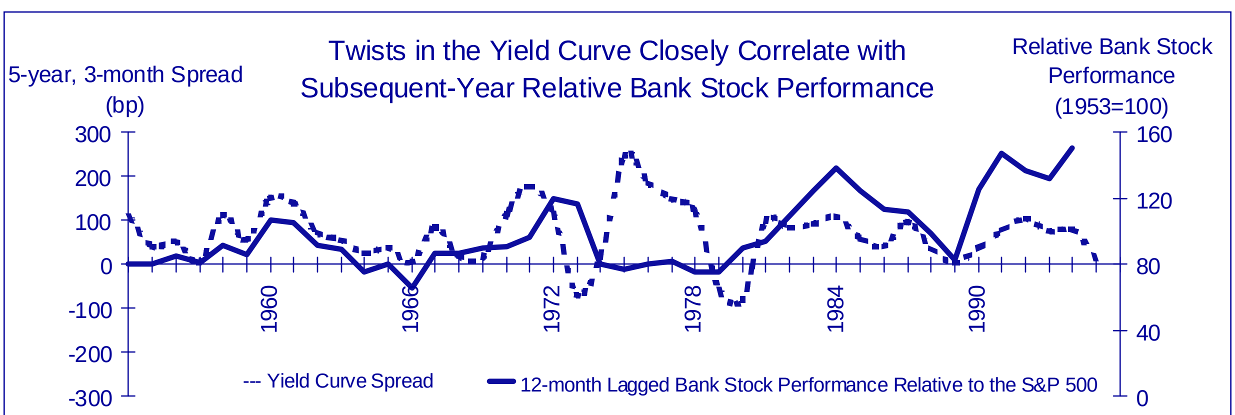
YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives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

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

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

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

CHART 3



Sources: Merrill Lynch, Federal Reserve Board

Current Regional Banking Conditions

- **The strength of the New York Region's banks reflects the generally favorable economic conditions throughout the Region.**
- **Core earnings of most insured institutions remain solid; however, third-quarter operating performance at a number of institutions was negatively affected by the SAIF special assessment.**
- **The asset quality picture remains strong with one notable exception -- credit card lending activities.**
- **Competition among banks and nonbanks in a number of traditional business lines presents significant challenges.**

Generally favorable economic conditions have aided in maintaining the financial health of the New York Region's banks and thrifts. Financial results and examination ratings paint a strong picture of the industry. Nevertheless, there are some areas of special interest this quarter. The first, recognition of the SAIF special assessment, was an isolated event which presented an answer to previously identified problems (see ***SAIF Capitalized***). The other areas, such as rising consumer loan losses, concerns over underwriting practices, and stiff competition among banks and nonbanks cause some concern over where insured institutions may be headed.

Bank Earnings Still Strong But Decline Slightly

The Region's commercial banks have shown consistently strong earnings over the past year. For the nine months ended September 30, 1996, the Region reported an average net interest margin (NIM) and return on assets (ROA) of 4.17 percent and 1.04 percent, respectively, a moderate decline from the 4.27 percent and 1.14 percent reported for the same period in 1995. More than 96 percent of all institutions were profitable. Chart 1 presents ROA data for banks and thrifts in states comprising the New York Region.

Contributing to the Region's decline in ROA was a 13 basis point decrease in the ratio of noninterest income to average assets (to 2.29 percent from 2.62 percent) Market sensitive revenues such as trading, equity gains, and other securities gains at many large multinational banks operating in the Region were lower and contributed to the decline in noninterest income during the third quarter. Fee income in the Region declined as a percent of average assets, from 0.44 percent on September 30, 1995, to 0.42 percent on September 30, 1996, likely as the result of competition.

Thrift Earnings Affected by SAIF Capitalization

A number of the New York Region's insured institutions were dramatically affected by the recognition of the SAIF special assessment. This third quarter charge was estimated to cost the Region's insured institutions $753 million. While both banks and thrifts were affected, the majority of the cost was borne by thrifts and savings banks. Thrift Financial Report filers posted aggregate net income of only $36 million for the third quarter compared to $323 million in the second quarter. Since the special assessment was a one-time charge, profitability for these institutions is expected to improve next quarter and should be further enhanced in 1997 due to lower assessment rates approved by the FDIC.

Capital Adequacy Remains High

Commercial bank capital ratios remain at historically

CHART 1

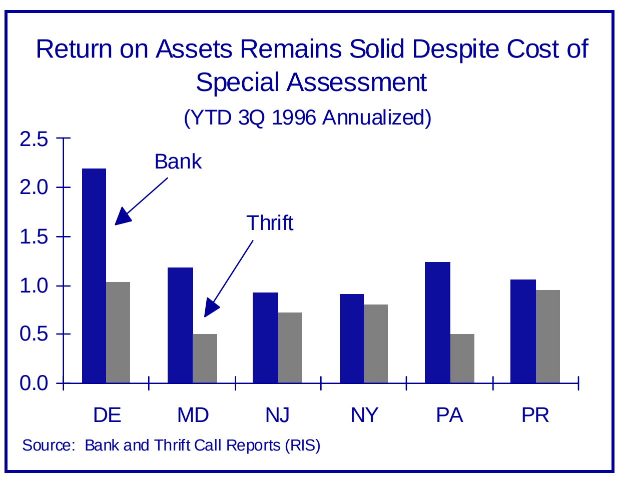
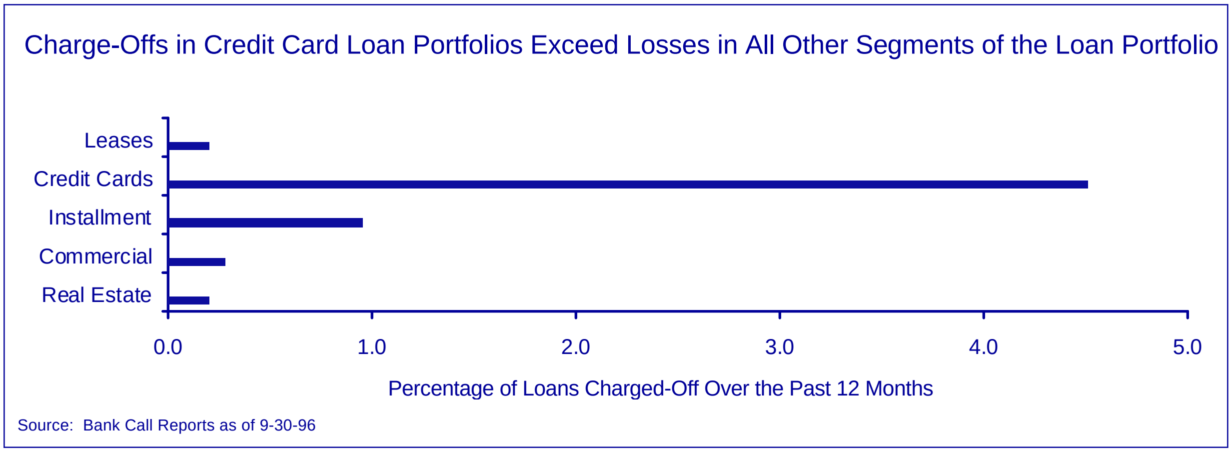


CHART 2



high levels. The Region's simple average Tier 1 leverage capital ratio and Tier 1 risk-based capital ratio were 10.77 percent and 19.92 percent, respectively, as of September 30, 1996. Strong earnings performance over the last several years has enhanced capital levels significantly.

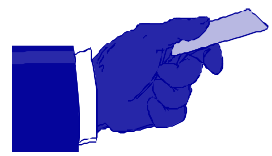
In reaction to record levels of capital, many of the Region's banks and thrifts have initiated stock buy-back programs. When growth is not a viable option due to factors such as market saturation or the high costs associated with a merger or acquisition, banks often consider an investment in their own stock a good alternative investment.

Asset Quality Measures are Steady . . .

The level of nonperforming loans in the Region's commercial banks has declined slightly over the past year. The ratio of noncurrent loans to total loans as of September 30, 1996, was 1.49 percent, down from 1.66 percent at year-end 1995. Asset quality at the Region's thrifts appears satisfactory despite a moderate increase in the ratio of noncurrent loans to total loans to 1.85 percent from 1.62 percent at year-end 1995.

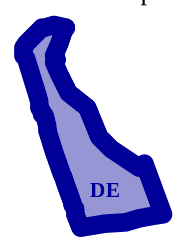
. . . with the Exception of Credit Card Loans

One negative note marring the asset quality picture is the rise in charge-offs of consumer loans, particularly credit card loans. During the first three quarters of this year, net charge-offs on credit card loans at the Region's commercial banks rose to 4.51 percent, up from 3.45 percent at year-end 1995. The quality of credit card portfolios is deteriorating at the same time the performance of the remainder of the loan portfolio is showing improvement. Chart 2 shows that net charge-offs on credit card loans far exceed charge-offs on other types of loans.



Delaware Hosts Most of the Region's Credit Card Assets

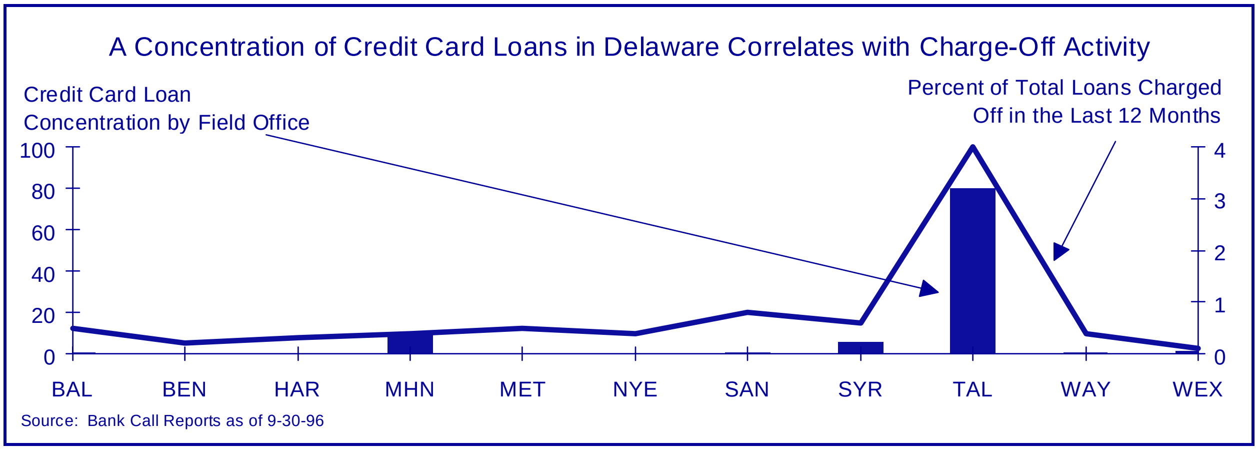
In total, the New York Region is home to 34 credit card specialty and credit card concentration banks (often collectively referred to as credit card banks). Delaware hosts all of the Region's credit card specialty banks. A credit card specialty bank is defined as any bank whose total loans exceed 50 percent of assets and whose credit card loans exceed 50 percent of total loans. The concentration of credit card specialty banks in Delaware correlates with the comparatively high charge-off activity of banks located in the Talleyville, Delaware field office shown on Chart 3 (next page). Banks that are not credit card specialty banks, but have credit card loans exceeding 100 percent of equity capital or 25 percent of total loans, are considered credit card concentration banks. Some institutions designated credit card concentration banks are located in other states in the Region.



Growth in Credit Card Portfolios is Significant

The median growth rate of the Region's credit card banks was 14.1 percent during the year ending June 30, 1996. Growth in unfunded credit card com-

CHART 3



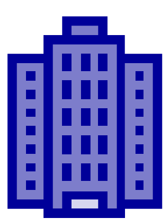
Source: Bank Call Reports as of 9-30-96

mitments also has been brisk, with a median growth rate of 23.9 percent for the year ended June 30, 1996.

Given all the recent publicity about negative performance trends in consumer loan portfolios and rising consumer debt levels (See ***Consumers Make a Break for Bankruptcy Court***), the growth in credit card exposures warrants continued close attention by bank management and regulators. In that regard, the Office of the Comptroller of the Currency (OCC) issued additional guidance to banks during the third quarter, focusing on maintaining prudent underwriting standards and controls.

Real Estate Lending Activities Hold Steady

Loans secured by real estate increased by 0.4 percent in the third quarter of 1996 following a 0.5 percent growth rate in the second quarter. Contributing to this low growth rate was a 2.2 percent decline in commercial real estate loans. Multi-family real estate loans continue to log the strongest growth (4.8 percent during the quarter). However, this segment remains a relatively small portion of the Region's real estate loan portfolio, equaling just 5.1 percent of total loans secured by real estate in the Region. Multi-family real estate lending is centered in banks located in the ***Manhattan***, ***New York East***, and, to a lesser extent, the ***Syracuse*** field offices.



Asset quality measures for real estate loans improved during the quarter. Noncurrent real estate loans equaled 2.12 percent of all real estate loans compared to 2.19 percent in the second quarter and 2.27 percent at year-end 1995. This measure is highest in banks that have total assets greater than $10 billion (2.64 percent).

Competition and Underwriting Standards

The Region's examiners registered some concern over rising competitive pressures. At the conclusion of each examination, examiners complete an underwriting survey developed by the Division of Research and Statistics. During 1996, examiners in the states of Delaware and New York have noted "above average" or "extreme" competitive lending pressures significantly more often than in other states in the Region. Also of interest is the Federal Reserve's November 1996 Senior Loan Officer Opinion Survey which disclosed modest easing of credit standards for middle market and smaller businesses on a nationwide basis.

Competition for the Small Business Market Intensifies

Similar to national trends, recent reports in the New York and Philadelphia areas suggest that larger banks are devoting increasing attention to the small business lending market, an area traditionally important for community banks. Small banks are finding it more difficult to compete with some larger banks that are willing to offer customers narrow pricing spreads. The concern for regulatory agencies is that riskier loans are not being priced appropriately due to the stiff competition among banks. This could lead to trouble in the future if the economy slows significantly.

Syndicated Lending Also Is Heating Up

Syndicated lending continued at a near record pace in the third quarter, driven by merger, acquisition, and leveraged buyout activity. Syndicated loans, credits of more than $50 million that originators carve up and sell to other banks, are expected to total $1 trillion this year. Recent trends noted by the OCC indicate that underwriting standards have eroded to a point where further deterioration would leave little margin of comfort. Increased competition and large investor appetites have contributed to this recent trend. The risks are particularly great for downstream participants, those who buy pieces of large loans from other, usually larger, lenders.

LPC Gold Sheets notes that activity is especially intense in syndicated loans for the communications sector, a result of deregulation in the broadcast industry as well as consolidation in the wireless and personal communications services industry. Pricing in this sector has continued to drop with bankers and investors indicating their desire to lend to these companies.

What To Expect?

Commercial banks in the Region should continue to benefit from the current slow expansion of the economy. The industry is expected to continue to report strong earnings and solid asset quality, despite some concern about consumer loan portfolios. Increasing competition in many traditional business lines, however, presents significant challenges to banks of all sizes and profiles.

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