
◆ Regional Outlook ◆

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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.*

By Steven Burton, Gary Ternullo

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◆ **Regional Economy**—A review of the San Francisco Region's largest metropolitan areas reveals several that are growing extremely rapidly, while a few others are performing relatively poorly. Banks' high and rising exposure to highly cyclical construction lending in several metropolitan areas is becoming an area of concern. *See page 14.*

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◆ **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...rating agencies and investment analysts have argued that trust preferred stock is a weaker form of Tier 1 capital. *See page 19.*

By Kathy R. Kalser

◆ **Regional Banking**—Favorable performance continues for most banks and thrifts in the Region...banks and thrifts show that renewed interest in commercial real estate lending in several areas has occurred as strong economic growth has reduced vacancy rates and spurred construction of commercial properties...exposure to higher-risk construction and commercial real estate loans is near record levels in some areas. *See page 23.*

By Catherine I. Phillips-Olsen, Roger Stephens, Millen L. Simpson

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Bank Earnings: Competitive Pressures and Cyclical Risks

- **Rapid loan growth, record low credit losses, vigorous expansion of income sources, and cost-cutting continue to propel bank earnings to record levels.**
- **Intense competition to preserve and attract business can lead to aggressive loan pricing, relaxed loan underwriting standards, increased portfolio concentrations, and other changes to risk-management practices that can reduce banks' ability to sustain earnings and capital through a downturn.**
- **As this economic expansion approaches an advanced age, prudent bankers will allow for the possibility of an adverse change in economic conditions.**

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

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

Credit Quality

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

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

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

CHART 1

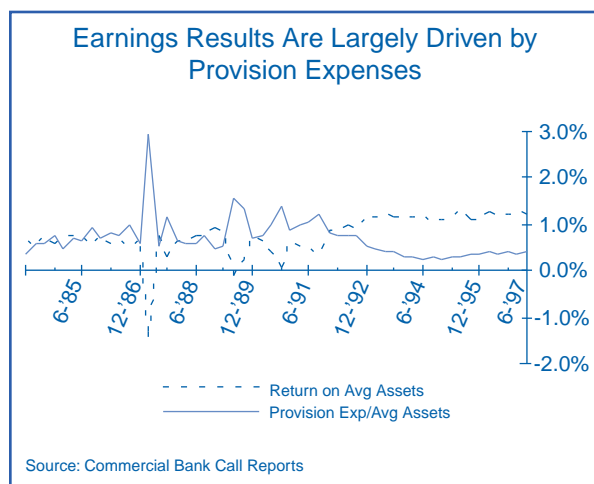


CHART 2

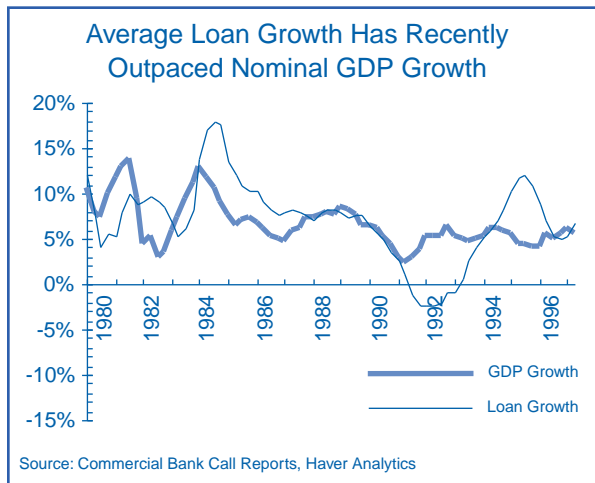
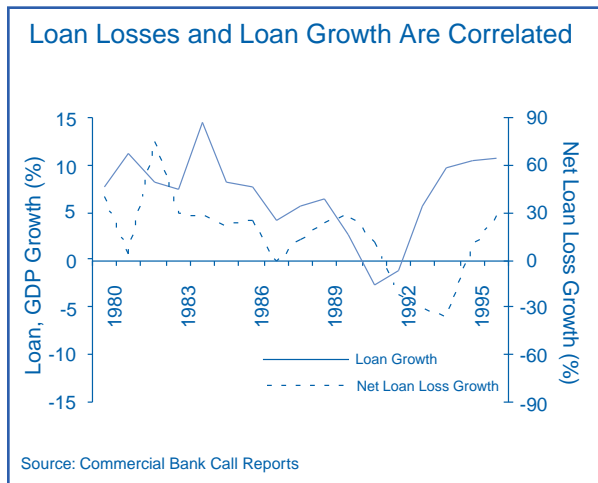


CHART 3



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

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

Although in the aggregate these reserve numbers remain high relative to the early to mid-1980s, when reserve levels ranged from 1.20 percent to 1.74 percent, the Office of the Comptroller of the Currency (OCC) recently issued an advisory letter expressing concern about declining reserve levels and the need to maintain an adequate allowance. This letter was a response to weakness in the credit card sector and to trends in the

market for syndicated commercial loans, including increasing leverage, declining spreads, and a weakening in other underwriting terms, all stemming from increasing competitive pressures.

Diversifying loan portfolios is another way for banks to help reduce susceptibility to economic downturns. It has often been noted that the trend toward interstate banking and branching may improve loan diversification. It should also be noted, however, that many banks retain high concentrations of credit exposure to specific economic sectors. For example, commercial real estate lending and construction lending has been a source of volatility in bank earnings since the real estate investment trust (REIT) crisis of the 1970s. As discussed in **Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets**, banks are leading a resurgence in commercial real-estate lending. As Table 1 shows, 28 percent of FDIC-insured institutions grew their total commercial real estate and construction portfolios more than 30 percent from mid-1996 to mid-1997, and 16 percent had total commercial real estate and construction exposures¹ 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 non-residential structures, as well as construction loans.

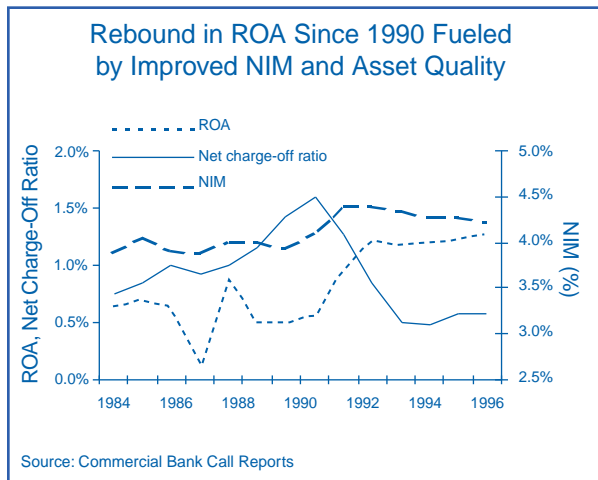
consumer debt. Despite seven years of economic expansion, commercial banks' net credit card charge-offs at mid-1997 were running at 5.22 percent of average outstanding balances, matching levels not seen since the aftermath of a 56 percent run-up in charge-offs that accompanied the recession of 1990 to 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

CHART 4



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).

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

TABLE 1

RAPID LOAN GROWTH IS OCCURRING AT A SIGNIFICANT NUMBER OF INSTITUTIONS (4 QTRS GROWTH ENDING 6/97)	PERCENTAGE OF INSTITUTIONS WITH LOAN CATEGORY GROWTH APPROXIMATING		
	20% TO 30%	30% OR MORE	TOTAL OVER 20%
TOTAL LOANS AND LEASES	11	13	24
CONSTRUCTION LOANS	4	36	40
COMMERCIAL REAL ESTATE LOANS	9	27	37
TOTAL CRE	10	28	38
1-4 FAMILY RESIDENTIAL LOANS	11	17	29
HOME EQUITY LINES	4	25	29
TOTAL RESIDENTIAL	12	18	29
CREDIT CARD LOANS AND RELATED PLANS	4	17	21
OTHER CONSUMER LOANS	9	18	27
TOTAL CONSUMER LOANS	9	18	27
COMMERCIAL LOANS	9	26	35

SOURCE: BANK & THRIFT CALL REPORTS

TABLE 2

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

SOURCE: BANK & THRIFT CALL REPORTS

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

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

On the asset side, pricing pressures also are frequently cited as contributing to sluggish NIM. For example, in the aforementioned syndicated lending market, average interest spreads charged to noninvestment-grade large customers have dropped more than 63 basis points between 1992 and 1996, while spreads on investment-grade debt are at all-time lows. Reportedly, some deals are being done at minimal or no risk-adjusted spreads

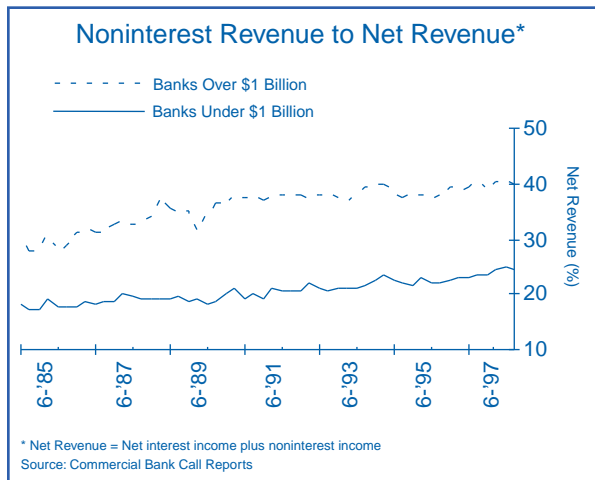
simply to preserve lending relationships. Increased securitization of various asset types has also had effects on pricing. By increasing the depth and liquidity of the market for the underlying loans, securitization has tended to lower spreads on these assets, thereby increasing competitive pressures on institutions not able to achieve the volumes necessary to efficiently utilize this new funding vehicle.

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

Growth in Noninterest Income

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

CHART 5



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

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

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

The Effect of Expense Control on Earnings Performance

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

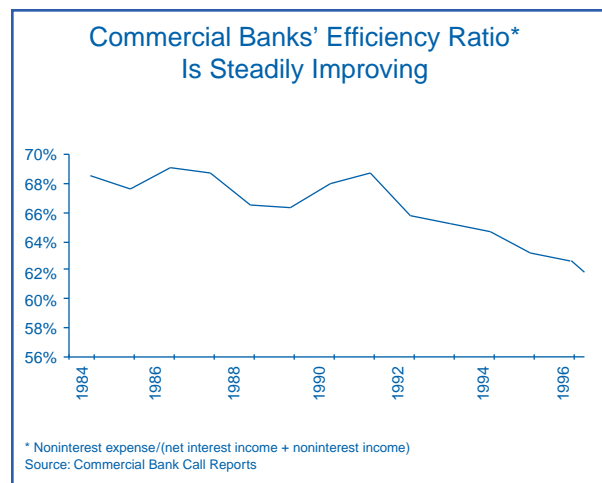
² The efficiency ratio is normally defined as noninterest expense divided by the sum of net interest revenue and noninterest revenue.

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

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

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

CHART 6



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

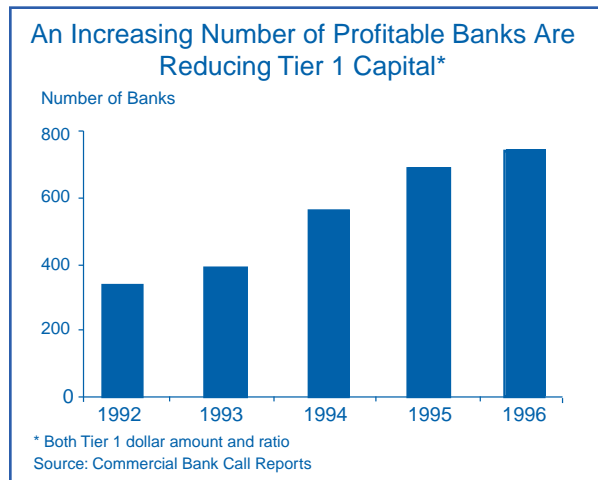
The Role of Capital in the Management of Earnings

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

Finding effective ways to deploy historically high capital levels appears to be one driving force behind the recent rash of mergers and acquisitions, high dividend payout ratios, increased stock repurchases, and the development of alternative types of hybrid capital such as trust preferred stock (see *Financial Markets*). For example, during 1995 and 1996, major merger and acquisition deals included some \$835 billion in bank and thrift assets. During 1996, commercial banks with over \$1 billion in assets had an average dividend payout ratio over 89 percent, up significantly from the 67 percent payout rate of 1994. Banks with under \$1 billion in assets averaged 55 percent for 1996 and 52 percent for 1994. In addition, banks and bank holding companies have issued some \$21 billion in trust preferred stock during the last nine months, some of which has been used to fund the almost \$42 billion in share repurchase programs announced by large banks during 1996 and early 1997.³

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

CHART 7



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

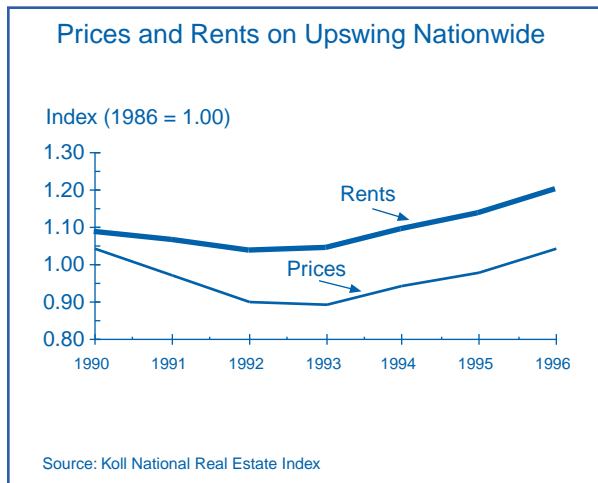


CHART 2

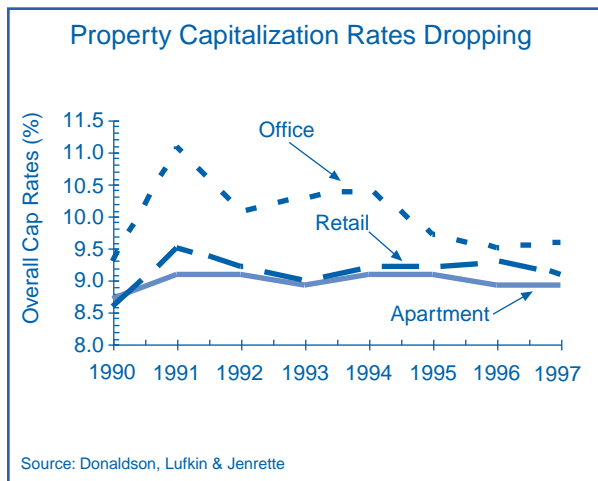
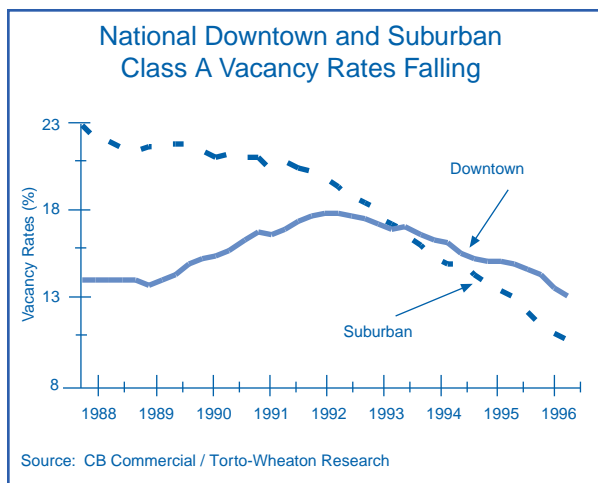


CHART 3



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 institu-

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.

tions 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.

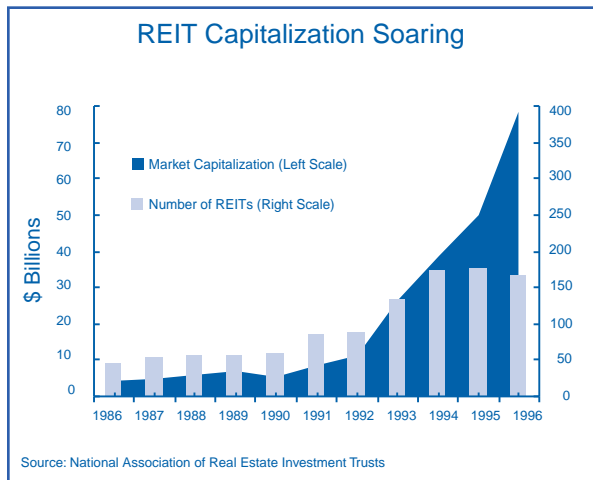
Whether or not banks take part, the continuing development of a market for securitized commercial real estate assets raises a number of efficiency issues for direct lenders. Securitization provides property developers and owners access to a much larger pool of potential funding sources and a wider array 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

CHART 4



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

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

Commercial Real Estate Securitization: Some Broader Implications

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

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

As an investment, commercial real estate is quickly regaining the broad favor it lost during the last market downturn. But the channels through which a lender or investor can participate in this market are expanding even more dramatically. Investment exposures to real estate are no longer effectively limited to private equity or debt. The choices are multiplying, with liquid public markets for both debt and equity providing the foundation for existing and future commercial real estate-

based instruments—instruments such as swaps, options, and property derivatives—that will permit the tailoring, hedging, and even creation of synthetic real estate investment positions. Although financial institutions are participating in this revival, it is clearly a different world from the old, and one in which they will have to choose

how best to compete against—or participate in—these new real estate financing strategies.

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Commercial Real Estate in the San Francisco Region Rebounds

Economic expansion in the Region has increased the demand for commercial real estate and stimulated commercial real estate and construction lending in many markets. While three of the Region's larger commercial real estate markets—**Honolulu, Los Angeles, and Riverside**—remain identified problems, strong economic growth has reduced vacancy rates and increased valuations to near replacement cost in most other markets. Consequently, commercial real estate construction activity has been brisk, especially in the Region's faster-growing areas. However, two other areas—**Fresno and Las Vegas**—deserve attention because of rising vacancy rates or deteriorating economic conditions or both (see *San Francisco Region's Large Metropolitan Areas Experience a Wide Range of Conditions and Risks*).

Lenders in the San Francisco Region have taken advantage of the rebound in commercial real estate and have significantly increased their concentrations

in construction and commercial real estate loans over the past three years. As of June 1997, exposure to both construction and commercial real estate loans at community banks—institutions with total assets less than \$1 billion that are not primarily credit card banks—has increased to levels not seen since the early 1990s (see *Regional Banking Conditions*). The concentration of construction and commercial real estate loans found in the San Francisco Region community banks is disproportionately high relative to the rest of the nation. Furthermore, not only have community banks increased their construction and commercial real estate loans outstanding, but they also have sharply increased construction and commercial real estate loan commitments. For these reasons, the regional and local real estate markets in areas with high real estate concentrations should be closely monitored.

Catherine I. Phillips-Olsen, Regional Manager

San Francisco Region's Large Metropolitan Areas Experience a Wide Range of Conditions and Risks

- The Region has several large metropolitan areas—Las Vegas, Phoenix, Seattle, and Portland—where employment is growing at almost twice the national rate or faster.
- Some of these metropolitan areas have experienced a moderation in both population growth and construction activity since 1996, and most face risks associated with their heavy exposure to the cyclical construction industry.
- Three other large metropolitan areas in the Region—Fresno, Tucson, and Honolulu—are performing much worse than the Region and face risks ranging from real estate slowdowns to recessions.
- In several metropolitan areas, community banks' exposure to construction lending is approaching that found at the peak in 1990 at southern California community banks, just before real estate markets in that area collapsed.

San Francisco Region Includes Both Fast- and Slow-Growing Large Metropolitan Areas

While the San Francisco Region leads the nation in economic growth and includes some of the nation's fastest-growing metropolitan areas, it also includes several underperforming areas. However, as the Region's economies differ, so do the economic and banking risks these areas face. Both groups of large metropolitan areas are subject to national economic risks, such as recessions. Other risks are regional. In some faster-growing areas, the economic risks center on demographics, specifically slower population growth that might dampen their booming real estate markets and economies. The group of weaker economies risks being left out of a sustained period of national economic growth. Moreover, some metropolitan areas in each group may be emerging as areas of special interest because of their heavy bank exposure to commercial real estate and construction lending (see *Regional Banking Conditions*).

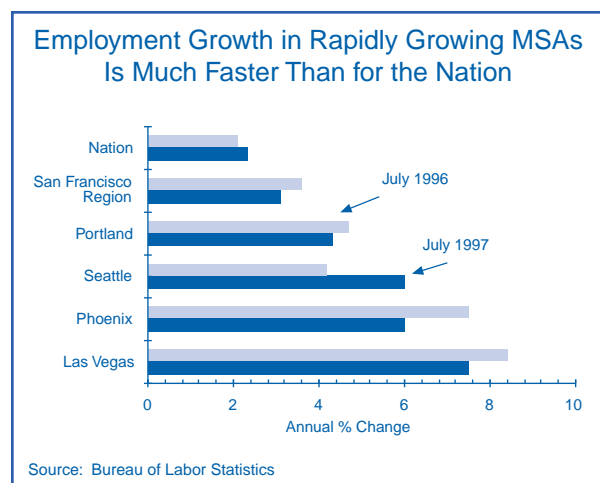
Of particular interest are the metropolitan statistical areas (MSAs) within each group where the local economy is very dependent on highly cyclical construction activity and where the local banks have a heavy exposure to construction and commercial real estate lending. Two faster-growing areas, **Las Vegas** and **Portland**, and one slower-growing area, **Tucson**, fall into this category. **Fresno** also may bear closer examination even though its economy is not highly dependent on construction. The overall weakness in Fresno's economy and real estate markets, coupled with its banks' heavy

construction lending exposure, should be carefully observed.

Large Metropolitan Areas outside California Continue Their Robust Growth

The four fastest-growing large MSAs (those with employment greater than 250,000) in the Region are Las Vegas, Phoenix, Seattle, and Portland. These MSAs continue to be among the fastest growing in the nation, and all are reporting strength in services and construction. Each of these MSAs reported robust growth over the 12 months ending in July 1997 (see Chart 1). These MSAs added jobs at a 4.3 percent pace or better, com-

CHART 1



pared with 3.1 percent and 2.3 percent, respectively, for the Region and the nation.

The service sector, which accounts for three of every ten jobs in the Region, continues to set the pace for expansion in the fast-growing MSAs. Each of these MSAs reported growth rates in service jobs equaled or exceeded the Region's 4.4 percent rate over the 12 months ending in July. All four also reported very strong growth in manufacturing jobs, well above the Region's 3 percent rate. With the exception of **Seattle**, each of the MSAs also added construction jobs at robust rates of 7.3 percent or better.

Despite the continued strong growth in these fast-growing MSAs, three grew at a slower pace in 1997 than in 1996. Seattle, which is experiencing an aerospace boom, was the only one of the four MSAs where employment growth accelerated over the past 12 months. However, Chart 1 also illustrates that the rapid growth of these MSAs over the past two years continues to easily outpace the Region, even with their slightly slower rate of growth in 1997.

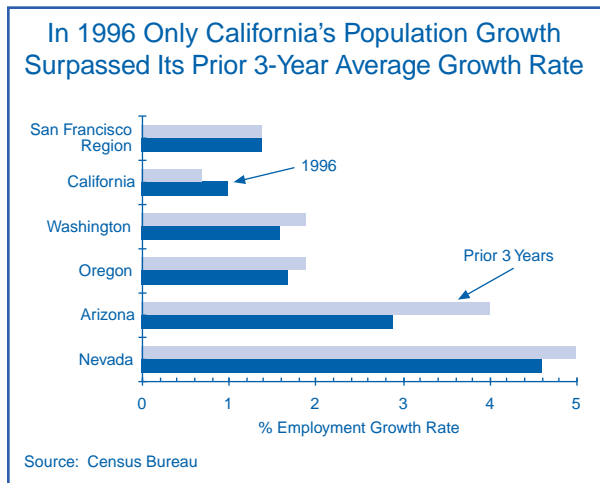
Demographic Forces May Slow Growth

The Region's four fast-growing large MSAs are all located outside California and could be subject to demographic shifts within the Region. Such shifts might slow population growth and adversely affect both real estate markets and financial institutions in those MSAs with heavy commercial real estate and construction loan exposures.

The influx of new residents, many arriving from **California**, was a strong factor in the expansion of the Region outside of California during the 1990s. States and metropolitan areas with strong economies and more favorable employment market conditions generally experienced accelerated population growth, while California suffered large job losses, high levels of unemployment, and an unprecedented net outflow of residents.

Recent population figures, however, suggest that the outflow from California may be slowing or even reversing as the state's overall economy picks up and job opportunities improve. Chart 2 shows that California's population growth was higher in 1996, compared with the prior three-year period. In contrast, population

CHART 2

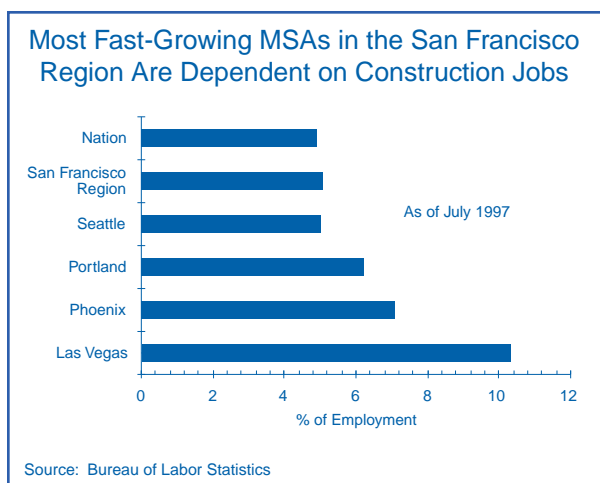


growth rates for all of the other states in the Region were slower in 1996 compared to the earlier period.

*Rapid population growth in the 1990s spurred the construction sector in these metropolitan areas and most of them became much more dependent on construction sector jobs than the Region as a whole. For example, as of July 1997 construction accounted for only 4.9 percent of all nonfarm jobs in the nation and 5.1 percent in the Region. Nevertheless, as is shown in Chart 3, as of July 1997 construction accounted for 10.3 percent of all jobs in Las Vegas, 7.1 percent in **Phoenix**, and 6.2 percent in Portland.*

The dependence of these MSAs on construction activity is reflected in the June 1997 banking industry statistics. *Community banks (those with less than \$1 billion in total assets, excluding specialty credit card banks) in*

CHART 3



three of these MSAs have a much larger share of their loan portfolio in construction loans than banks of similar size elsewhere in the Region. In Las Vegas, construction loans made up 17.3 percent of total loans, while Portland and Seattle report 15.9 percent and 14 percent, respectively. The comparable figures for their peers in the Region and for all community banks in the nation are only 8.2 percent and 4.8 percent, respectively. Finally, to give some historical perspective to the degree of exposure for community banks in these MSAs, at year end 1990, before the Los Angeles real estate markets tumbled, construction loans at Los Angeles-area community banks accounted for 15.4 percent of total loans.

Dependence on the Construction Industry Exposes These Areas to Weakness in the Event of a Slowdown

Amid a background of renewed strength in the real estate sector nationally, several fast-growing MSAs are reporting potential signs of softening in some real estate and construction indicators. Moreover, some softening is consistent with the slowdown in migration to these MSAs. Second quarter 1997 metropolitan office vacancy rates for Las Vegas rose to 3.6 percentage points above the third quarter 1996 vacancy rate as the supply of new facilities has outstripped demand. The area's vacancy rate of 13.2 percent is noticeably above the national average of 11.2 percent. In the first and second quarters of 1997, industrial vacancy rates rose slightly in Portland. Finally, nonresidential construction contracts fell modestly in both Portland and Seattle in 1996, and more recently Las Vegas, Phoenix, and Seattle all reported declines in the first quarter of 1997 compared with the same period in 1996.

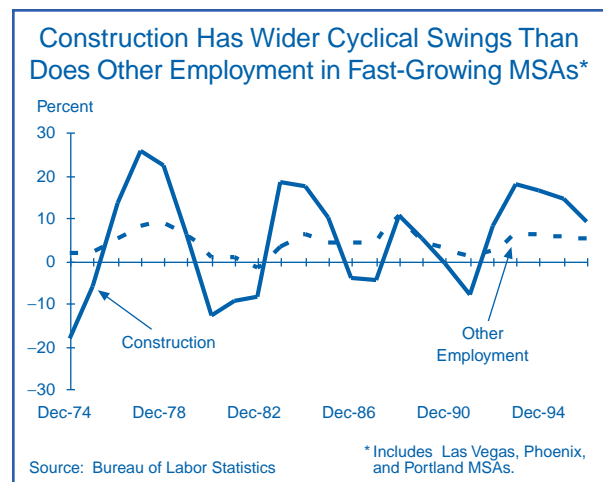
Residential real estate markets in much of the Region outside of California also appear to be showing signs of cooling off, such as smaller price increases. At midyear 1997, total single-family residential building permits for the Region were down slightly relative to the same period a year earlier. Except for Seattle, where real estate markets are picking up with the economy, the other three fast-growing areas all are reporting noteworthy declines in 1997 compared with 1996 for both single-family and multifamily permits. Total permits, usually an indicator of future residential construction activity, are below last year's pace in Phoenix (-10 percent), Portland (-9 percent), and Las Vegas (-7 per-

cent). Conversely, California, where housing sales and prices are exhibiting renewed strength, especially in the Bay Area, is showing a sizable increase in 1997 permits authorized.

The simultaneous softening of many real estate market indicators in these fast-growing MSAs, following the slowdown in migration to these areas, may be an early warning of deteriorating real estate market conditions and reduced construction activity. This is important, since the construction industry is one of the most volatile sectors of the economy and its boom and bust periods often lead the overall business cycle. Chart 4 shows the extent of these wide swings in construction for the fast-growing MSAs. The annual growth rate of construction-sector employment varied about four times as much over the past 20 years as the growth rate of total employment excluding construction jobs.

Implications: While the outlook for the fast-growing MSAs is positive, the effects of potential demographic changes on their booming real-estate-based sectors and the heavy exposure of real estate lenders in the construction and commercial real estate areas should be carefully monitored. Most economists expect these areas to continue to expand rapidly, although probably at somewhat reduced growth rates. For example, DRI/McGraw-Hill recently projected that Las Vegas (ranked first), Phoenix (seventh), and Portland (twelfth) would be among the top 20 large MSAs in the nation in employment growth over the five-year period ending in 2002. In spite of this optimism, slower growth and reduced immigration could have adverse impacts on these areas. Las Vegas in particular has been singled out

CHART 4



for concern by some economists because of its heavy dependence on the robust performance of its highly cyclical construction industry.

Warning Signs in Fresno and Tucson

The strength of the four metropolitan areas described above contrasts sharply with the performance of the three slowest-growing large metropolitan areas in the Region. These areas fall into two groups. The first includes Honolulu, which remains an established area of concern because of its lingering recession. The second group includes MSAs that are still expanding but also are experiencing signs of deterioration, such as a slowdown in employment growth or softening real estate markets. Fresno, in California's Central Valley, has recorded job growth of less than 1.5 percent for the past two years, and its unemployment rate of 12.1 percent is almost twice the rate for the state. Tucson's economy also has slowed noticeably from just two years ago, when it was one of the Region's fastest-growing MSAs.

Fresno's Economy Is Slow Compared with the Region, and Its Real Estate Markets Are Softening

Fresno is emerging as an area of concern because of its slow economy, erratic growth pattern, and softening real estate market conditions. The Fresno area reported only 1.4 percent growth in employment over the 12 months ending in July 1997, less than half the growth rate for the Region. Many sectors of the economy, including construction, finance, and wholesale and retail trade, are weak. Demographics also may be playing a role in the Fresno market. A sharp downturn in residential real estate markets may reflect a reduced inflow of residents from the Los Angeles Basin as the southern California economy improves. The weak economy and high and rising metropolitan office vacancy rates (14.4 percent for the second quarter of 1997) are important because community banks in the Fresno area have a relatively heavy exposure to both construction (16.1 percent of total loans) and commercial real estate loans (24.9 percent). This concern is underscored by a significant increase over the past year in the ratio of past-due and nonaccrual construction loans to total loans. For construction loans, the ratio soared from 5.6 percent to 10.7 percent (see *Regional Banking Conditions*).

Tucson's Economy Has Slipped over the Past Two Years

In recent months, Tucson's economy has grown slowly compared with the Region. It also has experienced some signs of deterioration in real estate markets. Despite the slowdown over the past year, Tucson remains at full employment. In July 1997, Tucson's 3.3 percent unemployment rate was well below the national average of 4.8 percent.

Tucson's reported employment growth rate dropped below 1 percent over the 12 months ended in July 1997; a year earlier it added jobs at twice that rate. Two key reasons for the slower growth were a loss of government jobs and a loss of construction jobs. In addition, there was a sharp slowdown in job creation by the service sector in general and business services in particular. While health care services picked up somewhat, the change was not enough to offset weakness elsewhere in the service sector.

Despite the apparent weakness in Tucson's local economy, activities more dependent on the health of the national economy, such as tourist-related services and manufacturing, continue to do well.



The decline in Tucson's construction employment is consistent with the signs of weakness in some sectors of the area's real estate markets. The softness is important because construction accounts for 6.4 percent of Tucson's jobs, well above the 5.1 percent share for the Region. Weakness is most evident in vacancy rates for industrial properties, where the second quarter 1997 vacancy rate of 13.1 percent is 5 percentage points higher than the national average. Tucson's metropolitan office vacancy rate rose from 8.5 percent in the first quarter to 9.0 percent in the second quarter. Within the Tucson area, however, while the downtown office vacancy rate remains very high (almost 22 percent), suburban office markets are very tight and vacancy rates are under 5 percent.

Not only have some segments of the commercial real estate market softened, but residential housing permits for the Tucson metropolitan area for June 1997 also fell almost 8 percent from a year earlier. The decline was most dramatic in multifamily housing permits, but

single-family permits also fell. The weakness also could be influenced by slower in-migration. These twin developments, a slowing in the economy and signs of deterioration in some real estate indicators, are of particular interest in Tucson. Banks in Tucson, especially larger institutions, are heavily engaged in real estate lending. Commercial real estate loans make up almost 27 percent of total loans at banks in Tucson; construction loans account for another 15 percent of total loans. Exposure to both loan types is high relative to other metropolitan areas in the Region.

Lingering Risks

Finally, **Honolulu** continues to suffer from a lingering recession, and current indicators do not foretell a quick turnaround. Commercial office vacancy rates remained



close to 15 percent in the second quarter of 1997, among the highest in the nation. Housing prices continue on a steep decline, and building permits are far below pre-recession levels. International forces have buffeted real estate investment and tourism; the soft Japanese economy and the stronger dollar have caused many foreign visitors to reduce their spending or shorten their visits.

Implications: *Weak economic conditions in these three MSAs warrant additional monitoring, although the risks vary somewhat across these MSAs.* For example, while the Tucson area has slowed recently, its long-term prospects are generally considered sound. **DRI/McGraw-Hill** recently ranked Tucson fifteenth among the top 20 MSAs in expected growth over the next five years. Still, community banks in the Fresno area and larger banks in the Tucson area have relatively high exposures to both commercial real estate and construction lending. Because of their high degree of exposure in these loan categories, which have created problems for the banking industry following slowdowns in other parts of the Region, the slower growth rate of these communities bears closer monitoring.

Gary C. Zimmerman, Regional Economist

For More Information

Gabriel, Stuart A., and Joe P. Matthey. "The Slowing Exodus from California." *Economic Letter*, Federal Reserve Bank of San Francisco, Number 96-38; December 27, 1996.

Zimmerman, Gary C. "California's Community Banks in the 1990s." *Economic Letter*, Federal Reserve Bank of San Francisco, Number 96-04; January 26, 1996.

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 contem-

plating 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).

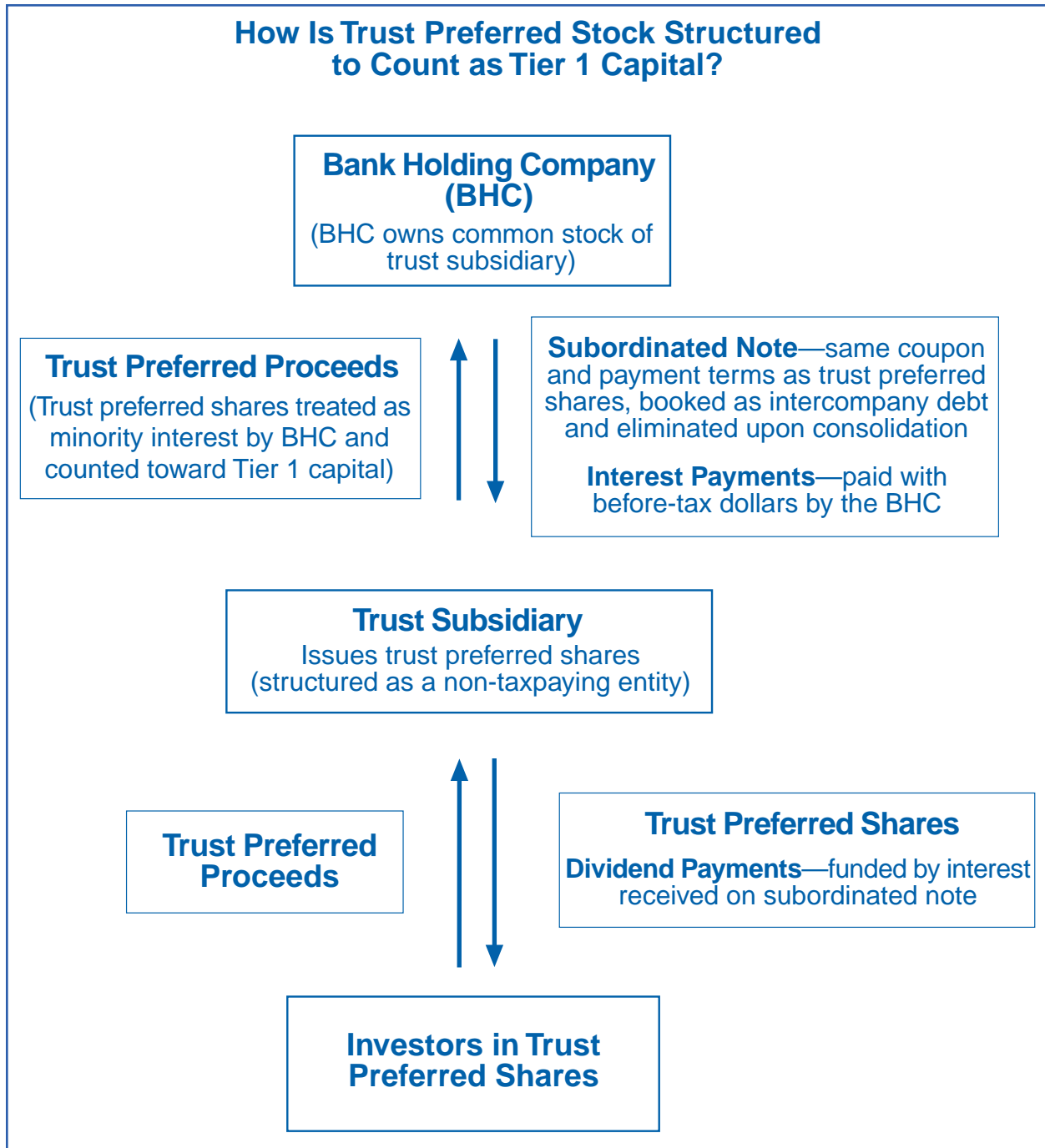
Although trust preferreds are issued under different names, they share the same basic structure (see Chart 1, next page). A non-taxpaying subsidiary, or "trust," of the bank holding company is formed. The trust issues two classes of stock: common and preferred shares. The common stock of the trust subsidiary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



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.

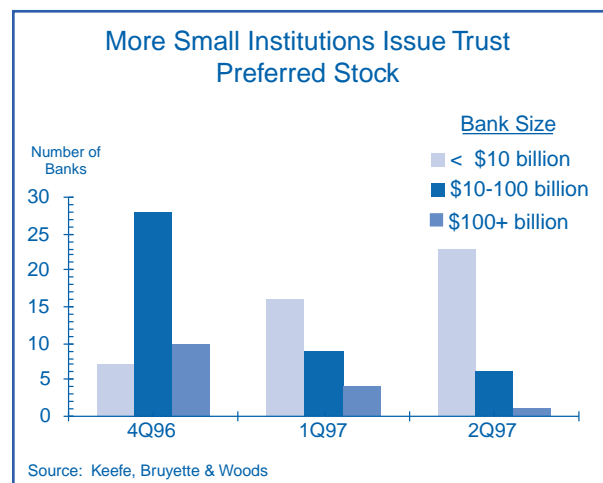
As the tax advantage of the trust preferred stock remained intact through the budget negotiations, the pace of trust preferred issuance subsided from an estimated \$4.3 billion in the first quarter of 1997 to just under \$2.5 billion in the second quarter. Trust preferred issuance by larger banks declined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

- Favorable performance continues in 1997 for most banks and thrifts in the San Francisco Region.
- Deposit service charges are becoming a more important source of revenue at the Region's large banks, widening the disparity between them and their community bank counterparts.
- The Region's community banks have significantly more equity capital exposed to commercial real estate, construction loans, and other real estate owned than do community banks nationwide.
- Exposure to higher-risk real estate lending warrants monitoring.

Second-Quarter Reports Reflect Overall Good Earnings, Capital, and Asset Quality

With the exception of a few slower-growing metropolitan areas in California, the Region's banks and thrifts overall continue to report relatively strong financial conditions. For the quarter ended June 30, 1997, insured institutions in the San Francisco Region reported:

- a return on assets (ROA) of 1.13 percent, down slightly from first quarter's ROA of 1.17 percent because of a slight decline in the net interest margin at the Region's banks and thrifts;
- an average leverage capital ratio that continued to improve, climbing from 7.48 percent during the quarter to 7.54 percent; and
- a decline in past-due loans to 2.09 percent of total loans from 2.38 percent in the first quarter of 1997, primarily due to improvement in the real estate and commercial loan portfolios.

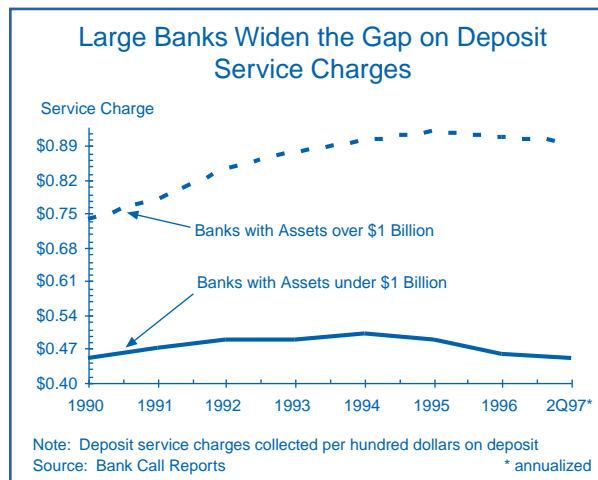
Fewer institutions reported losses during the second quarter of 1997 than during the second quarter of 1996. Eighty-one insured institutions, with combined assets of \$25 billion (2.5 percent of the Region's total assets), reported net losses in the second quarter of 1997. Together, these institutions lost a total of \$89.6 million. These statistics compare favorably with those from the second quarter of 1996, when 92 insured institutions with combined assets of \$30.5 billion reported a \$151.1 million loss.

Large and Small Banks Take Divergent Approaches to Deposit Service Charges

One reason for the improved financial condition of insured institutions in the San Francisco Region is the increasing effort banks and thrifts are making to generate more noninterest income and diversify their revenue streams. In many cases, traditional sources of noninterest income, such as service charges on deposit accounts and surcharges on automated teller machine (ATM) transactions, are being reevaluated and repriced.

In the San Francisco Region, service charges on deposit accounts have become a more important source of income. Since 1990, service charges on domestic deposits have climbed from 4.4 percent of gross operating income to 6.2 percent for the first half of 1997. However, Chart 1 reveals that in the San Francisco

CHART 1



Region, large banks, those with assets greater than \$1.0 billion that are not credit card banks, generate significantly more income per dollar of deposits from service charges on deposit accounts than do community banks (institutions with assets under \$1 billion).

The service charge disparity has arisen in part because several of the Region's larger banks made efforts to expand revenues by charging nontraditional service fees. In addition to the traditional minimum-balance maintenance charges, withdrawal penalties, stop-payment orders, and returned-check fees, these institutions also now are charging for such services as telephone access, personal teller service, home-based electronic banking, and ATM use for both bank customers and other users.

ATM charges for noncustomers started after MasterCard and Visa—the owners of the Cirrus and Plus ATM networks—lifted their ban on surcharges on April 1, 1996. The new noncustomer ATM surcharge has become popular with ATM owners across the nation. According to a nationwide survey conducted by *Carmody and Bloom, Inc.*, the share of ATM owners imposing surcharges on noncustomers grew from 40 percent to 65 percent in the six months ending February 1997. The same study found that in the West, noncustomers paid a surcharge at 87 percent of the ATMs owned by the banks that were surveyed. Large financial institutions own an overwhelming majority of these machines.

In contrast to the large banks that implemented surcharges, many of the Region's community banks (those with assets less than \$1.0 billion, excluding credit card banks) are not imposing ATM surcharges, in a strategic attempt to retain, and possibly gain, market share. According to a 1997 *Grant Thornton* survey, community banks recognize that ATM surcharges and other deposit fees could provide a means of paying for expanded ATM services. However, they also recognize "free" ATM access as a potential customer drawing card. These factors may in part explain why in 1997 deposit service charges collected per hundred dollars of domestic deposits at small banks continued to decline to less than half the amount collected by larger banks.

Implications: In light of the increased use of fees at some large banks and the reluctance of many small banks to raise fees, the disparity in deposit service charge income between the large and small banks in the Region may widen. However, as noted by Atlanta con-

sultant *George Albright*, over the long term, higher profits from ATMs may result in an increased supply of these machines and, eventually, downward pressure on fees.

Institutions in Several Areas of the Region Have Increased Their Risk Profiles

The Region's economic expansion over the past several years not only has revived several of the Region's real estate markets but also has resulted in significant asset and loan growth and improved profitability at many banks and thrifts. However, during this period of prosperity some institutions may have assumed additional risk in their loan portfolios by increasing their exposure to higher-risk types of loans, such as construction and commercial real estate loans. This exposure warrants monitoring, particularly in metropolitan statistical areas (MSAs) such as Fresno and Las Vegas, where the real estate markets appear to be softening and the economies are, in the case of Fresno, beginning to show signs of weakness (see *San Francisco Region's Large Metropolitan Areas Experience a Wide Range of Conditions and Risks*).

The Region's high level of exposure to commercial real estate and construction lending is most evident at community banks—defined here as institutions with total assets less than \$1 billion that are not primarily credit card banks. Chart 2 reveals that community banks in the San Francisco Region have significantly more equity capital exposed to commercial real estate and construction loans, direct real estate investments, and other real estate owned than do community banks nationwide. The

CHART 2

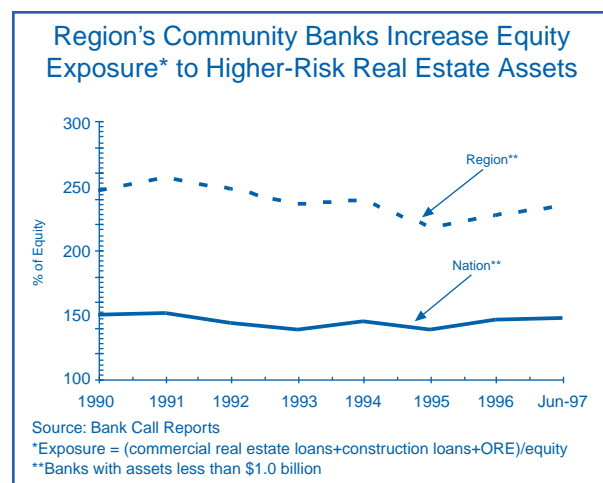


chart also shows that the Region's community bank exposure to these higher-risk real estate assets, at 235 percent of equity capital, not only is well above the national average of 147 percent but also has been trending upward since 1995.

Renewed interest in commercial real estate lending in many areas of the San Francisco Region over the past three years has occurred because strong economic growth has reduced vacancy rates and spurred construction of commercial properties. As discussed in *Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets*, the Region's renewed interest in commercial real estate parallels national trends. In a recent national report on commercial real estate, *Donaldson, Lufkin, & Jenrette* (DLJ) identified Las Vegas and Salt Lake City as the two most active smaller-area office construction markets in the nation. They also cited Portland, Phoenix, and Seattle as larger areas with booming office construction sectors. *Note, however, that DLJ's ranking of these markets as leaders in commercial real estate is based on the area's high level of construction activity, not the viability of the projects or overall market conditions.*

Because the resurgence in the commercial real estate market has not been uniform throughout the Region, the Region's community banks' exposure to real estate lending has a geographic component that also is not uniform across the Region. Chart 3 shows that during the second quarter of 1997, community banks in several MSAs reported combined commercial real estate and construction loans approaching 30 percent of assets, which is in excess of exposure of 23 percent and 15 percent, respectively, for the Region and the nation. MSAs

with exposures exceeding 30 percent of assets include Reno, Nevada; Eugene, Oregon; and Santa Rosa, Riverside-San Bernardino, Sacramento, San Diego, and San Jose, California. Furthermore, many institutions in these areas also are disclosing significant unfunded commercial real estate and construction commitments. The combined exposure to commercial real estate and construction loans in these areas is noteworthy because it has risen to levels not seen since the commercial real estate downturn in the early 1990s.

In addition to variances in risk exposure between metropolitan areas, profit and problem loan levels at community banks with concentrations in higher-risk real estate assets also differ significantly among the Region's MSAs. Table 1 (next page) lists seven MSAs, most with robust economies, where community banks significantly outperformed the Region. In each of these MSAs, the banks, as a group, reported an ROA exceeding 1.5 percent during the second quarter of 1997, with most well above the 1.3 percent earned by peer banks in the Region. Community banks in Utah's two largest metropolitan areas, Salt Lake City and Provo, lead the Region, with ROAs of 2.6 percent and 2.3 percent, respectively. Two Oregon MSAs also have community banks that, as a group, reported ROAs of more than 2.1 percent. *Such high ROAs may be an indicator that these banks are accepting an above-average level of risk.*

The Region also has several MSAs where community banks are underperforming relative to the Region and the nation. Five of these moderate- to slow-growing MSAs—Napa, Stockton, Riverside, Fresno, and Honolulu—also are highlighted in Table 1. Not only did institutions in these MSAs report ROAs of less than 0.75

CHART 3

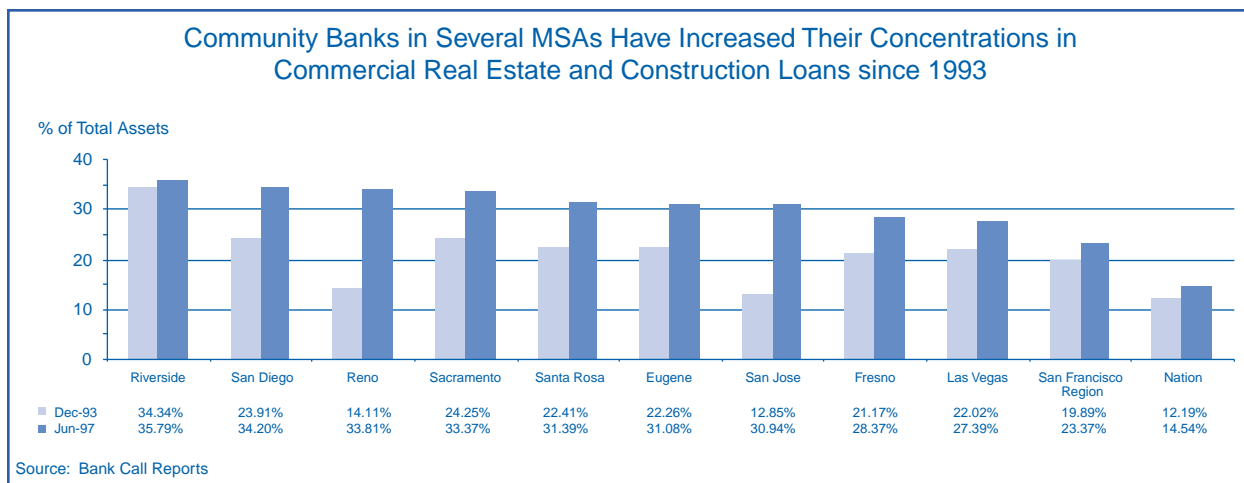


TABLE 1

PERFORMANCE VARIES ACROSS MSAs WITH HIGHER-RISK REAL ESTATE EXPOSURE											
MSAs	MSA ASSETS > \$500 MILLION	% EQUITY		PAST DUE COM'L RE & CONST.	ROA	MSAs	MSA ASSETS > \$500 MILLION	% EQUITY		PAST DUE COM'L RE & CONST.	ROA
		HIGHER-RISK RE	CON-STRUC-TION					HIGHER-RISK RE	CON-STRUC-TION		
	(1)	(2)	(3)	(4)		(1)	(2)	(3)	(4)		
MORE PROFITABLE...						LESS PROFITABLE...					
SALT LAKE, UT	\$3,504	111%	44%	1.7%	2.6%	NAPA, CA	\$1,007	308%	51%	4.6%	0.7%
PROVO, UT	\$656	212%	102%	0.7%	2.3%	STOCKTON, CA	\$2,533	178%	33%	5.0%	0.7%
SALEM, OR	\$605	251%	68%	0.7%	2.1%	RIVERSIDE, CA	\$1,485	444%	70%	2.3%	0.7%
EUGENE, OR	\$821	312%	125%	2.5%	2.1%	HONOLULU, HI	\$2,254	183%	31%	6.5%	0.6%
MONTEREY, CA	\$972	327%	45%	1.1%	1.7%	FRESNO, CA	\$724	316%	115%	5.6%	0.6%
BILLINGS, MT	\$755	173%	16%	2.2%	1.7%	REGION (5)	\$99,723	235%	51%	2.2%	1.3%
PHOENIX, AZ	\$2,933	196%	60%	1.1%	1.5%	NATION (6)	\$984,362	147%	29%	1.9%	1.3%

SOURCE: JUNE 30, 1997, BANK CALL REPORTS

(1) MSAs WHERE COMMUNITY BANK ASSETS (5) IN THE AGGREGATE SUM TO MORE THAN \$500 MILLION, AMOUNTS SHOWN IN MILLIONS.

(2) HIGHER-RISK REAL ESTATE: (CONSTRUCTION + COMMERCIAL REAL ESTATE LOANS + OTHER REAL ESTATE OWNED + REAL ESTATE INVESTMENTS)/EQUITY.

(3) MORE THAN 30 DAYS PAST DUE PLUS NONACCRUAL COMMERCIAL REAL ESTATE AND CONSTRUCTION LOANS AS A PERCENTAGE OF TOTAL COMMERCIAL REAL ESTATE AND CONSTRUCTION LOANS.

(4) ANNUALIZED EARNINGS AS OF JUNE 30, 1997, AS A PERCENTAGE OF AVERAGE ASSETS.

(5) COMMUNITY BANKS ARE DEFINED AS BANKS WITH ASSETS LESS THAN \$1.0 BILLION, EXCLUDING CREDIT CARD BANKS.

(6) COMMUNITY BANKS ARE DEFINED AS BANKS WITH ASSETS LESS THAN \$1.0 BILLION.

percent, typically due to abnormally high provisions for loan losses, but most also had above-average exposure to high-risk assets and higher levels of nonperforming assets relative to both the Region and the nation.

Although profits at most of the Region's banks and thrifts are at record levels and nonperforming assets are declining, changing economic conditions within individual MSAs can adversely affect the performance of an area's insured financial institutions. Table 2 reveals five major markets in the Region where office vacancy rates, a key economic indicator, are trending upward. Table 2 also shows that a total of eight markets continue to have vacancy rates in excess of the national average.

Four of the Region's eight underperforming real estate markets—Riverside, Bakersfield, Los Angeles, and Honolulu—remain well-identified problem commercial real estate markets, with office vacancy rates much higher than the rest of the Region and the nation. In contrast, Fresno and Las Vegas may be considered to pose risks either because of rising vacancy rates or, in the case of Fresno, generally weak economic conditions (see *San Francisco Region's Large Metropolitan Areas Experience a Wide Range of Conditions and Risks*).

In Fresno, where the economy is showing signs of weakness and the construction market has softened, community banks already are recording deterioration in asset quality. For example, *as the Fresno economy has slowed over the last year, the past-due ratio (loans 30 days or more past due plus nonaccrual loans divided by total loans of this type) for construction loans climbed from 5.6 percent in June 1996 to 10.7 percent in June 1997*. In contrast, the comparable ratio for the Region fell to 2.9 percent in June 1997 from 3.2 percent a year earlier.

Although office employment and construction growth in the Las Vegas area remain robust, the area's office vacancy rates have been trending upward since 1994 and are currently 2 percentage points above the national level. Moreover, Chart 4 reveals that, *in spite of the steadily increasing vacancies, Las Vegas-area community banks continue to increase their concentration in commercial real estate and construction loans, which is already well above both the Region's and the nation's peer levels*.

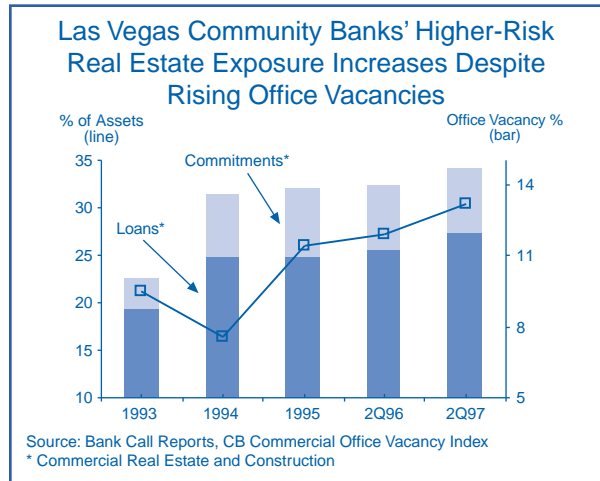
Implications: The Region's MSAs with very high concentrations of lending in construction and commercial real estate may warrant additional monitoring, even

TABLE 2

METROPOLITAN OFFICE VACANCY RATES EDGE UP IN FIVE MSAs					
MSA	VACANCY RATES				
	2Q93	2Q94	2Q95	2Q96	2Q97
RIVERSIDE*	21.3%	20.8%	22.6%	23.5%	24.3%
LOS ANGELES	21.6%	20.3%	19.9%	18.8%	18.0%
BAKERSFIELD	19.1%	15.1%	14.4%	14.1%	17.6%
HONOLULU	9.6%	11.9%	12.7%	15.5%	14.8%
FRESNO	18.0%	17.2%	12.5%	12.3%	14.4%
LAS VEGAS	11.7%	7.2%	8.9%	11.9%	13.2%
ORANGE COUNTY	17.2%	16.7%	15.8%	14.7%	12.9%
SAN DIEGO	21.9%	18.7%	17.7%	15.4%	12.2%
NATION	18.0%	16.3%	14.7%	13.1%	11.2%
SACRAMENTO	17.2%	12.9%	12.7%	9.9%	10.4%
PHOENIX	20.6%	17.7%	13.3%	10.4%	9.7%
TUCSON	21.2%	17.1%	11.4%	11.2%	9.0%
SEATTLE	13.2%	13.1%	10.3%	8.8%	7.5%
SAN FRANCISCO	12.4%	10.0%	9.9%	6.5%	6.7%
PORTLAND	13.1%	9.6%	9.8%	7.8%	5.8%
SALT LAKE	15.1%	8.8%	6.4%	5.5%	5.6%
SAN JOSE	1.3%	1.4%	1.4%	7.7%	2.6%

SOURCE: CB COMMERCIAL OFFICE VACANCY INDEX OF UNITED STATES
* VACANCY RATES FOR 1993 AND 1994 REFLECT YEAR-END RATES

CHART 4



though profitability in many of them remains high. In some of these areas, community banks in the aggregate have more than 30 percent of their assets and 100 percent of equity capital exposed to these higher-risk loan categories, with some individual banks reporting higher exposures. A significant deterioration in real estate markets or construction activity in these MSAs could have a disproportionate impact on their asset quality and profitability. This is particularly true in Las Vegas and Fresno, where some real estate market indicators are already showing signs of deterioration (see *San Francisco Region's Large Metropolitan Areas Experience a Wide Range of Conditions and Risks*).

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