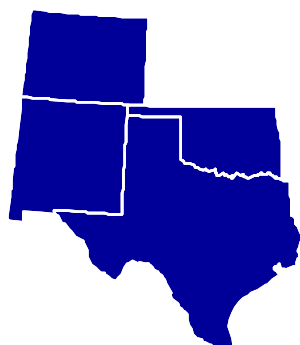

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

SECOND QUARTER 1997

In Focus This Quarter

FDIC DALLAS REGION



■ ***Will Credit Scoring Transform the Market for Small-Business Lending?*** - In an effort to reduce the cost of small-business lending, some institutions are using credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios, in some cases venturing into markets well beyond their local economies. The ramifications could be significant. An overreliance on credit scoring models could expose lenders to increased credit risks. Over time, the traditional niche enjoyed by small banks in small-business lending could come under considerable pressure. *See page 3.*

■ ***Banking on the Internet: New Technologies, New Opportunities, New Risks*** - Internet banking promises a wide range of new benefits. It also offers a host of new problems and some new twists on old ones. The tradeoff is one that depository institutions and regulators alike must grapple with as they stake out their positions in cyberspace. *See page 7.*

DIVISION OF INSURANCE

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- Slower Job Growth
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The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

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Will Credit Scoring Transform the Market for Small-Business Lending?

- **Small-business lending, traditionally a segment in which small banks have enjoyed comparative advantages, is receiving greater focus from larger banks and nonbank financial companies.**
- **Some insured institutions are beginning to re-think traditional approaches to small-business loan underwriting to include the use of credit scoring models.**
- **The use of small-business lending credit scoring models, while providing banks opportunities for underwriting and servicing efficiencies, carries with it a number of potential risks.**

Background

As of 1994, there were more than 22 million small businesses in the U.S., making this a very attractive potential market for lenders.

Small-business lending has been a line of business in which small banks have been very successful given their traditional strong niche in relationship banking. Small-business lending traditionally has been a relatively cost-intensive lending segment, since origination costs are spread over smaller loan balances. Some institutions are now beginning to use credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios. A number of larger banks, especially, appear to be looking to the efficiencies of credit scoring to help provide quick loan approvals and more competitive loan rates. With the aid of this technology, some institutions are rapidly expanding their loan portfolios, in some cases venturing into markets well beyond their local economies.

Commercial bank small-business lending exposures in the Dallas Region are considerable. (For purposes of this article, small-business lending refers to loans categorized as commercial and industrial loans with original amounts of \$1 million or less reported on the June Call Reports.) At mid-year 1996, commercial banks in this Region reported nearly \$17 billion of small-business loans, amounting to 37 percent of all commercial and industrial loans. This is an increase of \$1.1 billion or 7

percent from one year ago. There are 501 banks in the Region with small-business loan exposures exceeding 100 percent of equity, and 113 banks with exposure exceeding 200 percent of equity.

Small banks, those with assets under \$1 billion, have a substantial 65 percent share of the Regions' small-business loans. In fact, almost one-half of all commercial and industrial loans of these institutions were loans less than \$100,000 (see Chart 1 next page). Small banks' market share in this area may come under pressure, however. In **Oklahoma and Texas**, for example, some large banking companies have announced nationwide programs to increase their market share of small-business lending. Several of these companies reportedly are offering pre-approved and pre-qualified credit through the use of credit scoring.



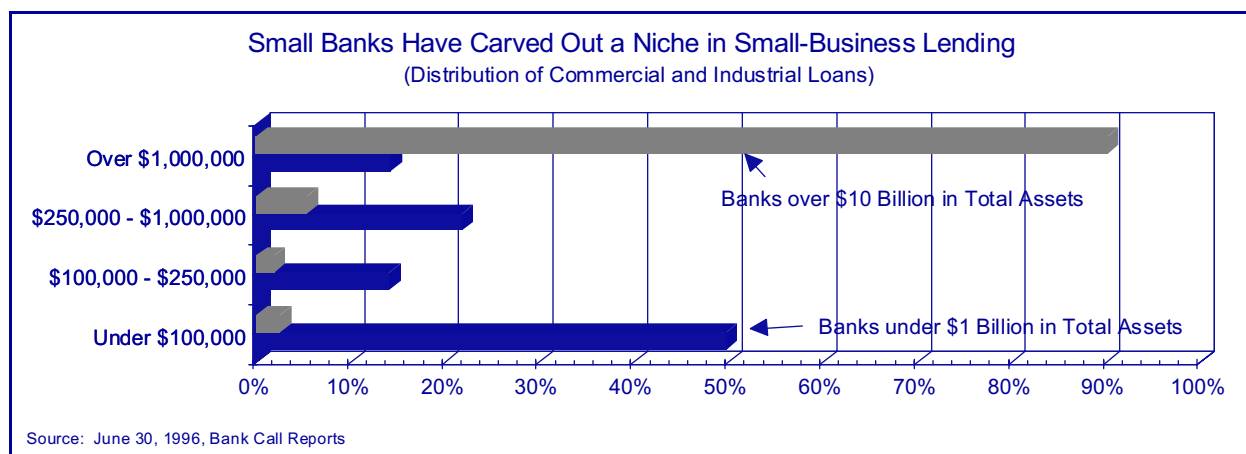
The Growing Importance of Credit Scoring

While credit scoring technology is not new, until recently it typically has been associated with consumer lending, particularly with credit card lending. Primarily using credit bureau information, credit scoring provides lenders with a tool to rank risks or probabilities of default, assigning statistically derived numerical ratings or scores based upon a borrower's past experience with paying debt. Based upon the enormous volume of historical information on consumers contained in credit bureaus, model developers link incidences of good and bad credit performance with borrower characteristics. Applicants then are compared to these credit performance indicators in order to make credit extension decisions. While credit scoring has helped consumer lenders reduce origination costs and to grow receivables at rapid rates, the recent rise in credit card charge-offs has raised concerns about the effectiveness of such models, or at least about how the models are being used.



Small-business credit scoring is a relatively new concept in scoring technology, but is gaining more attention from lenders. *Small-business credit scoring models are similar to consumer credit scoring models in one significant aspect -- the most important indicator of*

CHART 1



credit performance is the credit profile of the principals of the business derived from consumer credit bureau information. Other business information from companies such as Dun and Bradstreet Corporation and Experian (formerly TRW) also is used in the scoring process.

A primary vendor of these scoring models has cited analysis purporting to show that business financial statement information did not prove a useful indicator of credit performance for small-business loans. The reasons for this result may be due to inconsistency in financial statement quality and the difficulty in separating business entity cashflow information from the business owners' activities. Also, the relative importance of principals' credit history and financial statement information in predicting credit performance was found to change somewhat with the size of the business -- the larger the business the more important financial statements become in assessing performance.

Many institutions cite the potential cost savings involved in the underwriting process as one of the most significant characteristics of credit scoring. In many cases, with scoring technology, loan application processes have been streamlined to one page forms for loans up to \$50,000, not dissimilar to that of consumer loan applications. In some cases, financial statements are not required at all. Reducing paperwork helps to reduce both processing time and costs. Table 1 illustrates how scoring has changed underwriting practices, as reported by one large bank at a recent conference on credit scoring. While it is impossible to know whether the information presented in Table 1 is representative of the way most institutions are using credit scoring models, it is clear that credit scoring may represent a

significant departure from traditional underwriting methods.

Part of the reduction in underwriting costs may come from improvements in the allocation of underwriting resources. It has been argued that credit scoring allows banks to more easily identify those applicants which are clearly either approvals or denials. This process would enable banks to reallocate their underwriting resources more efficiently to those loans which pose intermediate risks and require closer attention. Other advantages of credit scoring systems that often are cited are greater consistency in underwriting, better measures for pricing strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

TABLE 1

SMALL-BUSINESS LENDING: CREDIT SCORING VERSUS TRADITIONAL LOAN UNDERWRITING			
	1993	1996	1997
PERCENT OF LOANS REQUIRING ANNUAL FINANCIAL STATEMENTS	100%	20%	--
PERCENT OF LINES REVIEWED ANNUALLY	100%	0 - 5%	--
PROCESSING TIME FOR LOANS OF \$50,000 - \$250,000	3 DAYS	1 DAY	1 HOUR
SOURCE: REPORTED BY A LARGE BANK AT A RECENT CONFERENCE ON CREDIT SCORING.			

Small-business lending has historically been a profitable area of bank lending. This situation is most likely attributable to lenders thoroughly analyzing potential customers, persistently monitoring their performance, and building solid lending relationships. Credit scoring for small-business lending raises the possibility that some banks will forgo the traditional underwriting concepts of relationship lending in favor of a more mass-marketing approach, in a manner similar to credit card lending. To the extent that credit scoring is used to rapidly gain new customers by either targeting out-of-territory customers, or customers with less business experience, the risk profile of an institution's small-business lending portfolio may change. Any such change in profile may be significant due to the risks associated with newer borrowers. For example, new firms tend to fail at an extremely high rate, with 53 percent of new businesses failing within the first four years of inception (see Chart 2). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

There are potential dangers associated with placing undue reliance on credit scoring models. *The predictive value of any credit scoring system may be substantially diminished if the model is used for unintended purposes or customer types.* Therefore, misuse of a scoring system could expose an institution to considerable losses. Since only the largest banks have small-business loan portfolios large enough to create statistically valid scoring models customized for their own customer base, smaller companies should be especially aware of potential misuse. This risk takes on added meaning when one considers that a \$1 million small-business loan represents substantially more capital to a \$100 million bank than to a \$10 billion bank. Adding further uncertainty, small-business credit scoring has been implemented during a period of relatively strong performance by businesses, with commercial and industrial loan delinquency ratios near historical lows. How well these models perform during an economic downturn remains to be seen.

Depending on the manner in which it is implemented, credit scoring for small-business lending may represent a fundamental shift in underwriting philosophy -- *viewing a small-business loan as more of a high-end consumer loan and, thus, granting credit more on the strength of the principals' personal credit history and less on the financial strength of the business itself.* While this may be appropriate in some cases, it is

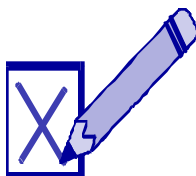
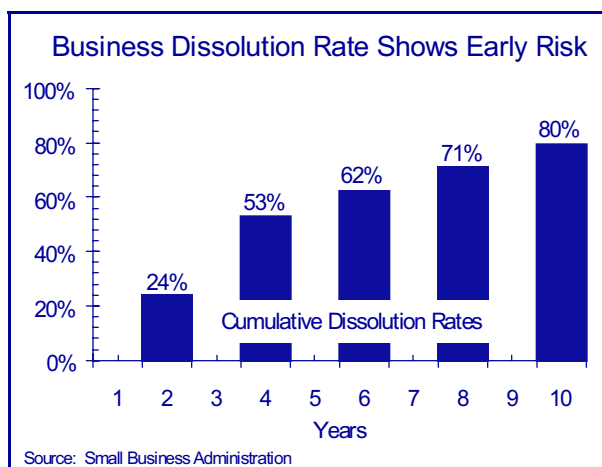


CHART 2



important to remember that the income from small businesses remains the primary source of repayment of most loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

Competitive pressures in small-business lending are increasing not only because of large banks' efforts to expand their lending but also because of greater participation in the market by nonbank financial companies. Several large firms, such as American Express, AT&T, the Money Store, and GE Capital Services, are expanding their business lines to service the needs of small businesses. These companies are offering small-business credit cards, innovative new types of credit, and other services such as consulting, accounting and investment services. Some observers have suggested that the cost advantages of credit scoring may cause small-business lending in the future to be dominated by 12 to 15 large banks or financial firms. Faced with stiff competition, there may be strong motivation for some banks to increase the dollar threshold on low documentation loans, streamline the process for larger loans, or lower credit scoring thresholds for loan approvals.

The most recent *FDIC Survey of Underwriting Practices* and the *Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices* both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth goals were seen as the main reasons for easing in these cases. With regard to small-business credit scoring techniques, the Federal Reserve survey pointed out that banks were most commonly using credit scores for automatic accep-

tance or rejection of loans up to \$50,000.

Summary

Credit scoring has the potential to transform the market for small-business lending. The traditional niche enjoyed by small banks in this area may come under tremendous pressure from larger banks and nonbank companies employing this new technology. Credit scoring at a number of institutions is driving dramatic changes in underwriting methods for small-business lending. These changes may facilitate short-term revenue generation as business can be expanded rapidly and underwriting costs can be slashed. It is extremely important, however, that banks understand and control the potential risks inherent in such a strategy. The application of credit scoring to small-business lending merits the close attention of both bankers and their supervisors.

Andrea W. Bazemore, Banking Analyst

Banking on the Internet

New Technologies, New Opportunities, New Risks

- Despite the potential for lower transaction costs, increased efficiency, and greater asset diversification, few banks do business through the Internet.
- Although competitive risks are pushing banks to create an Internet presence, operational risks remain an obstacle to actually using those sites for moving information or money.
- The FDIC's Division of Supervision recently released examiner guidance on Internet banking and is developing training programs for its examiners.

The Allure of Cyberbanking

On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking*, is of particular interest to banks because it exploits an existing and geographically extensive public network infrastructure and promises a range of new operating and marketing benefits. One such benefit is the ability for an institution to expand its trade area to include other cities, states, regions -- or even countries -- without a commensurate expansion of its branch structure. This greater geographic reach can

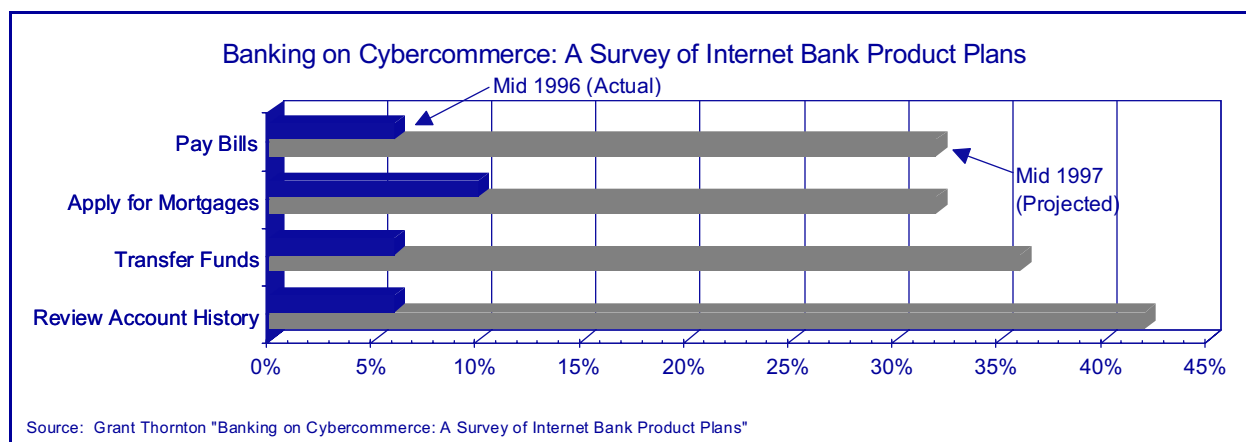


do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. A March 1996, study by *Booz, Allen & Hamilton Inc.* estimated an average Internet transaction cost of \$0.01 compared to \$0.27 for an ATM, \$0.54 for a telephone, and \$1.07 for a full-service branch.

Slow Migration to the Future

Another 1996 study, this one by *Grant Thornton* in July (see Chart 1), found that despite these potential benefits, most banks established an Internet presence for appearance's sake -- being perceived as a leader, advertising bank services or staying abreast of competitors -- rather than with an intent to grow deposits or capture the transaction economies that cyberbanking could provide. Of the 44 Internet institutions surveyed, only one in three expressed intentions to begin offering bill payment or funds transfer over the Internet by the end of the second quarter of this year. Even this subdued enthusiasm now appears optimistic. Despite the perceived benefits and the scarcity of competition, few banks have to date ventured into this area in a meaningful way. According to the *Bankweb* world-wide web site, only 800 or so banks -- less than 1 percent of the industry -- have an Internet site and only 18 of those permit transactions. In the Dallas Region, 104 institutions have an Internet presence but only two allow customers to pay bills or

CHART 1



transfer funds. A major question, then, is why so few institutions have chosen to exploit this medium?

Risk

The reason is risk. Banks are familiar with the control of exposures found in proprietary or private payment channels, but they are less comfortable with the new risks attendant to a public network. On one hand, there are *operational* exposures that convincingly argue against rushing headlong into cyberspace. On the other hand, there are *competitive* risks. Nonbank competitors with strong foundations in cybertechnology pose a budding threat to the banks' historical payment-services monopoly and argue with equal authority for an immediate Internet presence to gain or preserve market share. These opposing forces help explain the large numbers of banks establishing web sites that stop short of actually moving information or money.

Of these two types, operational risks are the most immediate and command the most attention. They derive from the formative state of both the technology supporting on-line commerce, and the legal and regulatory structure governing its use. These risks include theft or misappropriation of internal data or external transmissions, transaction fraud, errors in underwriting virtual transactions, liquidity shortfalls, changing technical standards, inadequate or geographically inconsistent regulatory and legal infrastructure, noncompliance with existing laws or regulations that were not designed for an on-line world, and damage to an institution's reputation from the realization of any or all of these risks (see *Some Concerns or the CyberBanker*, right).

Systemic Threats and a New Payments Model

In addition to bank-specific risks there are the systemic threats that a public domain payments model could bring. One of the key features of the Internet is redundancy. Any one of a large number of possible paths can be used for a given transaction and therefore the failure of any one path or node will not affect the functionality of the network as a whole. This feature presents a multitude of new and -- from a banker's perspective -- previously unconsidered points of vulnerability to technologically-sophisticated miscreants. In a cyber-world of small value transactions, the effects of an attack may not be much more severe than those which accompany credit card crime. However, there is good reason to expect that Internet transaction sizes will continue to grow. According to one software vendor,

Some Concerns or the CyberBanker

Internal Data Security. The Internet cannot distinguish between customers and criminals. Invasive attacks can range from simple vandalism to theft or destruction of proprietary operating or customer data. Firewall software, data encryption, specialized hardware configurations and commercial insurance can limit such exposures.

External Transmission Security. Because the Internet is an open network, transaction messages are completely exposed, rendering them vulnerable to theft or tampering. Message encryption is a common response, but hardware implementation flaws can circumvent it. This threat will increase greatly if large value or interbank transactions migrate to the Internet.

Transaction Fraud. Fraud takes two forms: misrepresentation during a transaction or repudiation following it. This problem takes new dimensions in cyberspace because no physical relationship with a customer exists. Encryption protocols which include digital signatures are one response. Biometric authentication schemes, the most commonly proposed being fingerprint or retinal verification, are another.

Difficulties with Virtual Underwriting. Even if your cyber-borrowers are who they claim to be, there remain difficulties in establishing their creditworthiness. The lack of a personal relationship is one factor. The limited knowledge of local employers and credit grantors that appear on applications is another. Such difficulties could hasten and heighten dependency upon credit scoring models.

Liquidity Risks. Internet transaction volume and velocity are expected to increase rapidly, potentially creating transactions which occur so rapidly as to exceed immediate bank liquidity. Denial of service attacks, where a site is intentionally deluged with transactions in order to shut it down, also can affect liquidity if affected customers decide to close their accounts.

Lack of Technical Standards. An institution building an early presence on the Internet is making a financial bet as to which standards will endure.

Lack of Regulatory and Legal Infrastructure. Regulators are waiting and observing. Future promulgated "best practices" may not be those which an institution has already adopted. Similarly, a lack of legal precedent hinders criminal and civil prosecution of cybercriminals. Even where precedent exists, it is frequently inconsistent across jurisdictions.

Reputation Risk. An image of solidity is a cornerstone of banking. Internet banking confronts banks with more exposure and potentially greater publicity about losses.

Competitive Risks. Unlike the operational risks discussed above, competitive risks accrue to institutions not securing an Internet foothold. They involve the threat of lost market share or payment system position to more aggressive peers and nonbank competitors.

interbranch payments on the Internet are likely to begin in 1997 with interbank activity to follow a year or so later. This development would be a significant evolution because wholesale transactions are generally large relative to bank liquidity. An attack or disruption of the Internet payments mechanism for a single large transaction could conceivably pass liquidity shocks to other banks in the same way that bad weather at a major airport can disrupt air traffic throughout the country.

New Technologies, Old Reporting

The advent of fully transactional web sites also could heat up bank competition for low cost deposits and frustrate regulatory oversight in the process. One possibility is a "deposit arbitrageur," a hybrid of brokered deposits and program trading in which a computer program could search the Internet for the highest deposit rates and immediately reallocate deposits accordingly. In the long run, such activities could harmonize local interest rates. In the short run, however, this rapid turnover could mean substantial liquidity drains on institutions accustomed to local deposit monopolies. From the regulatory perspective, this transaction velocity -- and its potential to rapidly alter bank balance sheets -- could present new challenges in a world of quarterly Call Reports and examination intervals that can exceed one year.

FDIC -- the CyberRegulator

New risks demand new supervision techniques and the FDIC's Division of Supervision (DOS) has responded with their recently-released electronic banking safety and soundness examination guidance. Under that guidance, institutions having Internet sites are placed into

one of three tiers based upon the "maturity" of their site. Safety and soundness examination procedures focus on bank policies, procedures and planning. The examination procedures are cumulative -- meaning that each successive tier adds an additional level of scrutiny to the tiers below -- and do not require a technical knowledge of Internet systems. "Information Specialist" involvement also varies by tier (see Table 1). A DOS training program for all safety and soundness examiners already has begun, and technical training for information systems specialists is being developed. A new specialty, the electronic banking Subject Matter Expert, also is being established.

Measured Steps in a New Environment

Banks increasingly are becoming distributors of commodity-like products. As such, profitability may become dependent upon both cost efficiencies and high volume -- a combination sometimes argued as inconsistent with high-cost branch structures. Internet banking offers institutions a means to compete in this new environment. It also offers new risks. Recognizing this tradeoff, many banks have entered this realm with measured steps. Those who have not face risk of a different sort. They face instead the risk that their competitive position will pass to more innovative competitors -- competitors with new technologies and the drive to accomplish old business in thoroughly new ways.

Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

TABLE 1

THE DIVISION OF SUPERVISION CLASSIFICATIONS FOR INTERNET BANKS			
	<i>LEVEL 1</i>	<i>LEVEL 2</i>	<i>LEVEL 3</i>
DESCRIPTION	AN INFORMATION-ONLY SITE	A SITE PERMITTING ELECTRONIC SUBMISSION OF LOAN OR DEPOSIT APPLICATIONS	TRANSACTIONAL SITE OFFERING ELECTRONIC BILL PAYMENT OR FUNDS TRANSFER SERVICES
SPECIALIST EXAMINATION REQUIREMENT (IN ADDITION TO SAFETY AND SOUNDNESS EXAM)	INFORMATION SPECIALIST REVIEW REQUIRED ONLY IF SITE IS TIED INTO INTERNAL BANK SYSTEMS.	CONSULTATION WITH INFORMATION SPECIALIST REQUIRED TO DETERMINE IF FURTHER REVIEW IS WARRANTED.	CONCURRENT INFORMATION SPECIALIST EXAMINATION REQUIRED.

For More Information:

Division of Supervision

DOS currently is implementing examination guidance for safety and soundness examiners and developing training for technical specialists.

*Cynthia Bonnette, Examiner
Chairman, New Banking Technologies Task Force
(202) 898-6583*

*Stephen White, Information Systems Review Examiner
Chairman, Information Systems Subcommittee
Federal Financial Institutions Examination Council Task Force on Supervision
(202) 898-6923*

Division of Compliance and Consumer Affairs

DCA is reviewing new banking technologies from a consumer protection, fair lending and CRA perspective to provide guidance on compliance matters. DCA also is coordinating outreach efforts with consumer community groups.

*John Jackwood, Special Assistant to the Director
(202) 942-3854*

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Dallas Regional Office
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Office of Policy Development

OPD provides leadership in developing FDIC policies, including those addressing new banking technologies. The office coordinates several interdivisional electronic banking efforts and represents the FDIC on the interagency U. S. Treasury Consumer Electronic Payments Task Force.

*Sharon Powers Sivertsen, Director
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Related Web Sites

FDIC	http://www.fdic.gov
FFIEC	http://www.ffiec.gov
NETBanker	http://www.netbanker.com
Bankweb	http://www.bankweb.com
National Computer Security Assoc.	http://www.ncsa.com
RSA Data Security Inc.	http://www.rsa.com
Smart Card Resource Center	http://www.smart-card.com
American Bankers Association	http://www.aba.com

High-Technology Exports Power Region's Economy

- Economic growth in the Dallas Region was moderate in 1996.
- The Region's exports totaled approximately \$61 billion in 1996, or about 10 percent of all U.S. export sales to the world.
- A slower growing Denver economy should cool off that metropolitan area's rapid construction pace, requiring lenders to carefully scrutinize future commercial real estate loans.

Employment Trends: Signs of a Slowdown?

The Dallas Region's economy continued slowing in 1996. Chart 1 shows that, after peaking in early 1995, nonfarm employment growth has gradually decelerated. Year-over-year growth of 2.8 percent in 1996 was the Region's slowest in four years. Table 1 suggests that the slowing in the Region's economic activity has been broad based. Most major industry sectors recorded slower job growth in 1996 compared to 1995.

Reasons for the Slowing

The following factors contributed to slower employment growth in the Region last year.

Tight labor markets. The number of entrants into the labor force has dropped dramatically over the past two years in Colorado and Texas -- states which accounted for 83 percent of the Region's total labor force in 1996. Colorado and Texas saw labor force growth decelerate from 5.2 percent and 2.5 percent, respectively, in 1994, to 1.4 percent and 1.6 percent in 1996. Previously, slow growth in other parts of the country, particularly

California, resulted in migration into the Region. However, in-migration has slowed because both the California and the Mexican economies are growing. A tight labor supply has contributed to low unemployment rates; both Texas and Colorado are enjoying some of the lowest unemployment rates in 20 years.

Corporate restructuring. Competitive pressures and brisk merger and acquisition activity have resulted in layoffs and downsizing across a broad range of industries, including health care, energy, and transportation.

Rising costs. Although the Dallas Region continues to enjoy a cost advantage in labor, housing, and commercial space relative to neighboring states, the cost differential has narrowed recently as a result of the Region's

CHART 1

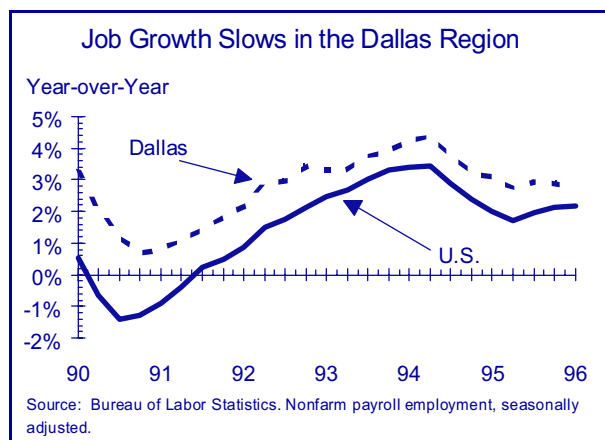


TABLE 1

THE SLOWDOWN IN JOB GROWTH WAS BROAD BASED		
	1995	1996
PRIVATE NONFARM EMPLOYMENT	4.0%	3.2%
GOODS PRODUCING	2.4%	2.8%
CONSTRUCTION	6.5%	6.0%
MANUFACTURING	1.9%	2.0%
SERVICES PRODUCING	3.9%	2.8%
TRANSPORTATION AND PUBLIC UTILITIES	4.4%	2.7%
TRADE	3.8%	2.2%
FINANCE, INSURANCE AND REAL ESTATE	0.4%	2.3%
SERVICES	6.0%	4.7%
GOVERNMENT	1.8%	0.9%

SOURCE: BUREAU OF LABOR STATISTICS, PAYROLL EMPLOYMENT SERIES

strong economic expansion over the past five years. As noted in the *Dallas Federal Reserve's* January/February 1997 publication entitled the *Southwest Economy*, Texas' cost differential with the nation is slowly narrowing. Meanwhile, the *Colorado Legislative Council (CLC)* cited that increasing costs are eroding the competitive advantage Colorado enjoyed in the early 1990s. The result may be fewer corporate relocations and expansions as compared to previous years.

Exports Are a Key Factor in the Region's Robust Growth

International trade is becoming a critical component of the Region's economy and explains, in large, part why the Dallas Region has enjoyed robust employment growth in recent years. Businesses from the Dallas Region are estimated to have shipped nearly \$61 billion of merchandise to foreign countries in 1996, or almost 10 percent of all U.S. export sales. Between 1993 and 1995, U.S. export sales grew 25 percent, compared to 30 percent for the Region.

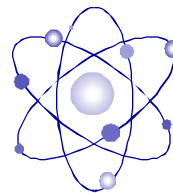


A large portion of the Region's exports are shipped to Mexico. Mexico was the destination for nearly one-quarter of the Region's exports in 1995 (see Chart 2). In comparison, exports to Mexico from outside the Dallas Region amounted to only 6 percent of total U.S. exports.

High-Technology Exports Lead the Way

The acceleration of exports from the Region in recent

years has been due, in part, to the Region's strong base of high-technology industries. The Region's comparatively low costs, its supply of highly educated labor, and its rapidly growing markets have made it a choice site for biotechnology and high-technology firms. *Because of its considerable base of high-technology industries, the Dallas Region has benefited disproportionately from the recent gains in world trade.*



"High-technology industries" can be defined in various ways, such as by a certain threshold percentage of technical workers or the dollar amount of spending devoted to research and development. For this article, high-technology industries will be defined simply as those industries within the standard industrial classifications of electronics and other electrical equipment, industrial machinery and computers, and scientific and measuring instruments.

In 1995, these three industries accounted for slightly more than \$30 billion in export sales, or about 53 percent of all exports from the Dallas Region. In comparison, exports from these same industries -- excluding the Dallas Region -- accounted for only 37 percent of total U.S. export sales (see Table 2).

Contributing to the burgeoning growth in high-technology exports have been the following factors:

Increased global trading The reduction of trade barriers and the promotion of world trade through agreements such as the North American Free Trade Agreement and General Agreement on Tariffs and Trade

CHART 2

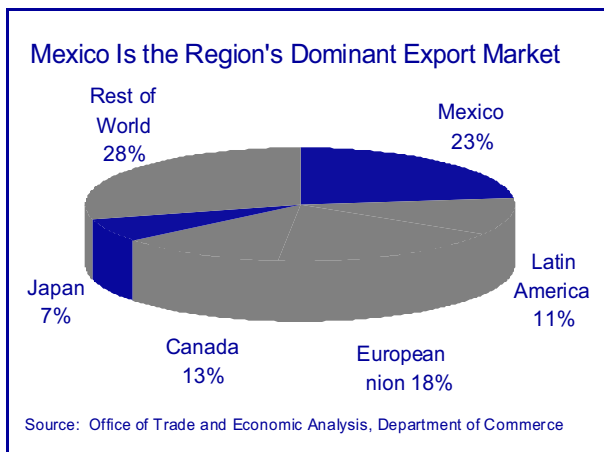


TABLE 2

LEADING EXPORTS FROM THE U.S. AND THE REGION BY INDUSTRY SHARES - 1995		
	U.S.	REGION
INDUSTRIAL MACHINERY AND COMPUTERS	16.7%	27.3%
ELECTRONICS AND OTHER ELECTRICAL EQUIPMENT	14.9%	21.1%
SCIENTIFIC AND MEASURING INSTRUMENTS	5.5%	4.4%
TOTAL	37.1%	52.8%
SOURCE: U.S. CENSUS BUREAU		

have led to greater trading between nations.

The spread of free market reform. The growing introduction of market-based economies to formerly communist nations and the industrialization of China's economy have contributed to these nations' increasing appetites for U.S. goods.

The privatization of Latin American economies. The privatization of formerly government-owned enterprises in Argentina, Brazil, Chile, and Mexico has opened the door for an influx of U.S. capital goods.

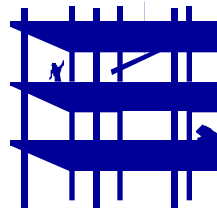
A rebounding Mexican economy. In 1996, Mexico, the Region's largest trading partner, had its best year of economic growth since 1990, with growth in gross domestic product (GDP) of 5.1 percent. A stronger Mexican economy usually translates into greater export growth from the Dallas Region. Several economists who follow the Mexican economy expect GDP growth of between 4.5 percent to 5.5 percent in 1997.

These factors have combined to produce a surge in high-technology exports from this Region. Industrial machinery and computer exports grew by 30 percent between 1993 and 1995. Exports of electric and electronic equipment grew by more than one-half over the same period. There is little doubt that high-technology exports have helped stimulate the Region's economy. Nonetheless, from the standpoint of lenders, increased dependence on high-technology exports could make the Region more susceptible to volatility in the high-technology sector, fluctuating exchange rates, and the economic problems of its major trading partners.

Construction in Denver Remained Strong in 1996...

According to the *Colorado Legislative Council's* De-

cember 1996 forecast, the state had more nonresidential building activity underway by year-end 1996 (as measured by inflation-adjusted value and square footage) than at any time during the last decade. This activity came on the heels of substantial growth in past years. Since 1991, the amount of retail, office and industrial square feet constructed in the state was 24.5 million, 11.6 million, and 7.5 million, respectively. A tremendous amount of this construction activity occurred in the Denver metropolitan area.



Although local real estate experts believe construction activity in Denver may have reached a peak in 1996, they also believe there is a sufficient number of projects in the pipeline to sustain a high level of new construction in 1997.

Denver's office vacancy rates are generally low, and the demand for office space, particularly in suburban markets, remains strong. Office employment growth is still occurring, especially in the financial sector. Industrial vacancy rates also are very low, and are the result of strong demand for industrial space caused by the influx and expansion of high-technology industries, particularly firms that are export oriented.

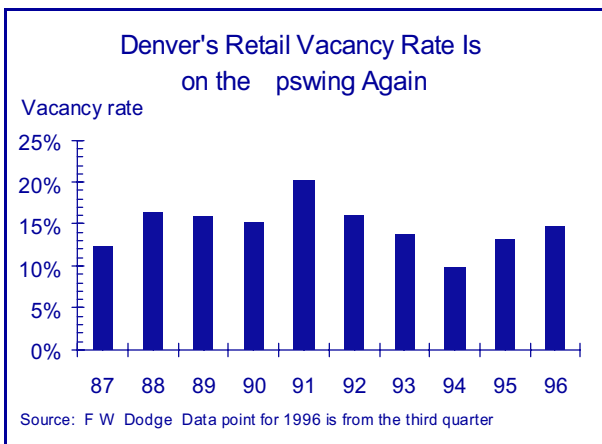
...but the Retail and Apartment Markets Bear Watching in 1997.

The Colorado Legislative Council, in its March 1997 publication, singled out the retail and upscale apartment (monthly rents over \$800) markets as two candidates likely to achieve overbuilt status sometime in 1997. Denver has a high retail vacancy rate (almost 15 percent in the third quarter of 1996 according to *F.W. Dodge*) that continues to rise.

Consumers were cited as unlikely to spend as much this year in the face of slower job and income growth, rising debt levels, and the alleviation of earlier pent-up demand. Moreover, the shake out among "Big Box" retailers could put more retail space onto the market, lessening the demand for retail projects currently in the pipeline. Examples of retailers who have closed stores recently in the Denver area are Media Play, Home Express and Incredible Universe.

The apartment market (5 units or more) in Denver saw a surge in construction activity during the period 1994 to 1996. Over twice as many multifamily permits were filed in the past three years (16,275) as in the previous six years (7,973). However, the level of in-migration is

CHART 3



predicted to taper off slightly and job growth is expected to slow, which may have an effect on the demand for multifamily housing.

Implications for Banks. Denver's economy enjoyed another strong year of economic growth enabling the area to absorb the amount of new space coming on-line in most categories of construction in 1996. However, real estate foreclosures rose nearly 15 percent in the metropolitan Denver area last year, the first increase in 8 years, and bankruptcies in Colorado rose 20 percent in 1996. Area forecasters also are calling for a moderation of job growth in 1997. Therefore, lenders may need to adjust their loan underwriting standards to reflect the possibility that economic growth in the Denver area may fail to keep pace with the growth recorded in recent years. In this regard, the retail and multifamily sectors may merit special attention.

Adrian Rangel Sanchez, Regional Economist

Financial Markets

- While demand for asset-backed securities continues to be strong, further deterioration in consumer credit quality could have adverse effects on both investors and issuers.
- Although there has been little net change in the Treasury yield curve between September 30, 1996, and early March 1997, rates in the 5-year to 30-year segment of the yield curve did fluctuate modestly during this time period.
- During the fourth quarter 1996, the S&P Composite Bank Index and the Dallas Region's Bank Index both outperformed the S&P 500, gaining 12 percent and 17 percent, respectively, compared to an almost 8 percent gain for the S&P 500.
- Banks' price/earnings ratios relative to the broader market have been trending upward since 1994, perhaps signaling an improved perception of the quality of bank earnings.

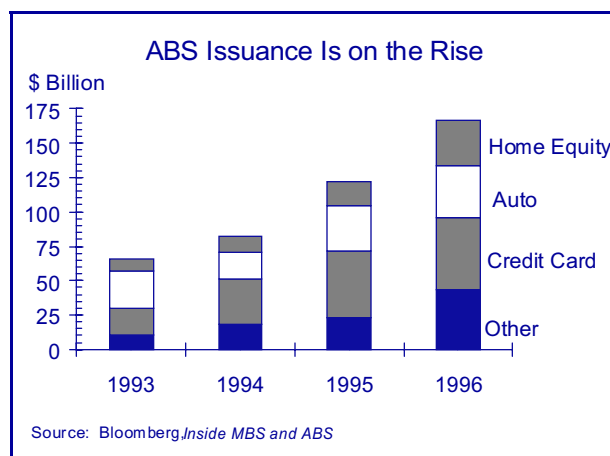
The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

Asset-backed securities (ABS) are debt securities that are backed by loans such as credit cards, car loans, and home equity loans. Over the past ten years, the ABS market has grown dramatically. In 1996, the issuance of ABS was \$167 billion, up from \$65 billion issued in 1993 as illustrated in Chart 1. Commercial banks and credit card companies accounted for approximately 35 percent of total ABS issuance last year. Major buyers of ABS were mutual funds, insurance companies, corporations, and foreign and domestic banks. Although it is difficult to quantify the amount of bank investment in the ABS market, market participants have observed that small and mid-sized banks have recently increased their holdings of ABS.

Monoline credit card banks and large banks with significant credit card operations have been particularly active ABS issuers. Issuing banks generally structure ABS transactions as nonrecourse sales (loans that cannot be "put back" to issuers upon default), which results in the removal of the assets from the bank's balance sheet and lowers capital requirements. In order to receive investment grade ratings on their ABS, issuers must provide credit support either in the form of over-collateralization, reserve accounts, or third party credit enhancement from bond insurers.

Bank issuers benefit from the sales treatment of assets into the security without completely severing their economic interest in the income generated by the assets. The economic interest results when the revenue generated by the sold assets after charge-offs, servicing fees,

CHART 1



and interest coupon payment is recognized as income by the issuer. This surplus is referred to as excess spread. Banks that issue ABS usually continue to service the underlying assets, which not only generates servicing income but also permits customer relationships to continue.

Delinquency and charge-off rates rose in 1996 on consumer loans, particularly in credit cards and auto loans. Despite this rise, the difference between ABS and Treasury yields of similar maturity did not increase. As Chart 2 (next page) shows, the average spread to the two-year Treasury note on selected ABS products continued to tighten during 1996. The lack of widening spreads despite the overall weakening in consumer credit quality reflects strong demand from an expanding investor base, which increasingly includes overseas

buyers. Spreads on selected credit card and auto ABS products began to increase during the first quarter of 1997, however, as investors reacted to higher than expected charge-offs reported by some of the larger issuers.

The increasing frequency of rating agencies' reviews for possible downgrades of credit card transactions, as well as problems in the auto finance sector, have raised some concerns in the ABS market. How would a further deterioration in consumer credit affect the ABS market? For the issuer, higher charge-offs, absent a corresponding increase in fees or rates, reduces the excess spread from the ABS. If deterioration worsens, the ABS face potential rating downgrades. This situation may compel the issuer to improve the overall loan quality in the ABS or face what is termed an "early amortization" event. An early amortization event may result in the termination of the ABS issue prior to the maturity date. Once an early amortization occurs, new receivables associated with the accounts in the asset-backed security no longer move into the security but must be funded by the bank on their balance sheet and accounted for in determining capital requirements. In addition, an issuer's access to the ABS market may become more costly after an early amortization if investors demand higher yields on subsequent issues.

For the investor, the threat of a ratings downgrade usually impairs the market value of the security. Investors also may forfeit some interest income in an early amortization because principal may be paid prior to the scheduled maturity date. ABS investors would lose principal, however, only if the deterioration in the quality of the underlying loans is severe enough to deplete the entire credit support. The high level of credit support demanded by rating agencies on existing

ABS deals minimizes the risk of principal loss by investors.

During 1996, some bankcard issuers took steps to prevent a ratings downgrade or a possible early amortization. Methods used by bank issuers to support deteriorating ABS have included the sale of new receivables at a discount, the repurchase of low quality receivables from the issue, and the infusion of additional cash into a reserve account of the ABS. However these strategies were specifically cited by the Office of the Comptroller of the Currency (OCC) as actions that could be considered recourse and require full risk-based capital treatment for the assets in the particular ABS issue. The FDIC is working with other regulatory agencies through the Federal Financial Institutions Examination Council (FFIEC) on new Risk-Based Capital Guidelines that are expected to address limitations on post-sale actions and capital requirements for direct credit substitutes or credit enhancements for ABS.

Given the continuing trend of higher charge-offs and delinquencies for credit card loans, investors consider the ABS market less homogeneous in terms of issuer quality and therefore are scrutinizing the securitizations of issuers more closely. Although the risks vary by ABS issuer, banks that issue or invest in the ABS market should be cognizant of the changing market conditions and potential risks associated with ABS.

Changes in Interest Rates and Bond Values

Chart 3 (next page) shows little change in the Treasury yield curve between September 30, 1996, and early March 1997. What this chart does not show, however, is how rates in the 5-year to 30-year segment of the yield

CHART 2

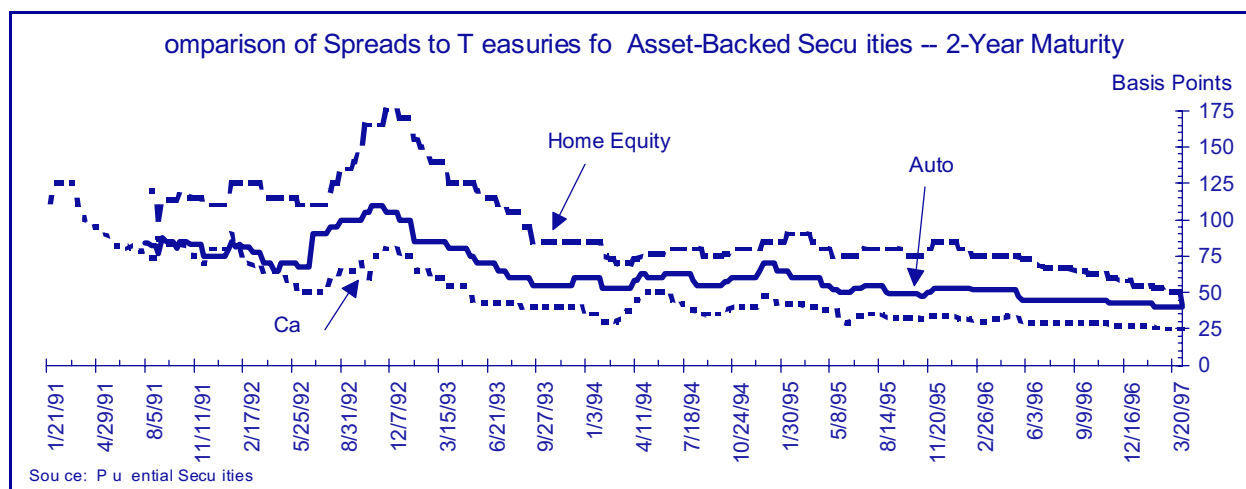
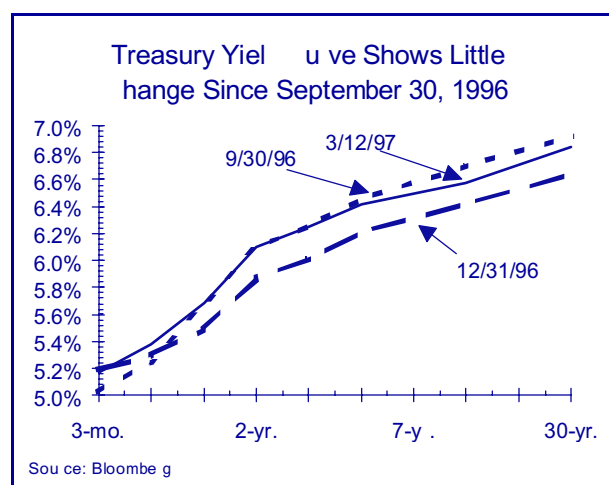


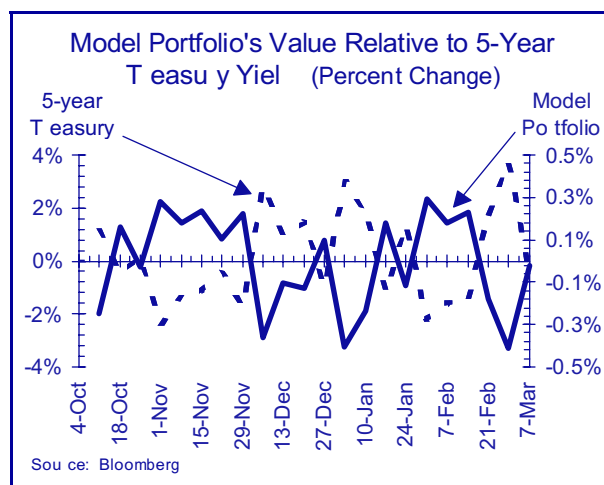
CHART 3



curve fluctuated during this time period. The path of yields on Treasury bonds with 5-year through 30-year maturities changed directions four times, rising or falling by more than 30 basis points. Movements in the shorter segment of the yield curve have been less pronounced.

In order to consider the effect that these rate swings may have had on banks' fixed income portfolios, Chart 4 shows the percent change in the yield on the 5-year Treasury and the percent change in the market value of a model bank portfolio created by the Division of Insurance. The presentation of this model portfolio extends an analysis that was introduced in the first quarter 1997 edition of the *Regional Outlook*, which looked at the market values of several common fixed income instruments relative to interest rate movements.

CHART 4



In order to enhance the model portfolio's applicability to bank portfolios, the type and amount of the securities chosen for the portfolio are based on an aggregation of securities-related Call Report data. The limitations of Call Report data concerning the maturity distribution of securities required that assumptions be made when choosing the maturity of the securities for the model portfolio. An effort was made, however, to construct a model portfolio that approximates, in the aggregate, the maturity distribution of the aggregate commercial bank portfolio. The model portfolio is shown in Table 1.

As shown in Table 1, the total market value of the portfolio changed less than one-half of 1 percent since September 30, 1996. The portfolio's period-high value, representing a 1.51 percent increase from September 30, 1996, occurred on November 29, 1996, when the 5-year

TABLE 1

TYPE OF SECURITY	PAR VALUE	PERCENT OF PORTFOLIO	MATURITY OR WAL	PERCENT CHANGE FROM 9/30/96 TO 12/31/96	PERCENT CHANGE FROM 12/31/96 TO 3/12/97	PERCENT CHANGE FROM 9/30/96 TO 3/12/97
U.S. TREASURY 5.6%	2,000	20%	1YR	0.35%	-0.05%	0.30%
FNMA AGENCY 5.8% CALLABLE	1,200	12%	2YR	0.59%	-0.25%	0.34%
STATE COUNTY MUNICIPAL GO 4.8%	800	8%	11YR	1.95%	-0.64%	1.95%
FNMA MORTGAGE PASSTHROUGH 7.5%	3,000	30%	8YR	1.08%	-0.30%	0.78%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5YR	0.58%	-0.68%	-0.10%
CREDIT CARD ASSET-BACKED SECURITY	1,000	10%	5YR	0.10%	0.00%	0.10%
TOTAL	10,000	100%	4.85YR	0.77%	-0.29%	0.48%

Treasury rate fell to its period-low of 5.83 percent. Observe that, while longer term rates fluctuated modestly over the reporting period, the reasonably short weighted average life (WAL) of the portfolio further moderated the value changes sustained by the portfolio. Changes in the value of the model portfolio demonstrate a higher correlation to changes in the 5-year Treasury yield than to other maturities along the yield curve because the 5-year bond's maturity better matches the WAL of the model portfolio. Even though the 30-year Treasury rate is often cited as a benchmark for daily rate changes, it may not be the most significant rate in assessing exposures of bank securities portfolios to changes in interest rates.



On March 25, 1997, the Federal Reserve Open Market Committee met and raised the target federal funds rate 25 basis points to 5.50 percent. By the following day, the 5-year Treasury yield had risen to 6.66 percent, 23 basis points higher than the 5-year Treasury yield dated March 12, 1997, displayed in Chart 3 (previous page). The rise in rates from March 12 to March 26 caused the model portfolio's market value to fall 0.56 percent to \$9,965.

This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect a portfolio's relative volatility.

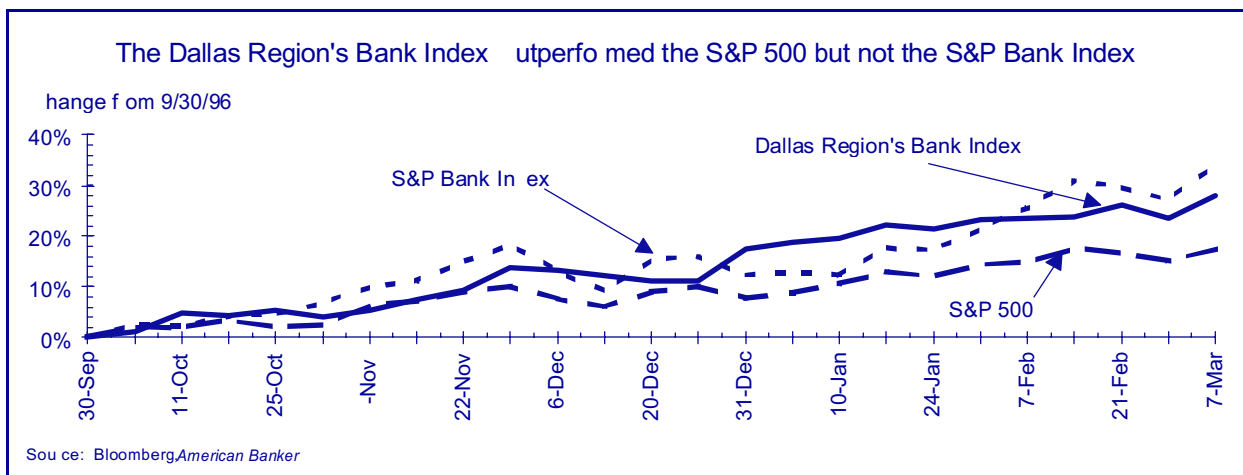
Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market

Improving its Perception of the Quality of Bank Earnings?

During the fourth quarter of 1996, the S&P Composite Bank Index outperformed the S&P 500, gaining over 12 percent compared to an almost 8 percent gain for the S&P 500. The fourth quarter results topped off a year during which the S&P Composite Bank Index gained 37 percent compared to a 20 percent gain for the S&P 500. As shown in Chart 5, the Dallas Region's Bank Index (DRBI) gained more than 17 percent in the fourth quarter 1996. While both the DRBI and the S&P Composite Bank Index, both returned about 37 percent for the full year, the DRBI's gains have shown less variability. The year's moderate economic growth, contained inflation, and favorable interest rates are credited for providing a friendly environment for bank stocks. As 1997 began with much the same economic conditions, bank equities have continued to do well. The DRBI is up only 9 percent compared to an almost 20 percent gain for the S&P Bank Index and a 9 percent gain for the S&P 500 through March 7, 1997.

While appreciating stock prices provide an obvious positive signal about the health of the industry, the market provides other information about the prospects for the industry through the price/earnings (P/E) ratio. The P/E ratio presents the price of a company's stock as a multiple of its earnings per share and is derived by dividing the stock's market value by the company's earnings per share. Typically investors are willing to pay a higher price for a company with earnings that are expected to be consistent and growing. However, firms with more volatile earnings are generally penalized by investors in terms of stock price and lower P/E ratios. Generally, a higher P/E ratio can be interpreted to mean that investors have more confidence in the outlook for

CHART 5

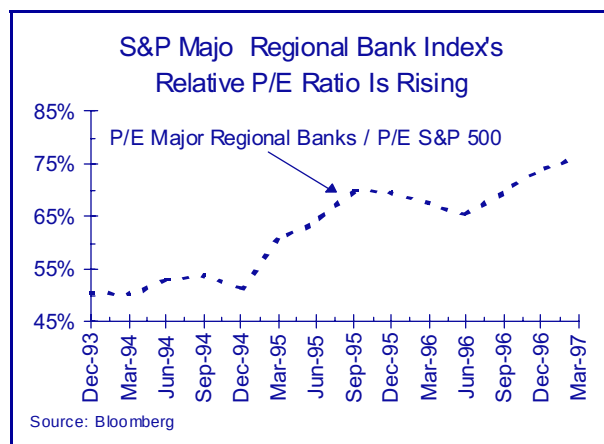


future earnings performance.

The relationship between bank P/E ratios and the P/E ratios for the broader market provides further insight into the market's perception of the quality of bank earnings compared to other firms. Historically, bank P/E ratios have been lower in the aggregate as compared to the rest of the market. The rationale posed for this discounted bank P/E ratio relative to the broader market has been that the primary sources of bank revenue, deposit taking and lending activities, traditionally have been viewed as being more volatile because they are prone to rising and falling with changes in the business cycle. For example, despite recording some of the highest quarterly return on equity averages ever at the end of 1993, the P/E ratio of the major regional bank index was at a level that was still only about 50 percent of the broader market P/E.

Over the past two years the magnitude of the banking sector's P/E discount has declined. As seen in Chart 6, the P/E discount has gone from 50 percent to only 24 percent (a relative P/E ratio of 76 percent). The higher P/E ratio may represent a view by market participants that bank earnings are becoming less sensitive to the business cycle, perhaps as a result of geographic or product-related diversification and more efficient management of overhead expenses. Another factor contributing to higher bank P/E ratios could include speculation on bank stocks as investors anticipate potential

CHART 6



acquisitions.

*Allen Puwalski, Banking Analyst
Kathy R. Kalser, Chief,
Financial Sector Analysis Section*

Current Regional Banking Conditions

- Overall, the strength of the Region's economy has provided a foundation for continuing favorable bank performance; however, modest increases in loan losses persist.
- The number of banks in the Region is falling due to mergers, especially involving smaller banks under \$50 million, while the number of bank offices is rising.
- Agriculture banks show capital strength, but their performance has weakened and competition for market share is heating up.

Overall Conditions

Supported by a strong economy in the Dallas Region, insured financial institutions reported a strong performance for 1996: an unparalleled net income of \$4.75 billion was reported by banks and thrifts in the Region. As measured by return on assets (ROA), the Region's 1.31 percent level for 1996 surpassed the nation's 1.10 percent. The asset-weighted Tier 1 capital ratio increased modestly from 7.61 percent to 7.77 percent (compared to the national average of 7.67 percent).

The Region's performance was driven by a strong net interest margin (4.18 percent compared to 4.06 percent for the nation) and advancing noninterest income (1.88 percent of earning assets compared to 1.73 percent at year end 1995). Detracting from earnings performance were increases in provisions for loan losses and overhead expense.

Loan loss provisions climbed for the third consecutive year and reached 23 basis points of average assets. Similarly, net charge-offs have begun to climb after

reaching an low point in 1994 (see Chart 1). Overhead expenses, at 3.94 percent of average assets at year-end 1996, increased 17 basis points since year-end 1995.

While consumer lending (particularly credit card loans) has captured the attention of bankers, regulators and the public, data reported by the Dallas Region's Call Report filers show real estate loans and commercial and industrial loans also were important contributors to the upward shift in loans past due greater than 30 days (see Chart 2).

Rapid Decline in the Number of Banks in the Region

As Table 1 (next page) depicts, there has been a rapid decline in the number of banks in this Region over the past six years. The Region's 30 percent decline in the number of banks exceeded the nation's 24 percent decline from year-end 1990 to year-end 1996. This decline in the number of banks was led by Texas (334), but Colorado's 49 percent reduction was the largest

CHART 1

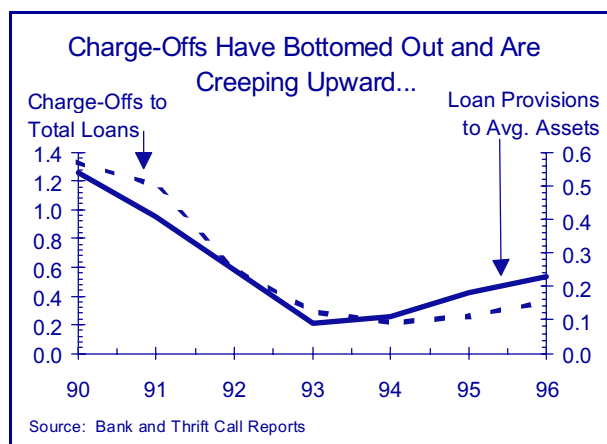


CHART 2

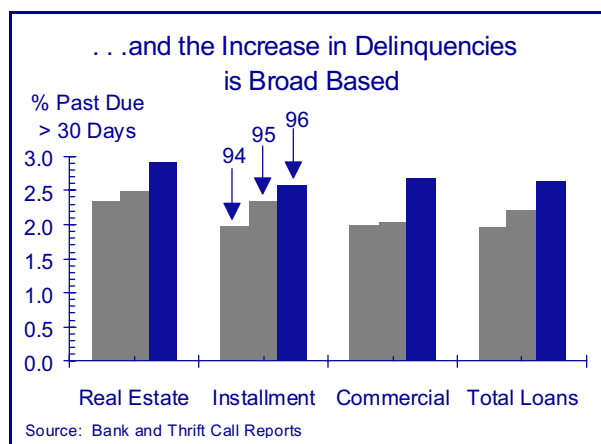


TABLE 1

THE NUMBER OF INSURED INSTITUTIONS IN THE DALLAS REGION HAS DECLINED					
	1990	1992	1994	1996	% CHANGE 90-96
CO	466	369	295	238	-49%
NM	104	97	82	79	-24%
TX	1,263	1,153	1,040	929	-26%
OK	446	413	362	345	-23%
RE- GION	2,279	2,032	1,779	1,591	-30%
U.S.	15,158	13,852	12,603	11,452	-24%

SOURCE: BANK STRUCTURE DATA

percentage decrease. The large number of banks in Texas and Colorado, both former unit banking states, made each of those states ripe for consolidation.

Bank failures played only a small role in the Region's consolidation. From year-end 1990 through year-end 1996, the Dallas Region experienced a reduction of 688 insured institutions. Of these, only 65 were due to failure. Of the 65 failures, 54 were in Texas.

Consolidation has been driven by mergers and has resulted in fewer but larger banks (see Chart 3). Large-bank asset growth has significantly outpaced small-bank asset growth: the average asset size of the largest 25 percent of banks in this Region grew 72 percent from year-end 1990 to year-end 1996, from \$459 million to \$791 million. The smallest 25 percent of banks, in contrast, grew from \$14 million to \$19 million, or 37 percent over the same time period. In addition, the number of small banks is declining rapidly. In 1990, there were 1,390 banks under \$50 million in the Region. At the end of 1996, that number declined by 49 percent, to 711. Many of these banks became branch locations through mergers and acquisitions, fueling growth of larger institutions. During 1990 through 1996, the number of domestic offices in the Region increased by 402 from 6,267 to 6,669, and the *average* institution size increased substantially from \$141 million to \$233 million.

Does the declining number of small banks reflect an inability of these banks to compete? Not necessarily, but the profitability structure for different sized banks may be changing with the introduction of larger geographic boundaries, new technologies and increased nonbank competition (see *Will Credit Scoring Transform the Market for Small-Business Lending?* and *Banking on the Internet*). Recently, Bank of America announced divestiture of 68 branches located in small

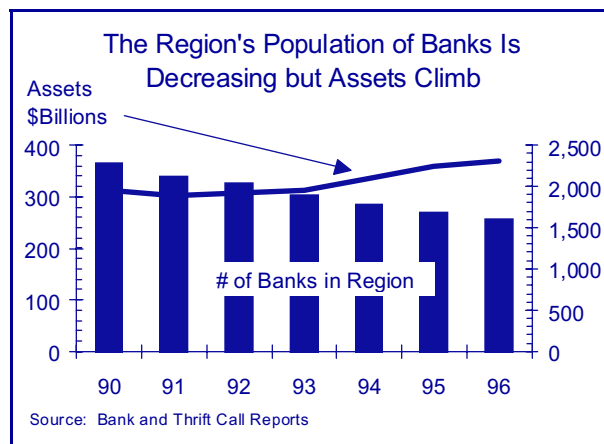
Texas markets. Elsewhere, KeyCorp has announced an intent to sell more than 140 branch locations in primarily rural areas. A plausible interpretation of the Bank of America and KeyCorp branch divestitures is that the overhead necessary to provide the personal service needed to run a successful small bank operation may not fit the profitability requirements of a large bank. Thus, this type of service may differentiate the small bank from the large bank and provide the smaller institutions with a measure of protection from large-bank acquisition.



Such an interpretation is consistent with the view of many analysts and industry leaders that large banks are gaining a profitability edge because of their ability to tap the benefits of scale and diversification. As the landscape of banking tilts more to fee-based services, the advantages of scale may become increasingly important. To prosper in this environment, many industry observers argue that small community banks will need to emphasize core competencies and localized, personal service that institutions headquartered many miles (or states) away may find difficult to match.

A December 1995 study by the *Federal Reserve Bank of Philadelphia* predicts that midsized banks will have the most difficulty in competing with the large banks, in terms of resources, to achieve scale economies. Additionally, the study argues that it is more difficult for midsized banks to diversify risk. Accordingly, *midsized banks may be less able to shield themselves from acquisition or merger, and prospects for a barbell shaped distribution of banks, by size, are increasing.*

CHART 3



Agriculture Banks Remain Strong, but Oklahoma Banks Are Feeling the Effects of the Drought

The solid condition of the Region's agriculture banks (ag banks), in general, appears to have helped them withstand borrowers' problems related to weak yields in wheat and cotton and the depressed cattle prices brought on by last summer's drought. Ag banks are defined as institutions with agricultural loans of 25 percent or more of gross loans. Ag banks in Oklahoma continue to hold stronger capital positions as a group than do non-agriculture banks in the state. However, Oklahoma was among the states most severely affected by the drought and, as a result, *asset quality problems are appearing at a number of Oklahoma ag banks, particularly the smaller banks.*



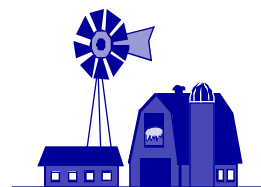
Ag banks with assets under \$100 million make up 35 percent of all banks in Oklahoma -- higher than any other state in the Region. The combination of this dependence, the severity of the drought in certain pockets of Oklahoma, and higher feed costs, helps to explain the increase in problem asset indicators for these banks. Net charge-offs in Oklahoma ag banks with assets under \$100 million increased from 0.37 percent to 0.59 percent during 1996, while nonperforming assets to total assets increased from 0.91 percent to 1.26 percent. Comparably, the Region's totals for net charge-offs and nonperforming assets to total assets were reported at 0.36 percent and 0.69 percent, respectively.

These asset quality problems are likely due to the substantial declines in both yield and production of wheat, the state's primary crop. According to the ***National Agriculture Statistical Service*** wheat yields in Oklahoma decreased 34 percent (29 bushels per acres to 19 bushels) from 1993 through 1996, and wheat production declined by 40 percent from 156.6 million bushels to 93.1 million bushels. In addition to the poor wheat condition, cattle conditions also have been weak. According to Dr. Kim Anderson, an Agricultural Economist at Oklahoma State University, 70 percent of Oklahoma's agricultural economy is centered in livestock. As a result, many Oklahoma livestock producers were affected by the 42 percent rise in average feed corn prices between 1995 and 1996, poor haying conditions from the drought, and weak cattle prices.

Market Pressure Is Heating Up and Small Ag Banks Are Facing Some Difficult Challenges

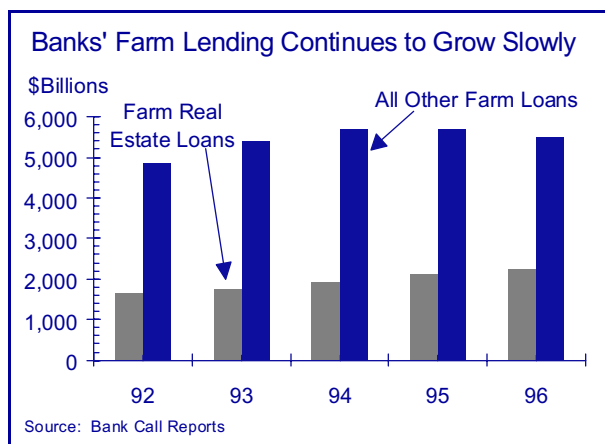
Currently, there are three primary areas that present challenges to small ag banks. First, large banks are increasing their market share of farm lending. Since 1993, banks under \$100 million in this Region have seen their share of farm loans decline from 60 percent of the Region's total to 51 percent at year-end 1996. Concurrently, banks with assets between \$1 billion and \$10 billion almost doubled their share from 8 percent to 15 percent, in part a result of large-bank acquisitions of small banks. Several large banks are initiating farm lending programs to take advantage of scale that comes with size. Large banks may be better able to provide borrowers with the resources necessary to address price and income volatility risks arising from the 1996 Farm Bill. Moreover, larger, more diversified banks may be in a better position to withstand additional risks as the government safety net for farmers is curtailed with the implementation of the 1996 Farm Bill.

Second, in addition to competition by larger banks, financing from "input" companies, such as implement manufacturers and seed and feed companies with financing subsidiaries, is encroaching on banks' agriculture lending. Companies like John Deere are taking advantage of the ability to provide the convenience of both the inputs *and* financing at aggressive pricing made possible because of large-scale funding. Given that non-real estate farm loans (operating loans) account for 63 percent of banks' agriculture lending, this battle for market share with input providers is striking at the largest segment of bank lending to farmers.



Finally, the Farm Credit System (FCS) is renewing its challenge for market share after years of credit quality and image problems brought on by the farm crisis of the 1980s. From 1994 to 1996, FCS increased its market share from 24.4 percent to 25.6 percent through government-backed land and operating loans funded through access to the capital markets. According to the ***U.S. Department of Agriculture (USDA)*** banks held 39.4 percent of total farm debt in 1996, down from 39.8 percent in 1995. Although only a modest decrease, it is the first time that banks' market share has declined since the 1980s. The USDA expects the share to drop a another percentage point in 1997.

CHART 4



As Chart 4 illustrates, farm real estate lending by banks continues a slow pattern of growth. As just discussed, however, growth in farm operating loans is coming under pressure from aggressive nonbank credit providers. *For many small ag banks, this challenge for market share could influence either underwriting standards or pricing, or both.* The increased competitive pressures from large banks and nonbanks, coupled with changes brought about by the 1996 Farm Bill, mean the challenge for small ag banks could be substantial.

Alan C. Bush, Senior Regional Analyst



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