Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FIRST QUARTER 1998

FDIC
NEW YORK
REGION

DIVISION OF
INSURANCE

SUZANNAH L. SUSSER,
REGIONAL MANAGER

NORMAN GERTNER,
REGIONAL ECONOMIST

KAREN A. WIGDER,
FINANCIAL ANALYST

In Focus This Quarter

◆ ***Y2K***—**Preventing the Year 2000 (Y2K) computer problem is becoming ever more costly as the time and resources left to do so disappear. Equally costly, according to some estimates, will be the litigation that follows in the problem's wake. A failure to address Y2K exposures immediately and successfully may amount to a gamble backed by the value of the bank franchise and the officers and directors who run it.** *See page 3.*

By Gary Ternullo

◆ ***Trends in Commercial Real Estate Loan Pricing and Underwriting***—**An abundant supply of financing is placing pressure on commercial real estate loan pricing and underwriting standards. Underwriting standards are being increasingly influenced by the rapid growth in commercial mortgage-backed securities and real estate investment trusts. While many within the industry believe that broader public funding of commercial real estate projects will lead to greater market transparency and improved underwriting discipline, there are a number of unique risk considerations related to the rapid growth and continuing development of these alternative funding sources.** *See page 7.*

By Steven Burton

◆ ***Total Return: A Useful Tool for Monitoring Investment Portfolio Risk***—**The Federal Financial Institutions Examination Council is rescinding the 1991 policy that required "high-risk" testing for mortgage derivative products and has released for comment a policy encouraging risk management across all types of instruments on an investment portfolio basis. Total return, a concept that includes fluctuations in market value, is a useful tool for measuring the performance of an investment portfolio and providing information about market risk at the portfolio level.** *See page 14.*

By Allen Puwalski

Regular Features

◆ ***Regional Economy***—**The New York Region is continuing its job expansion, although growth slowed during the third quarter of 1997…the largest cities in the Region, including Baltimore, New York City, Philadelphia, and Washington, D.C., continue to lag behind in job growth…after two decades of economic growth, Puerto Rico's employment growth appears to be leveling off.** *See page 17.*

By Norman Gertner

◆ ***Regional Banking***—**Favorable banking conditions continue, despite higher credit card charge-offs…merger and acquisition activity heats up as the regulatory environment changes, competition intensifies, and banks focus on efficiency…new banks spring up in the Region, hoping to fill a niche in small communities.** *See page 21.*

By Suzannah L. Susser, Karen A. Wigder

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

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, FJ, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov/publish/regout. For more information or to provide comments or suggestions about the New York Region's ***Regional Outlook,*** please call Suzannah Susser at (212) 704-1482 or send an e-mail to *ssusser@fdic.gov.*

Chairman	Andrew C. Hove, Jr.
Director, Division of Insurance	Arthur J. Murton
Editor	George E. French
Assistant Editors	Daniel Frye Craig A. Rice
Publications Manager	Teresa J. Franks

Y2K: Banking in the twenty-first century may provide grand new opportunities—but you have to get there first

- **As a result of a three-decades-old programming convention, January 1, 2000, may find some computer systems unable to function correctly, if at all. Links within and between systems and organizations make the problem a complex one.**

- **Cures are expected to be difficult and costly. If those cures fail, litigation could be equally costly, and much of it may be aimed at directors and officers.**

- **Accordingly, senior bank management should be actively involved in making sure the cure takes place. A failure to do so amounts to a gamble backed by the value of the bank franchise and those who run it.**

Complex Problem, Complex Cure

By now the story is well known. At midnight on December 31, 1999, computer systems that process dates using only the last two digits of a year will cease to function correctly, if at all. Equipment that contains embedded systems—chips or circuitry designed to perform specific functions—also may fail. And the problem is pervasive. It lies within systems and between systems, in both software and hardware. The large number of ways dates are used, the number of places they can occur, and the number of creative ways for naming them confounds an accurate assessment.

Fixing the Year 2000 (Y2K) problem will require considerable time and effort. Computers and applications must be inventoried, examined for date usage, corrected where necessary, and then tested—not just by themselves but in combination with every other system with which they interact. This includes not only a bank's own systems but also those of its servicers, correspondents, customers, vendors, and trading counterparties. Moreover, there are a variety of ways to address the problem, ranging from expanding date fields to four digits to simply subtracting 28 years from every date before processing—any of which could introduce new incompatibility problems when systems that have been fixed in different ways attempt to interact.[1] And because not all systems can be corrected at once, interfaces or bridges between corrected and uncorrected systems also must be developed to maintain business system continuity. Most important, it must all be done *before* the non-negotiable deadline of December 31, 1999.

For bank management, there are two ways to find out how serious the problem will be. The first is to commit resources to determining just how exposed the bank's systems are—the first concrete step in actually solving the problem. The second is to gamble the franchise by doing little or nothing and letting the century date change provide the ultimate stress test.

Costs

The costs of a cure are many. First, there are the costs of actually finding and fixing the problem. Estimates of this cost have ranged widely, although the ***Gartner Group***'s estimate of $300 to $600 billion worldwide is the most widely quoted. Using a different approach, ***Software Productivity Research (SPR)*** places the global number at over $1.3 *trillion*, including a $176 billion slice for the United States alone. Then there are the estimated costs of litigation. At the low end, SPR places them at $300 billion globally and projects that fully one-third of that amount will be generated in the United States. At the high end, the ***Giga Information Group*** sees a much more litigious future—estimating that Y2K-related legal costs could exceed $1 *trillion*.

Significant opportunity costs may accrue as well, and the degree to which Y2K-related outlays fail to provide

[1] Every 28 years the same combination of dates and days recurs. Subtracting 28 years from a date before processing and then adding them back upon output has been suggested as a temporary but partial remedy because it permits applications to continue measuring time by subtracting two-digit years from each other. *Windowing* is another partial correction whereby some two-digit years—say those less than "50," for example—are assumed to be preceded by "20" (thus "49" becomes "2049" in date calculations) while the remainder are assumed to be preceded by a "19" (thus "50" becomes "1950"). Both approaches only delay the need for permanent corrections.

more efficient or functional systems will serve as a starting point for measuring the value of technology investments forgone. These forgone improvements will be especially costly for institutions that have started their repairs too late. They may find not only that the time for system improvements and upgrades has slipped away, but that they have insufficient time for anything beyond a patchwork solution that will continue to cost them beyond the year 2000.

At the macro level, the tally of potential Y2K costs includes declining stock values, business failures, and recession. ***J.P. Morgan*** has estimated that as much as 40 percent of organizations' remediation costs have not been accounted for in their information technology budgets, presumably indicating that many firms will see their share value erode as the costs of Y2K fixes and related losses are priced into their future earnings. The cost of *not* being Y2K compliant might be substantial as well. According to the ***Gartner Group***, as many as one in two firms may discover just how substantial as they head into 1999 with even their most *mission-critical* systems unfixed. The potential for these firms to fail looms large among the factors that have led Edward Yardeni, chief economist at ***Deutsche Morgan Grenfell***, to assign a 40 percent chance of recession in the year 2000. Peter de Jager, a consultant who also has commented extensively on Y2K issues, went even further, suggesting that 1 percent of all businesses would fail because of Y2K problems. Whatever the eventual number, many of these businesses will also be bank borrowers.

Systems and Systemic Risks

More immediate than the risk of borrower failures is the risk that a bank's own systems may fail. Banks are heavily dependent on software applications that employ dates. Among other things, they use them for calculating interest paid or due and for managing the horizons of their assets and liabilities. If these applications begin returning erroneous calculations, bank operations could be seriously disrupted.[2] If they fail altogether, the bank's credibility—and hence its franchise value—can be substantially damaged or even irrevocably lost.

The solution is often described in software terms, but executable software is not the only problem. Correcting software to process four-digit years does little good if bank databases that store the critical information about who owes what to whom and when still store them in two-digit form. Hardware is another critical area. Nearly all electronic devices have embedded, permanently programmed chips that can be difficult to find because the functions they perform are not always apparent. This situation could lead to a host of nuisances, with automated teller machines, point-of-sale terminals, bank vaults, check and credit card processing equipment, and even building systems succumbing to the Y2K problem.

This dependence on external components and services creates a systemic exposure as well. The substantial efficiencies that now exist in transmitting payments among and between banks and borrowers are a direct result of technology. Servicers and clearinghouses fulfill computer-intensive intermediary roles in this high-velocity business—pooling payments from those who owe and redistributing them among those to whom they are due. Anything that interrupts these flows can have a substantial impact on the ability of banks to settle with their customers and with each other. Accordingly, both the Bank for International Settlements and the U.S. Federal Reserve are concerned about the Y2K threat for two reasons—first because it can interrupt the operations of systems dedicated to making interbank payments and second because it can interrupt the operations of the individual participants and generate a liquidity shock that could cause other institutions to fail.

Unfortunately for banks, even a fully successful, industry-wide Y2K fix will not completely mitigate their risk. The year 2000 story is simply too dramatic and lends itself too well to sensationalism. Therefore, in addition to managing the cure, bankers will have to manage the perceptions of their customers and of the public at large—a considerable challenge given that a loss of confidence by a small number of customers could precipitate liquidity problems for institutions even in the absence of a genuine threat.

[2] For example, interest due from borrowers for a one-year period beginning in 1999 and ending in 2000 might be calculated not as one year's interest *due* but rather as nearly one century of interest *payable* (00 – 99 = –99) if only the last two digits of the year are used in the calculation. Similarly, any other time calculation that straddles the century date change might return answers wrong in both size and sign.

Liability in the Executive Suite

It bears frequent repeating that Y2K is a business problem and not just a technical one. Its intricacies go beyond those of the systems themselves and extend into the labyrinth of business relationships and fiduciary obligations that bind directors and officers—and the assorted attorneys, auditors, consultants, and service providers who assist them—to their banks. Through this network could pass liability and litigation that could be several times the cost of fixing the problem itself. And although the problem may have had a technical origin, claims would likely be directed against those with deeper pockets who jointly and severally, it will be argued, should have corrected or disclosed the institution's Y2K exposures.

While the bank failures of the late 1980s and early 1990s are often attributed to unforeseen economic events, it will be difficult to assert such a defense for a failure to address the Y2K problem. It is simply too visible and offers too much advance notice. This is one reason why the potential potency of Y2K litigation should be taken seriously. Moreover, placing the blame, no matter how well deserved, at the feet of vendors and consultants may offer little protection. The Federal Financial Institutions Examination Council (FFIEC) has indicated that senior bank management should be fully aware of their vendors' progress and develop contingency plans should those vendors fail.[3] This pronouncement has elevated the standard for prudent Y2K actions in such a way as to make imperative the active involvement of top bank management in both solving

[3] *Safety and Soundness Guidelines Concerning the Year 2000 Business Risk,* December 1997. The full text is available on the FFIEC website at www.ffiec.gov.

Managing the Y2K Process

On May 5, 1997, the Federal Financial Institutions Examination Council—an interagency group composed of the Federal Deposit Insurance Corporation, Federal Reserve, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration—released a statement on Year 2000 project management awareness that included an outline of the Y2K management process. That outline identified five phases that each financial institution would have to navigate in identifying and fixing its Y2K exposures:

Awareness. Before Y2K exposures can be fixed, they must be seen as problems. Creating awareness, however, is not easy because the pervasiveness of components and intersystem links that can harbor or pass the problem create complexities that are neither intuitive nor easily quantified. However, it is critical that senior managers understand the problem and fully support the commitment of resources to fixing it.

Assessment. In this phase, all information systems, electronic equipment, and building systems must be evaluated for specific Y2K exposures. Remediation plans must then be devised. In addition to plans for fixing the problem, contingency plans will be needed as a precaution against unforeseen Y2K failures originating from both within and outside the bank.

Renovation. Renovation includes not only fixing the problem internally but monitoring the efforts of customers, counterparties, vendors, and service providers. The prudent execution of due diligence and best practices at this stage will provide a measure of confidence that exposures have been addressed. It will also provide a measure of protection from liability claims should problems nevertheless emerge.

Validation. Validation means testing how a bank's systems will respond on their own as well as when connected with those outside the bank. The FFIEC believes that one full year should be available for testing and correcting problems that either remain or are introduced by the renovation process. Accordingly, institutions should plan on completing the previous three phases by the end of 1998.

Implementation. Testing corrected systems to ensure their compliance does not complete the process. The final step is to gain acceptance by the users as to the ability of the system to satisfy business requirements. A failure at this stage will require further correction or the implementation of contingency plans.

*For the full text of this and other FFIEC guidance, see the FFIEC website at **www.ffiec.gov**.*

the problem and ensuring that the franchise will be protected if one or more of those solutions fail.

Betting the Franchise

The FFIEC has divided Y2K remediation into five phases—awareness, assessment, renovation, validation, and implementation (see Inset 1, page 5). As a benchmark for progress, the FFIEC has indicated that the validation phase—the phase in which testing of Y2K fixes is conducted—should be well under way for all banks by the end of 1998. This leaves less than a year for laggards to complete the first three phases. Banks that are not devoting adequate resources to identify and address their exposures need to be aware that the consequences of delay or inaction could be severe. The bank supervisory agencies, Congress, and the financial markets are taking the risk to heart. So too are attorneys intent on sharing in what has been described as potentially the most expensive litigation in history.

Insurance companies are concerned as well, as evidenced by extremely high Y2K policy premiums or outright refusal to write Y2K coverage. Thus, any business interruptions and liability that emerge may have to be financed from the bank income statement and balance sheet. As such, a bet that Y2K will not be a problem might well amount to a gamble backed by the bank franchise and those who run it. (See Inset 2 below for additional sources of information.)

Gary Ternullo, Senior Financial Analyst
gternullo@fdic.gov

For Further Information

Further information on the Y2K problem can be obtained from banking regulatory agencies at the websites shown below.

Federal Deposit Insurance Corporation (FDIC)	*www.fdic.gov*
Federal Financial Institutions Examination Council (FFIEC)	*www.ffiec.gov*
U.S. Federal Reserve Board of Governors	*www.bog.frb.fed.us*
National Credit Union Administration (NCUA)	*www.ncua.gov*
Office of the Comptroller of the Currency (OCC)	*www.occ.treas.gov*
Office of Thrift Supervision (OTS)	*www.ots.treas.gov*

The following websites contain additional information concerning the Y2K problem. Their inclusion here does not serve as an endorsement by the FDIC of any information contained therein.

Market Partners Inc.—*Year 2000 Resources for Banks*	*www.marketpartners.com*
Gartner Group—*Technology Consultant*	*www.gartner.com*
Software Productivity Research (SPR)—*Technology Consultant*	*www.spr.com*
De Jager LLC (Peter de Jager)—*Technology Consultant*	*www.year2000.com*
Giga Information Group—*Technology Consultant*	*www.gigaweb.com*
Y2K LLC (Williams, Mullen, Christian & Dobbins)—*Attorneys*	*www.Y2K.com*
Economics Network (Dr. Edward Yardeni)—*Economist*	*www.webcom.com/yardeni*

Trends in Commercial Real Estate Loan Pricing and Underwriting

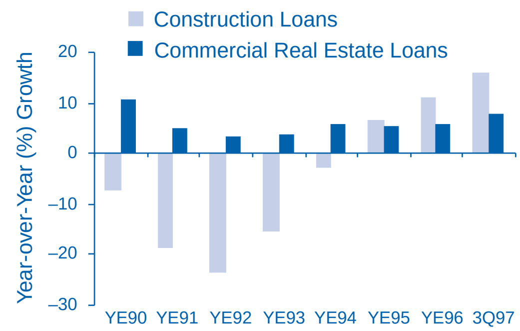
- **An abundant supply of capital is placing significant pressure on commercial real estate loan pricing.**
- **Considerable evidence suggests that a large percentage of insured institutions are easing commercial real estate and construction lending underwriting standards.**
- **The rapid rise in commercial mortgage-backed securities and real estate investment trust funding could change the way banks underwrite commercial real estate loans and have important effects on their competitive position in the lending markets.**

As reported in last quarter's ***Regional Outlook***, banks provided the largest share of funding for commercial real estate during 1995 and 1996 compared with all other financing sources (see ***Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets***). Chart 1 shows that banks' commercial real estate and construction lending continues to increase and that year-over-year growth rates in these two loan categories are accelerating. At the same time, however, alternative funding sources in the form of commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs) are also experiencing significant growth. ***Commercial Mortgage Alert*** reports that $26 billion in CMBS was issued through September 1997, up from $17 billion for the same period in 1996. The same publication projects that CMBS issuance will top $40 billion during 1997, compared with last year's record issuance of $29.8 billion. Measures of REIT activity also indicate impressive growth. According to the ***National Association of Real Estate Investment Trusts***, REITs issued $26.3 billion in equity through October, compared with $12.3 billion for all of 1996. In addition, REIT market capitalization rose $50 billion (64 percent) through the first nine months of 1997.

While it is good news to borrowers, the abundance of capital for commercial real estate projects raises the often-quoted concern that "too much money is chasing too few deals." Market observers worry that fierce competition and an excessive supply of financing are lead-

CHART 1

Banks' Commercial Real Estate and Construction Lending Rebounds



Source: Commercial Bank Call Reports

ing to both inadequate loan pricing relative to risks borne by lenders and looser loan underwriting standards. This article examines current trends in commercial real estate loan pricing and loan underwriting. It also explores the possible influences of CMBS and REITs on loan underwriting practices and commercial real estate markets.

An Abundance of Capital Has Placed Significant Pressure on Commercial Real Estate Loan Pricing

Chart 2 (next page) shows that prime-graded commercial mortgage spreads have steadily declined since 1992 and are now at levels not seen since the real estate boom years of 1988 and 1989. At 113 basis points above ten-year treasuries, current spreads on ten-year commercial mortgages are only slightly higher than A-rated ten-year industrial corporate bonds, which traded at spreads of 66 basis points over comparable-term treasuries as of September 1997. Some property sectors have experienced more narrowing of spreads than others. ***American Council of Life Insurance (ACLI)*** data show that mortgage spreads relative to treasuries compressed 31 basis points for industrial, 22 basis points for hotel, 21 basis points for retail, 11 basis points for multifamily, and 10 basis points for office real estate from March 1996 to March 1997. Moreover, because of continuing downward pressure, current pricing varies little across

CHART 2

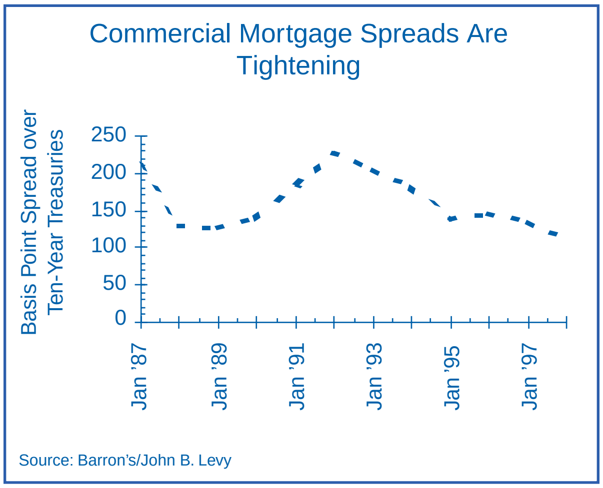
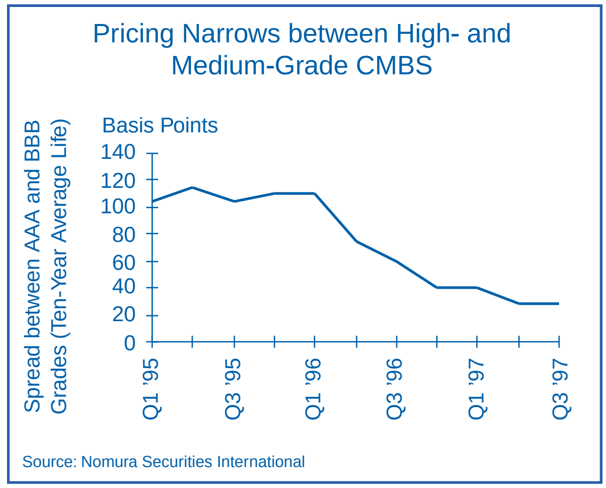


CHART 3



the quality spectrum. For instance, Chart 3 indicates that spreads between AAA- and BBB-rated CMBS have narrowed considerably since year-end 1995, from 110 basis points to a scant 28 basis points.

It seems likely that competitive factors will continue to place pricing pressure on lenders. The relatively recent entrance of Wall Street firms into the financing arena via conduits is a striking example of just how competitive the market for commercial real estate financing has become.[1] Conduits are rapidly becoming the dominant issuer of CMBS and underlie much of the rapid growth in CMBS noted above. Through the first nine months of 1997, ***Commercial Mortgage Alert*** reported that conduits accounted for 50 percent of total CMBS issuance, compared with 30 percent during the same period in 1996.

Many industry participants see conduits and REITs as significant and increasing competitive threats to traditional lenders. For example, a recent issue of ***Commercial Real Estate South*** discussed the continuing expansion of conduit business into a much wider range of property and credit quality types. This publication noted that conduits have a particular incentive to aggressively pursue higher quality loans in order to strengthen pools that contain weaker credits. Such aggressiveness threatens to squeeze banks' profit margins on low-risk deals, which might give banks an incentive to pursue lower quality credits. Given their focus on larger credits, conduits presently pose a competitive threat primarily to larger lenders. However, the rapid growth of capital within the industry may eventually force larger lenders to target smaller markets, which would in turn increase competition at the regional or local community level. While their influence is less direct, the growing use of REITs to finance commercial real estate projects also places pressure on loan pricing spreads, since lenders must compete for a smaller pool of customers. With their access to a seemingly limitless source of public funding, REITs could pose a particular threat to community bankers by dominating certain geographic markets or property sectors.

Narrowing pricing spreads raise concerns over whether lenders are being adequately compensated for the operational, funding, credit, and market risk inherent in originating, servicing, and holding commercial real estate loans. More important, tightening spreads raise prospects that lenders will ease other loan terms and relax loan standards to the extent that they are unable to differentiate their product based solely on price. While such easing may enable lenders to retain business in the face of stiff competition, imprudent underwriting could ultimately lead to higher loan losses than would otherwise be the case in the event of a downturn in commercial property markets.

Are Commercial Real Estate Loan Underwriting Standards Becoming Looser?

Most industry experts have argued that the memory of the real estate downturn of the late 1980s and early 1990s keeps lenders from becoming overly aggressive in making commercial real estate loans despite the abundance of funding alternatives currently available to

[1] Conduits are entities created to originate mortgage loans for distribution to investors in the secondary market.

borrowers. These experts point out that today's loan-to-value (LTV) ratios are lower than they were at the peak of the last real estate boom, that lenders are concentrating more on obtaining adequate debt-coverage ratios, and that lenders are requiring borrowers to bring more cash equity to the table. One might also argue that practices have improved and become much more uniform with the implementation of regulatory appraisal standards and the adoption of interagency guidelines for real estate lending policies. Rating agencies impose additional guidelines and standards as lenders originate loans for possible sale into the secondary markets.

While information about specific quantitative underwriting criteria applied to new loan originations by commercial banks is not readily available, some sense of industry trends may be gleaned from competitors' practices. For example, the ***ACLI*** performs a quarterly survey of underwriting criteria for commercial real estate loan commitments originated by major life insurance lenders. The ACLI's second quarter 1997 survey indicated that new commitments (total volume of $4.1 billion) had a weighted average LTV for all property types of 66 percent and a weighted average debt-coverage ratio (DCR)[2] of 1.6 times. These figures compare favorably to an LTV ratio in late 1989 approaching 75 percent and a DCR just under 1.3 times.

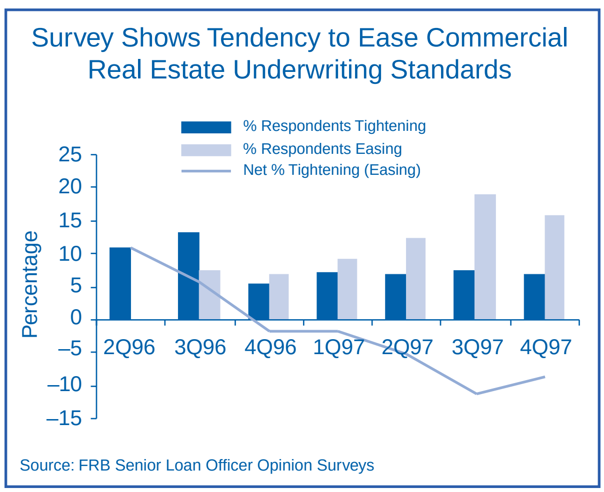
ACLI data suggest that recent commercial mortgage originations are better supported by borrower equity and property cash flows than they were in the late 1980s. It is important to recognize, however, that LTV and DCR ratios are driven largely by market conditions and expectations. Property valuations take into account recent sales and expected cash flows, and cash flows available to service debt are based on projected net operating revenues, which often incorporate projected increases in rents and other revenue sources. In other words, the overwhelmingly favorable conditions in today's real estate markets may also be a factor in the improved LTV and DCR ratios. Keeping in mind the cyclical nature of real estate, one can easily see how a shift from today's positive outlook to a more pessimistic outlook might result in a sharp reversal in these commonly cited ratios.

Notwithstanding these quantitative considerations, there are indications that banks are easing commercial real estate underwriting standards. This evidence, derived from industry and examiner surveys conducted by the three banking agencies, includes the following observations:

- In the ***Office of the Comptroller of the Currency's (OCC's) 1997 Survey of Credit Underwriting Practices***, OCC examiners reported eased commercial real estate lending standards in 38 percent of banking companies surveyed. For comparison purposes, the 1996 survey reported eased standards in 16 percent of banking companies surveyed. Among institutions with eased lending standards in the 1997 survey, examiners noted a 75 percent incidence of reductions in loan fees or rate spreads, a 43 percent incidence of eased guarantor requirements, and a 29 percent incidence of lower collateral requirements. Examiners cited competitive factors and a change in economic outlook as the main reasons for changes in underwriting standards.

- Chart 4 summarizes current and historical results of the ***Federal Reserve Board Senior Loan Officer Opinion Survey*** for responses to the question of whether bank credit standards for approving applications for commercial real estate loans have eased, tightened, or remained unchanged. These survey results show that banks have had a tendency to ease underwriting standards since the fourth quarter of 1996. This tendency appears to have become stronger through the third quarter 1997 survey but moderated somewhat in the most recent survey. The most recent survey showed that large banks (over $15 billion in assets) were much more likely to indicate easing commercial real estate standards than

Chart 4



[2] The debt-coverage ratio measures annual net operating income generated by a property relative to annual principal and interest payments due on the underlying loan.

smaller banks. Specifically, 21 percent of large banks reported easing standards, while only 3 percent reported tightening standards. In comparison, only 9 percent of smaller banks reported easing standards, while 13 percent reported tightening standards.

- Results from the ***FDIC Report on Underwriting Practices*** indicate possible easing of standards for construction and development (C&D) loans at FDIC-supervised banks. A comparison of examiner responses for the third quarter 1997 survey (covering examination reports filed from April through September 1997) with responses for the third quarter 1996 survey leads to the following observations[3]:

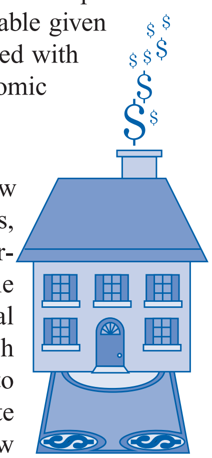
- The percentage of banks frequently or commonly originating C&D loans tied to speculative projects (that is, projects lacking meaningful preleasing or presales, or loans without a formal take-out commitment for permanent financing following completion of construction) rose markedly, from 11 percent to 29 percent.

- The percentage of banks frequently or commonly granting C&D loans without considering alternative repayment sources other than income generated by the project being financed rose significantly, from 8 percent to 20 percent.

- The percentage of banks frequently or commonly basing C&D loans on unrealistic appraisals rose from 5 percent to 11 percent.

- The percentage of banks frequently or commonly funding or deferring interest payments during the term of construction loans rose from 7 percent to 15 percent.

Much of the commentary in recent issues of various trade journals echoes the results of these regulatory surveys.[4] In brief, many industry participants are seeing a higher incidence of (1) banks funding construction loans without preleasing commitments on major portions of rentable space, (2) banks easing LTV ceilings, (3) lenders curtailing reserve requirements for such items as tenant improvements and insurance, and (4) nonrecourse lending. Some industry participants have also noted the increasing acceptance of "trended rents," whereby property valuations are based on positive rent projections extrapolated several years into the future. Of course, these trended rents will hold true only if economic circumstances remain favorable for extended periods—an assumption that may not be reasonable given the cyclical nature of real estate coupled with the advanced age of the current economic expansion.



With a combination of relatively low interest rates, rising real estate prices, and an expanding economy, it is perhaps not too surprising that some lenders have eased commercial real estate underwriting standards. Such easing may be a natural response to improved confidence in the real estate markets. However, indicators that show loosening standards may also be warning flags that lenders have succumbed to tighter pricing and competitive pressures. To avoid losses like those sustained by banks during the last real estate downturn, prudent lenders will refrain from incorporating unrealistic expectations into their lending practices.

CMBS Could Change the Way Lenders Underwrite Loans

Much as residential mortgage lending standards were shaped by the advent of mortgage-backed securities, CMBS promise to change the way banks underwrite and service commercial real estate loans. For instance, lending terms and practices could become increasingly standardized as lenders attempt to improve the liquidity and marketability of their commercial mortgage portfolios. Banks that choose to deviate from these emerging standards will sacrifice flexibility in terms of their ability to manage portfolio risks and respond rapidly to liquidity demands.

The ability to securitize commercial real estate loans also may fundamentally alter the way lending decisions

[3] The authors of this survey note that comparisons of survey results across time periods must be interpreted with caution since the survey samples are dictated principally by examination scheduling factors. As a result, sample populations may be materially different from one period to another.

[4] See, for example, ***Commercial Real Estate South***, "Public Markets Fuel Financing Glut" (October 1997); ***Midwest Real Estate News***, "Wall Street and Main Street Squeeze Lenders" (October 1997); and ***Commercial Property News***, "Michelson, Greenland Seize Low CMBS Spreads" (1 May 1997).

are made. Before the development of CMBS markets, loan approval was essentially a binary, good-or-bad, accept-or-reject decision whose primary focus was on the credit risk inherent in a single asset. In contrast, the most important elements in CMBS are deal structure, price execution for multiple tranches, credit enhancements, and portfolio composition. Here, the loan originator is more likely to use a portfolio approach in making credit decisions: That is, how will this loan enhance the expected return and risk diversification of the overall pool?

External rating agencies will become increasingly important as CMBS markets expand, since these agencies' guidelines will effectively dictate the underwriting standards applied to securitized loans. While such standardization could arguably improve market discipline and loan performance disclosure, there are several potential risks to consider as the CMBS markets evolve:

- While rating agencies do incorporate qualitative considerations into their analysis, issue ratings and credit enhancement level decisions are driven primarily by *quantitative* factors, namely debt service coverage and expected loss levels. Moreover, most of the *qualitative* factors the agencies consider involve an analysis of portfolio balance and pool diversification. Hence, weak or poor qualitative standards (for example, lack of alternative repayment sources or minimal borrower equity in the project) applied to individual loans within the pool may receive only secondary consideration. A quantitative perspective also ignores such immeasurable factors as borrower "character" and the existence of long-standing lender-borrower relationships.

- Rating agencies cannot be relied upon as a backstop to unsound underwriting practices. While they generally review a substantial volume of the loans within a pool, typically the largest individual credits, they are not practically able to review every credit in the securitization. Some within the industry have even suggested that investment bankers commonly move one problem property, discovered through one agency's sample, into pools reviewed by another agency in the hope that it will not be sampled.

- Competition among the rating agencies could become a factor in the underwriting process. This "shopping of the agencies" could result in continual pressure for rating agencies to ease their underwriting guidelines.

- In theory, bank-issued CMBS transfer much of the underlying credit risk associated with commercial real estate lending to investors. However, like other types of asset securitization, CMBS raise concerns over the degree to which banks will voluntarily absorb investor losses. Bank issuers may be more likely than nonbank issuers to provide voluntary support to poorly performing CMBS for at least two reasons: A tarnished reputation in one aspect of a bank's operations could carry over to other business activities like deposit taking and borrowing due to a bank's broad brand name association within the marketplace; and banks often have greater financial resources than nonbanks with which to support securitization activities.

Because the rapid growth in CMBS has been a relatively recent phenomenon, current underwriting guidelines applied by the rating agencies to CMBS have not been tested during a cyclical downturn in real estate prices. It remains to be seen how the market will react to rising loan losses that result in investor losses.

Will Increased Public Funding through CMBS and REITs Improve Market Discipline?

Many contend that the increased transparency brought to the market by CMBS will temper cyclical swings in real estate values. This viewpoint argues that investors will serve as a constraint against the natural tendency to overbuild commercial real estate during boom periods, since less funding will be allocated to segments of the market where excess capacity exists. This viewpoint presupposes that the investing public is sophisticated enough to recognize when markets are out of balance and when projects are economically infeasible. In this sense, CMBS shift much of the burden of monitoring credit quality standards and credit performance from lenders to public investors.

In contrast, others have argued that lenders are much better suited than investors to make judgments about credit quality standards and project feasibility. This line of reasoning suggests that the increase in public ownership of property through CMBS and REITs could actually reduce market discipline, since the most sophisticated participants with access to the best information (that is, lenders) may come to have less at stake in making prudent credit decisions. Of course, excessive losses attributable to any one CMBS issuer might lead to differentiation in pricing based on investors' perceptions of the quality of underwriting applied by specific issuers.[5]

Putting market efficiency arguments aside, the sheer volume of REIT and CMBS activity causes some concern over the extent to which such financing is driving property valuations. With such an abundance of capital flowing into the commercial real estate market, it is perhaps easy to see why lenders might opt to ease standards rather than lose business. However, to the extent securitization activities are driving decisions in today's commercial real estate markets, lenders might wish to consider how property values would react if the availability of such financing were sharply diminished. The most recent real estate downturn provided a ready example of how tighter credit availability compounded the effects of declining commercial property values by limiting the ability of lenders to sell distressed properties. While there may not be consensus on whether CMBS and REITs will temper cyclical price swings, the underwriting standards and practices evolving in response to these financing vehicles will likely play a crucial role in determining the magnitude of losses experienced by investors and banks during the next downturn in commercial property values.

Steven Burton, Senior Banking Analyst
sburton@fdic.gov

Selected Articles for Further Reading

Bloomfield, Craig. "Michelson, Greenland Seize Low CMBS Spreads." *Commercial Property News.* 1 May 1997. p. 33.

"CMBS Issuance Seen Topping $40 Billion." *Commercial Mortgage Alert.* 10 November 1997. p. 1.

Fitch Investor Services, Inc. "Commercial Mortgage Stress Test." *Fitch Research: Structured Finance Special Report.* 8 June 1992.

Office of the Comptroller of the Currency. *Advisory Letter 97-3: Credit Underwriting Standards and Portfolio Credit Risk Management.* 3 March 1997.

Sinderman, Martin. "Public Markets Fuel Financing Glut." *Commercial Real Estate South.* October 1997. p. 1.

Wolf, Barney. "Wall Street and Main Street Squeeze Lenders." *Midwest Real Estate News.* October 1997. p. 1.

[5] The evolution of the credit card securitization markets is one example of how investors now differentiate between issuers in terms of pricing.

Regional Results: General Underwriting Trends

Regional responses to the Report on Underwriting Practices during the reporting period indicated that an equal proportion of banks examined had either tightened or loosened underwriting standards since the last examination (see Chart 5). Of the 72 banks examined in the New York Region during the reporting period, 3 percent had tightened underwriting practices while 3 percent had loosened them.

Highlights in construction lending underwriting trends in the New York Region include the following:

- Just over 6 percent of banks examined were funding construction projects on a speculative basis without meaningful pre-sale, pre-lease, or take-out commitments "frequently enough to warrant notice."

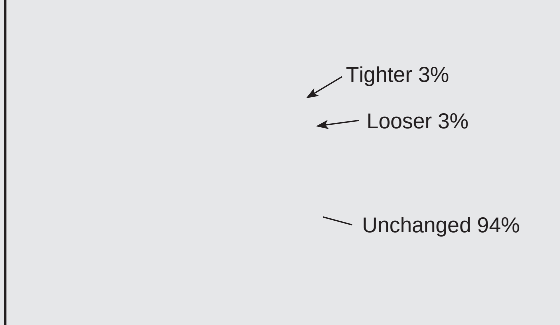
- An equal percentage of banks examined were making construction loans without consideration of repayment sources other than that the project was being funded "commonly or as standard procedure."

- Nearly 8 percent of banks examined were funding or deferring interest payment during the term of construction loans "commonly or as a standard procedure."

Chart 5

Have the Institution's Underwriting Practices Materially Changed since the Last Exam?

(Percent of Responses Received: 4/97–9/97)



Source: Report of Underwriting Practices

Total Return: A Useful Tool for Monitoring Investment Portfolio Risk

- **The Federal Financial Institutions Examination Council (FFIEC) is replacing the 1991 policy that contained a specific "high-risk test" for mortgage derivative products (MDPs) held by insured institutions with a policy that encourages risk management across all types of instruments on an investment portfolio basis.**

- **A good way to start measuring portfolio risk is by monitoring an appropriate measure of return.**

- **Total return, a concept that includes fluctuations in market value, is a more appropriate tool than simple yield for measuring the performance of an investment portfolio, especially one that contains bonds with embedded options.**

The Federal Financial Institutions Examination Council (FFIEC) has released for comment a new Joint Agency Policy Statement on Investment Securities and End-User Derivatives Activities that will replace a statement issued February 3, 1992. While much of the content of the former statement has been retained, the section requiring specific "high-risk" testing for mortgage derivative products (MDPs) has been eliminated. The "high-risk" test applied specifically to bonds collateralized by residential mortgage pass-through certificates or whole loans but that distributed cash flows to bondholders on a basis other than pro rata.[1]

The goal of the original policy statement was to deter banks from investing in products that presented risks that they were not able to adequately monitor and control. MDPs were singled out because of their rapid growth, nontraditional and potentially risky nature, and common use by insured financial institutions. The new policy states that, as a sound management practice, institutions should conduct prepurchase and ongoing analysis of all their investments at a level appropriate to the size and complexity of those holdings.

The policy change is in part a response to increasing bank investment in securities that have complex cash flows analogous to MDPs but that escaped the analysis requirement of the previous policy. Mortgage index amortizing notes are an example of popular bank investments that potentially exhibit all the risks of MDPs but were not subject to the testing requirement of the soon-to-be rescinded policy because they are not collateralized by mortgages. Callable agency and "step-up" bonds are popular bank investments because they offer a slightly larger spread to Treasury than noncallable agency securities, and they were not subject to the "high-risk" test under the old policy. However, the additional yield offered on these kinds of securities compensates the investor for assuming additional risk. Appropriately measuring portfolio return can enhance the ability to monitor the extent to which these kinds of securities put future earnings at risk.

Total Return Analysis Is a Useful Tool for Analyzing Risk at the Portfolio Level

Total return analysis is a basic but useful tool that can alert management to the level of certain risks in an investment portfolio. It can also provide information that is useful for validating the assumptions used in more sophisticated models. Total return is calculated from three components: beginning price, income and reinvested cash flow, and ending price (market value) at a horizon date. Total return incorporates the change in the market value of the investment, resulting in a more comprehensive measure of performance than other measures that ignore such changes. Monitoring total return on a portfolio basis can provide institutions with important information about the risks inherent in the portfolio and how these risks may be changing over time.

In two articles in the ***ABA Banking Journal***,[2] Nicholas Betzold and Richard Berg convincingly dispute the

[1] A security was deemed "high risk" if it exhibited any of the following characteristics: (1) it had a weighted average life of more than ten years; (2) its average life extended by more than four years or shortened by more than six years from a 300 basis point parallel shift in rates; (3) its price changed by more than 17 percent given a 300 basis point parallel shift in rates.

[2] The articles were published in December 1996 and April 1997. Reprints of the articles are available at the *ABA Banking Journal* website at http://www.banking.com.aba/backissues.htm.

view that if the investment strategy is to buy and hold to maturity, total return is not relevant. Consider the following example. In 1990, Bank A purchases a seven-year security yielding 8.83 percent that is callable after three years. At the same time, Bank B buys a noncallable seven-year agency security yielding 8.53 percent. For three years, Bank A's bond yields 30 basis points more than Bank B's. However, from 1990 to 1993, interest rates fell almost 300 basis points. Bank A's bond would likely be called, forcing the bank to reinvest at a significantly lower rate for the remaining four years of the seven-year investment horizon. Over the seven-year horizon, Bank A could expect an average yield that is about 150 basis points less than Bank B's.

From the yield perspective, Bank A enjoyed three years of superior performance. However, during those three years, monitoring total return might have revealed a less favorable but more accurate picture of Bank A's performance relative to Bank B's. Here is why: As rates fell from 1990 to 1993, bonds gained in value. However, as rates fell, the market value of the callable security would have gained incrementally less than the noncallable bond because each downward tick in rates increased the expectation that the bond would be called, and the higher coupon would be earned over a shorter period. In contrast, the noncallable security's market value would have enjoyed the full benefit of the falling rate environment because its maturity and cash flows are fixed.

The disparate change in the market value of the two bonds reflects the fact that Bank A, in essence, sold a call option to the bond issuer. The issuer bought the right to repurchase the debt at par after three years. Bank A was compensated for selling this right to the issuer with increased yield. In the example, the issuer's option to call the bond would have gained value as rates fell. The increasing positive value of the call option to the issuer represents an increasing negative value to the bondholder and erodes the value of the bond.

Step-up bonds present reinvestment risk similar to that of generic callable bonds, but with the added complexity of a coupon that rises, usually annually, if the bonds are not called. Total return analysis would similarly reveal adverse changes in the value of the embedded call options and the extent to which the additional coupon is compensating for call risk.

UBPR Yield

Bank management often uses the portfolio yield that is calculated in the Uniform Bank Performance Report (UBPR) to assess performance of the bank's securities portfolio against its peers. This yield measure is calculated by dividing annualized book income on a tax equivalent basis (plus or minus amortization or accretion of any premium or discount) by the amortized cost of the securities. This measure of present yield says little about potential future yield and the extent to which, because implicit options have been sold, the latter has been put at risk for the sake of the former.

Total return measures the risk-adjusted return of a portfolio more closely than yield because it incorporates changes in reinvestment risk over time. *Ultimately, a portfolio manager who earns total returns consistently higher than average will earn more in terms of simple yield. Conversely, a manager who earns less in terms of total return will eventually find an unfavorable reinvestment environment that will erode reported yield.*

The popularity of using yield to gauge the performance of bank securities portfolios may be due to the convenient presentation of bank peer portfolio yields in the UBPR. Some managers may be reticent to evaluate portfolio performance using total return without a peer-like benchmark for calibrating total return expectations.

Betzold and Berg have devised an investment portfolio index (introduced in the April 1997 ***ABA Banking Journal***) that is designed to track the total return of a typical bank portfolio composed of the same percentages of investment sectors as the average bank. The portfolio on which the index is based is rebalanced monthly as principal pays down, and it is rebalanced quarterly to reflect the latest Call Report data on portfolio allocations. Table 1 depicts the investment weighting of the index as of December 31, 1996, based on September 30, 1996, Call Report data.

According to Betzold and Berg, this index produced total returns that closely approximated those of the actual median bank total portfolio measured by Call Report data from 1993 through third quarter 1997.[3] They concluded that their index seems to provide a reasonable proxy for the total return of the "average" bank investment portfolio.

Chart 1 shows the performance of the index so far this year.[4] Changes in the index value over time can be translated into total returns that approximate the median bank portfolio's total return. For example, the annualized total return for the index from year-end 1996 through third quarter 1997 was 6.72 percent and is calculated as follows:

> Calculate the bond equivalent semiannual yield and express the semiannual bond equivalent yield as an effective annual yield.

$$6.72\% = 100\left[\left(\frac{105.00}{100.00}\right)^{\frac{4}{3}} - 1\right]$$

The performance of the index for 1997 suggests that banks' total investment portfolio returns were highly negatively correlated with changes in the five-year Treasury rate (see Chart 2). This finding indicates that changes in total return from period to period can provide useful information about the level of a portfolio's interest rate sensitivity. As emphasized above, these changes in total return over time include the effects of changes in market value of any call options on a bank's investment securities and hence provide information about the degree to which future income is at risk.

Given the increasing level of optionality embedded in the average bank securities portfolio—even if it arises solely from callable agency debt and "step-up" structured notes—yield should not be the sole measure of overall portfolio performance. Total return analysis is an appropriate supplement that gauges the risk-return characteristics of an investment strategy that involves selling implicit options.

Allen Puwalski, Senior Financial Analyst

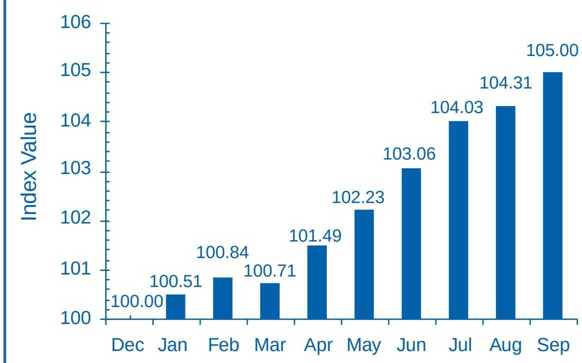
Table 1

Composition of Betzold Berg Index December 31, 1996	
Security Type	Percent of Index
Treasuries	24.52
Agencies	24.38
Municipal bonds	12.26
Fixed-rate mortgage or mortgage-related products	19.93
Other securities	6.09
Adjustable-rate securities	13.00

Source: Bank and Thrift Call Reports, September 30, 1996

Chart 1

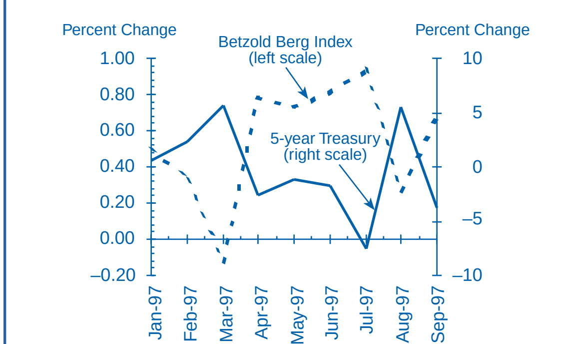
Index Tracks the Total Return of an "Average" Bank Portfolio



Source: *ABA Banking Journal*

Chart 2

Total Return Index Is Correlated to Changes in Interest Rates



Source: *ABA Banking Journal*, Bloomberg

[3] While the Call Report does not contain the information necessary to compute total return precisely, the authors computed an estimate using the reported yield and market value data.
[4] The index is published monthly in the ***ABA Banking Journal.***

New York Region: Expansion Continues, but Big Cities Lag

- **The New York Region is continuing its job expansion, although growth slowed somewhat during the third quarter of 1997.**
- **The largest cities in the Region, including Baltimore, New York City, Philadelphia, and Washington, D.C., continue to lag behind the Region in job growth.**
- **After almost two decades of economic growth, Puerto Rico's employment growth appears to be leveling off, especially in the business service and lodging sectors.**

Regional Employment Gains Continue, Although at a Slower Pace

Employment expansion in the New York Region continued in the third quarter of 1997, with about 270,000 new jobs added compared to the third quarter of 1996. This increase represents growth of about 1.3 percent, which is somewhat slower than the 1.7 percent Regional job growth recorded in the first half of 1997, compared to the first half of 1996. Employment growth in the Region still lags the nation despite the new jobs. In the third quarter of 1997, the nation's job base grew 2.2 percent.

The Region's largest cities, including **Baltimore, New York City, Philadelphia**, and **Washington, D.C.**, continue to lag behind the rest of the Region in employment growth. The slower growth of these cities, in part, explains why the Region is growing more slowly than the nation. In 1996, these four cities combined had a population of more than ten million people, representing slightly more than one-fifth of the Region's population. In that year, they had a combined nonfarm workforce of over five million workers, hosting nearly one-quarter of all the jobs in the Region.

Continuous erosion of the employment bases in Baltimore, Philadelphia, and Washington, D.C., has taken place since 1990, as shown in Chart 1 (next page). Between 1989 and 1996, Baltimore lost 70,000 jobs or almost 15 percent of its workforce. During that same time frame, Philadelphia lost more than 85,000 jobs or 11 percent of its workforce, and Washington, D.C., lost about 58,000 jobs or 8.5 percent of its workforce. In New York City, where the recession was the most severe, job losses totaled more than 250,000 or about 7 percent of the city's employment base.

Recent job growth in these large cities remains modest despite the strong national economy. Between 1993 and 1996, New York City regained more than 74,000 jobs, representing 1.3 percent average annual growth over the three-year period. Moreover, during the first three quarters of 1997, New York City added about 46,000 new jobs, representing a 1.4 percent growth rate compared to the same period in 1996. Baltimore and Philadelphia have experienced only minimal job growth during the first three quarters of 1997. Conversely, Washington, D.C., lost more than 8,000 jobs or 1.3 percent of its workforce over the first three quarters of 1997, compared to the same period in 1996.

Unemployment Rates for the Cities Are Well above Those for the Surrounding Suburbs

As a result of the slow job growth, the unemployment rates for the cities are well above those for the surrounding suburbs. For example, during the first three quarters of 1997, unemployment rates in suburban Anne Arundel, Carroll, Frederick, Howard, and Montgomery Counties in **Maryland** were four to five points below the 8.4 percent average rate in Baltimore. The same is true of Philadelphia, where the average unemployment rate of 6.7 percent is two to four points higher than in the surrounding **Pennsylvania** counties of Bucks, Delaware, Lancaster, Chester, and Montgomery. Furthermore, unemployment rates in Charles and Prince George's Counties in Maryland are three to four points below Washington, D.C.'s, 7.7 percent unemployment rate. The largest discrepancy is in New York City, where the unemployment rate recently has approached double digits. Unemployment rates are five to six points lower in suburban Nassau, Suffolk, and Westchester Counties in **New York State**. In general, the suburban areas have

CHART 1

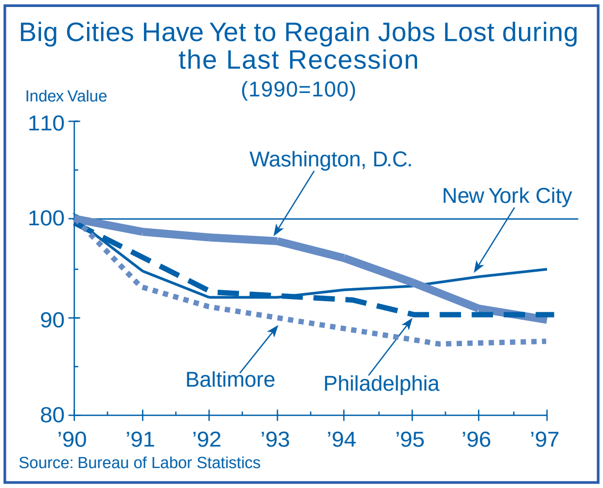
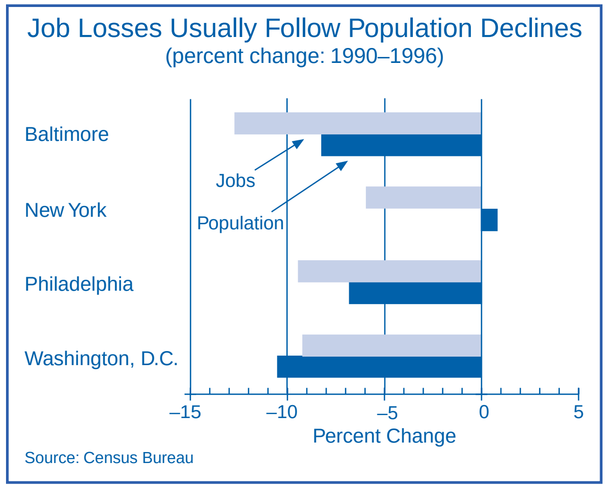


CHART 2



benefited more than the cities from job increases in business services, high-tech industries, and health care. The cities have not attracted these kinds of jobs to the same degree, and they continue to lose manufacturing positions.

Population Loss Follows Job Decline

Employment and population growth are often associated. Employment growth can stimulate population growth as more workers migrate into the area to take advantage of employment opportunities. Once living in the area, more people generate increased demand for goods and services, which may in turn create more local jobs. On the other hand, declining population is often associated with job losses. In three of the Region's four largest cities, losses in jobs have paralleled losses in population (see Chart 2). Only in New York City did the population remain relatively steady. The relative stability of New York City's population may be a factor in its recent modest turnaround.

Personal Income Growth Also Is Stronger in the Suburbs

Personal income growth generally tracks employment growth, and the big cities are lagging in that measure as well. For example, between 1990 and 1995, personal income in the United States rose 28 percent or about 5 percent a year. However, in Philadelphia it rose less than half that amount, or 13.5 percent, while in Baltimore personal income rose only about 15 percent. In Washington, D.C., personal income rose 19 percent, and in New York City it rose 22 percent. New York City's personal income growth has been boosted by the large bonuses Wall Street paid in recent years as the stock market surged.

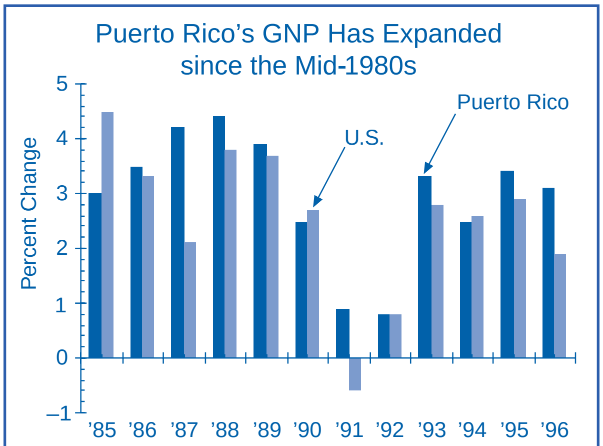
Personal income growth patterns are similar to employment growth patterns in that the surrounding suburban counties are outperforming the Region's largest cities. Personal income growth in the surrounding counties of Baltimore ranged between 25 and 36 percent between 1990 and 1995. In the counties surrounding Philadelphia, personal income growth ranged from 20 to 37 percent, while in the surrounding counties of Washington, D.C., personal income rose between 26 and 29 percent. Only New York City had comparable personal income growth rates with its surrounding counties. Personal income growth ranged from 16 percent in Nassau County to 23 percent in Westchester County.

Why Are These Cities Underperforming?

There are many explanations for the lagging performance of these cities, including the age of the cities, high taxes, costs of doing business, quality of life, and population changes. All of the Region's four largest cities are older industrial cities, with aging infrastructure and transportation systems, a relative lack of space for business expansion, and an acute housing shortage. Quality of life issues—including personal safety, educational opportunities, housing stock, cultural attractions, restaurants and park facilities, and overall congestion—clearly affect location decisions for businesses and individuals.

Another major factor is the cost of doing business. Although the degree to which businesses make location and expansion decisions based on local costs cannot be precisely measured, it is clear from numerous surveys that taxes, energy, labor, and telecommunication costs can help or hurt a company's bottom line. In the aggregate, these factors may have an important effect on an area's growth rate. The 1997 annual study of metropolitan area business costs for 100 metropolitan areas by ***Regional Financial Associates*** (RFA) indicates that the Region's major cities score very high in cost components (see Table 1). The data used by ***RFA*** included four components: unit labor costs, office rents, energy costs, and taxes. All the Region's largest cities scored in the top ten for the combined cost category, with New York City ranking number one in most of the categories.

CHART 3



Source: Commonwealth of Puerto Rico Official Statement

Puerto Rican Economy Expanded during the 1980s and 1990s

Puerto Rico has experienced a wide-ranging expansion since fiscal year 1985, with growth in almost every sector of its economy and record levels of employment. Although increases in real gross national product slowed to less than 1 percent in fiscal year 1991, reflecting the effects of the recession in the U.S. economy, the more rapid growth pattern resumed after the U.S. recession. Gross national product increases of 3.4 percent and 3.1 percent for fiscal years 1995 and 1996 outperformed growth rates in the U.S. economy (see Chart 3). Factors contributing to Puerto Rico's long-term expansion include government-sponsored economic development programs, relatively stable prices of oil imports, the continued growth in the U.S. economy, and the relatively low cost of borrowing from the mid-1980s to the present.

According to the ***1997 Commonwealth of Puerto Rico Official Statement***, the economy in Puerto Rico is now more diversified than it was in earlier periods of its development. Over the past 20 years, industrial development, for example, has become more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by the heavy investment in pharmaceutical, scientific instrument, computer, microprocessor, medical product, and electrical product industries over the past decade. The Puerto Rican economy also has become more service oriented, with growth in business, social, and health care services taking a greater share of the new jobs. One of the major factors aiding the development of the manufacturing sector has been tax incentives offered by the federal and Puerto Rican governments. However, federal legislation amending Internal Revenue Code Section 936 phases out the federal tax incentives over a ten-year period beginning last year (see ***Regional Outlook,*** First Quarter 1997.)

The strong growth in the economy has been responsible for declining unemployment rates in all the metropolitan areas in Puerto Rico (see Table 2, next page). However, the 13.5 percent overall unemployment rate in Puerto Rico is still high compared to the U.S. unemployment rate, which averaged about 5 percent throughout 1997.

TABLE 1

Largest Regional Cities Rank High in Business Costs - 1997 (U.S. Index = 100)

	Combined	Rank	Labor	Rank	Energy	Rank	Taxes	Rank	Rent	Rank
Baltimore	112.1	6	101.9	44	105.9	39	130.4	9	89.2	39
New York	129.0	1	103.9	32	187.8	1	180.6	2	151.8	1
Philadelphia	110.0	10	103.8	33	148.9	4	105.1	44	96.5	27
Washington, D.C.	112.4	5	104.8	27	94.7	53	186.0	1	151.1	4

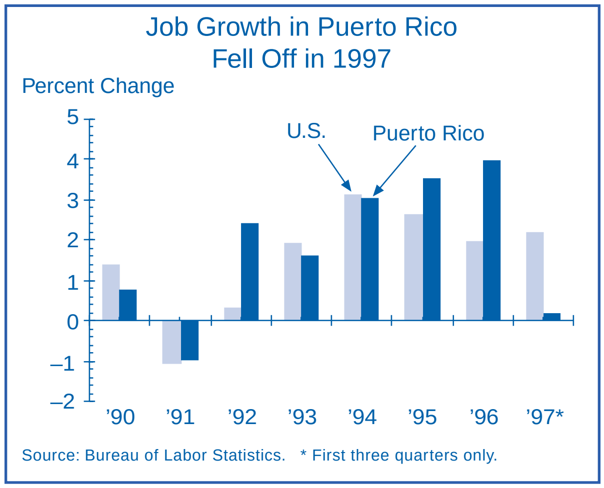
Source: Regional Financial Associates

Table 2

Puerto Rican Unemployment Rates Remain High in the 1990s					
	1991	1993	1995	1996	1997
Puerto Rico	16.0	17.0	13.7	13.4	13.5
Aguadilla	20.3	21.8	18.1	19.9	20.1
Arecibo	18.3	19.2	16.6	16.2	16.1
Caguas	16.6	17.0	13.3	12.4	12.2
Mayaguez	18.6	18.2	14.8	15.7	16.7
Ponce	20.0	21.7	17.3	18.3	18.1
San Juan	13.3	14.1	11.8	10.6	10.7
United States	6.8	6.9	5.6	5.4	5.1

Source: Bureau of Labor Statistics. 1997 Is Average of First Three Quarters.

Chart 4



Puerto Rico's Employment Growth May Be Leveling Off

Job growth in Puerto Rico in 1997 may be leveling off. After adding almost 32,000 jobs (3.5 percent) in 1995 and 37,000 jobs (almost 4.0 percent) in 1996, growth during the first three quarters of 1997 dropped to 2,000 jobs (less than 1 percent) compared to the same period in 1996 (see Chart 4). The slowdown contrasts with Puerto Rico's rapid growth throughout the 1980s and 1990s, when Puerto Rico added a substantial number of jobs to its workforce. Between 1990 and 1996, for example, Puerto Rico added more than 120,000 jobs, for an increase of about 2.2 percent on an annual average basis. The **San Juan** area, which represents almost 65 percent of the island's workforce, added more than 84,000 jobs, or 2.5 percent annually. The other major metropolitan areas combined (**Caguas**, **Mayaguez**, and **Ponce**) added about 38,000 jobs, or 3.4 percent annually. These growth rates exceeded comparable U.S. rates, which were about 1.5 percent on an annual average basis.

Some of the slowdown can be traced to a sharp decline in business service employment growth, which had risen at about 10 percent annually in 1995 and 1996. This sector grew less than 1 percent during the first three quarters of 1997 compared to the same period in 1996. The erosion of manufacturing jobs is also hurting growth in the economy. Manufacturing employment was down 0.5 percent in 1996 and declined another 1.3 percent through the first nine months of 1997 compared to the same period in 1996. In addition, during the first three quarters of 1997, employment in the hotel and lodging industries dropped 4.9 percent compared to the same period a year earlier. Ironically, these industry sectors are currently adding jobs throughout the Region and the United States, and they are partially responsible for the record job expansion in the nation.

The slowdown also may be related to changes in Section 936 implemented in 1996. However, a ***General Accounting Office*** study published in May 1997 was unable to conclude whether the loss of the tax provisions would have a detrimental effect on the Puerto Rican economy. At the time of the study, the economic indicators through 1996 looked positive. Nevertheless, some negative effects from the provision's loss may now be taking place. In response to the loss of Section 936, the government recently passed several local tax incentive measures designed to stimulate business development.

Implications: It is still uncertain whether the leveling off in employment growth in Puerto Rico is a result of the loss of Section 936 or is a short-term cyclical event. It is possible that employment growth will bounce back in 1998. *However, after almost two decades of sustained economic expansion, the Puerto Rican economy may be entering a period of slower growth. If so, loan demand may slow and banks may have to adjust temporarily to a more slowly growing economy. If the slowdown is structural and due to the loss of Section 936, banks may have to adjust more permanently to a changed economic environment.*

Norman Gertner, Regional Economist

Current Regional Banking Issues

- **The New York Region's financial institutions report solid performance.**
- **Credit card banks' charge-off rates and past due levels continue to rise.**
- **The wave of mergers and acquisitions in the Region persists as the regulatory environment changes and competition intensifies.**
- **New bank formation in the Region heats up, especially in New Jersey and Pennsylvania, as merger activity leaves fewer independent community banks.**

The Region's Insured Institutions Remain Healthy, Despite Credit Card Problems

The Region's banks and thrifts reported relatively strong financial conditions for the nine months ended September 30, 1997 (see Table 1). Insured institutions in the New York Region reported a return on assets (ROA) slightly higher than one year earlier, despite a decline in net interest margin (NIM), primarily due to an increase in noninterest income. The Region's average leverage capital ratio fell slightly over the same period but continues to be strong. Insured institutions showed a continued decline in nonperforming assets (NPA) in the third quarter of 1997, reflecting improvement in commercial real estate loan portfolios. Residential real estate portfolios, however, are showing signs of weakness as nonperforming residential real estate loans have increased to a weighted average of 2.82 percent from 1.91 percent a year ago. This ratio, weighted based on one- to four-family first-lien residential real estate loans, is highest in northern **New Jersey**, **Puerto Rico**, and upstate **New York**.[1] Since residential loans make up about 25 percent of the Region's total loans, any negative trend in that sector warrants attention.

Table 1

New York Region Institutions Continue to Show Strength			
	9/30/97	9/30/96	9/30/95
Return on Assets	1.04	1.01	1.11
Net Interest Margin	3.51	3.69	3.82
Rate of Exchange	13.82	13.40	14.50
Tier 1 Leverage	7.18	7.25	7.43
Nonperforming Assets/Total Assets	0.83	1.00	1.22
Past Due Loans (%)	2.58	2.72	3.07
Nonperforming Residential Real Estate Loans (%)	2.88	2.00	2.15
Source: Bank and Thrift Call Reports			

The Region's 26 credit card banks continued to report higher charge-off rates in the third quarter. Their weighted average charge-off rate was 5.96 percent, compared to 5.67 percent as of June 30, 1997, and 3.72 percent as of December 31, 1996. Past due and nonaccrual rates, which had been declining over the previous two quarters, rose to 4.86 percent in the third quarter, compared to 4.5 percent in the second quarter.

Merger and Acquisition Activity Continues to Sweep through the Region

In 1997, 46 merger and acquisition transactions involving New York Region banks and thrifts were announced. These deals had an aggregate value of $22.7 billion. Merger and acquisition activity was up compared to 1996 in terms of aggregate value; in 1996, 46 transactions with an aggregate value of $4.5 billion were announced. Capping off merger and acquisition activity in 1997 was the November 19 announcement that First Union Corporation of Charlotte, North Carolina, will acquire CoreStates Financial Corp., a Philadelphia-

[1] The weighted nonperforming residential real estate loan ratio was 5.57 percent in the Wayne field office, 5.37 percent in the San Juan field office, and 3.18 percent in the Syracuse field office.

based banking company. Analysts are speculating about other potential "regional" bank targets and opine that banks operating independently in larger markets are likely acquisition targets.

Regulatory and State Legislative Changes Spur Acquisitions as Financial Modernization Stalls

Despite intense congressional debate on financial modernization over the past two years, it has been regulatory and state legislative changes that have altered the profile of the financial services industry and spurred acquisition activity. Financial services companies, including banks, are maneuvering through existing regulations and court rulings to enter into deals once forbidden by Depression-era laws separating the banking, insurance, and securities industries.

One example is the number of acquisitions of investment banks and brokerages by banking companies since the Federal Reserve Board of Governors more than doubled the amount of revenue a so-called Section 20 company can derive from its underwriting and dealing in bank-ineligible securities.[2] Effective March 6, 1997, this limitation (part of the regulations implementing Section 20 of the Glass-Steagall Act prohibiting affiliations between banks that are members of the Federal Reserve and companies that are "principally engaged" in underwriting and dealing in bank-ineligible securities) was increased by the Federal Reserve from 10 to 25 percent. This change substantially increased the ability of a Section 20 company to engage in all types of underwriting and dealing activities. The change also provided the impetus for new players to enter these businesses. The opportunity to purchase an equity underwriting franchise may be an attractive alternative to banks compared to the slow, expensive, and uncertain process of internal building. ***Moody's Investors Service*** *believes that the strategic decision to speed the building process will continue to be a prime factor motivating future acquisitions*.

Twenty-one banking organizations headquartered in the Region have Section 20 powers. This group includes some of the largest bank holding companies in the Region and ten foreign banking organizations. While some banking organizations have committed to building new securities units, others have used acquisitions to build this business line. For example, Bankers Trust New York Corp. acquired an investment bank, and PNC Bank Corporation purchased a portion of an institutional brokerage firm. Mellon Bank Corp., with an eye toward technology in the investment business, acquired an on-line discount brokerage firm. Mellon's acquisition strategy cited the time and costs that would be required to create the same capabilities internally versus the established presence of the target.

States also are moving forward with legislative changes that allow banks to enter previously precluded businesses. **Pennsylvania** enacted legislation that liberalizes the regulation of insurance sales for state banks. Pennsylvania banks can now sell life as well as property and casualty insurance, in addition to annuities and credit life insurance.

Interstate Banking and Branching Influences Acquisition Activity

One piece of federal legislation that has changed the profile and acquisition strategies of the banking industry is the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. This Act, which in many cases confirmed a push for interstate banking that began at the state level, provided further momentum for bank and thrift acquisitions. For example, the total number of interstate acquisitions in the country in 1996 was 146, or 34 percent of all acquisitions, compared to just 46 transactions, or 24 percent, in 1990. Interstate branching has changed the profile of bank operations in the Region, with out-of-state banks holding a large share of deposits in most states in the Region (see Table 2).

Mergers Emphasize Profitability, Efficiency, and Technology

Market pressure on insured institutions has shifted from growth in the loan portfolio to the identification of new sources of revenue and cost savings. Many banks have succeeded in expanding their business lines and diversifying their income streams. Over 26 percent of total income for the Region's banks and thrifts now comes from sources other than interest income, nearly double the proportion in 1990. Some analysts believe this figure could reach 50 percent by 2005. While the Region's

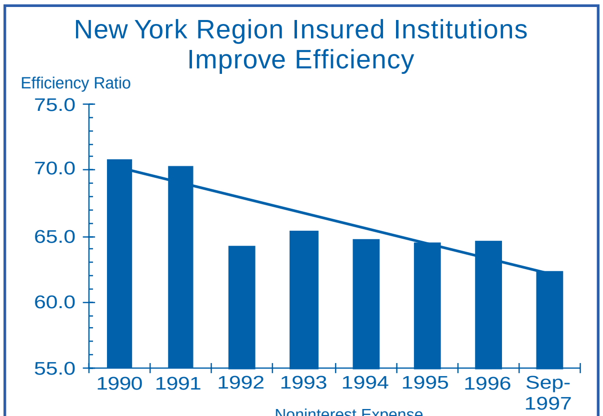
[2] Bank-ineligible securities generally include all types of debt and equity securities other than obligations of the United States government, general obligations of states and political subdivisions, banker's acceptances, and certificates of deposit.

TABLE 2

OUT-OF-STATE BRANCHES HOLD A LARGE SHARE OF INSURED BRANCH DEPOSITS	
STATE	% OF DEPOSITS HELD BY OUT-OF-STATE BRANCHES
DELAWARE	24
DISTRICT OF COLUMBIA	75
MARYLAND	37
NEW JERSEY	33
NEW YORK	6
PENNSYLVANIA	0
PUERTO RICO	15

SOURCE: SUMMARY OF DEPOSITS, FDIC/OTS DATABOOK, JUNE 30, 1997

CHART 1



Note: Efficiency Ratio = Noninterest Expense / (Noninterest Income + Net Interest Income)

Source: Bank and Thrift Call Reports

largest commercial banks generate the largest proportion of noninterest income to total income, commercial banks with assets between $100 million and $1 billion have made the largest shift toward a more diversified income stream in the 1990s. Commercial banks in this segment generated noninterest income equal to over 22 percent of total income as of September 30, 1997, compared to 9 percent in 1990. The shift toward more diversification in the income stream may in part be driving higher price/earnings ratios for bank stocks (see ***Second Quarter 1997 Regional Outlook, Financial Markets***). In turn, greater market capitalization has significantly enhanced the ability of buyers to make acquisitions, and higher price levels have made mergers more attractive for potential sellers.

Merger and acquisition strategies have placed emphasis on increased efficiencies. Often, mergers allow banks to cut costs through shared staffing and technology costs. In the case of mergers in which a significant number of branch operations overlap, substantial cost savings may be realized by closing or consolidating bank branches. *Measures of efficiency for insured institutions in the Region have generally improved since the beginning of the decade, when the high costs associated with the workout of problem loans elevated the efficiency ratio* (calculated as noninterest expense divided by noninterest income plus net interest income). The aggregate efficiency ratio of the Region's insured institutions as of September 30, 1997, was 62.3 percent compared to 65.3 percent in December 1993 (see Chart 1). Segmentation of the Region's commercial banks by size revealed that banks with assets between $1 billion and $10 billion were the most efficient, with an aggregate efficiency ratio approaching 56.4 percent as of September 30, 1997. With many banks attaining efficiency ratios below 50 percent, analysts indicate that the industry can yet make considerable improvement with regard to efficiency, and mergers may enable banks to do so. Mergers also enable banks to market their products to an established base of existing customers at the target institution. To the extent that these customers can be retained, the acquirer has, in effect, purchased a market for its products.

Technology will play a key role in merger and acquisition activity, especially as the year 2000 approaches. Many banks have invested heavily in technology, and those that have not may become merger targets. Analysts predict that problems associated with the year 2000 have the potential to push banks not prepared for the millennium into the arms of an acquirer.

Mergers Create New Risks

Risks associated with mergers and acquisitions often include striking the appropriate balance between opposing goals. For example, in an effort to maintain or increase current shareholder value, a bank may reach for yield by increasing risk. Emphasis on strict cost controls may impede a bank's capacity to maintain an appropriate control environment. This situation may be compounded when a bank acquires a company with a different business line or risk profile. For example, in attempting to transform into "financial services supermarkets," bank acquirers face significant challenges in harmonizing acquired cultures with their own banking and capital markets activities. A ***Moody's Investors***

Service report, ***Mergers and Acquisitions in the Securities Industry***, identified the following risk factors:

- management incompatibility resulting in turnover and loss of top producers;
- management unfamiliarity with the acquired business;
- inadequate due diligence that fails to identify the extent of legal, reputation, or asset quality problems;
- risk tolerance levels at the acquired company that are dangerously high; and
- incompatible technologies that undermine adequate controls and require costly upgrades.

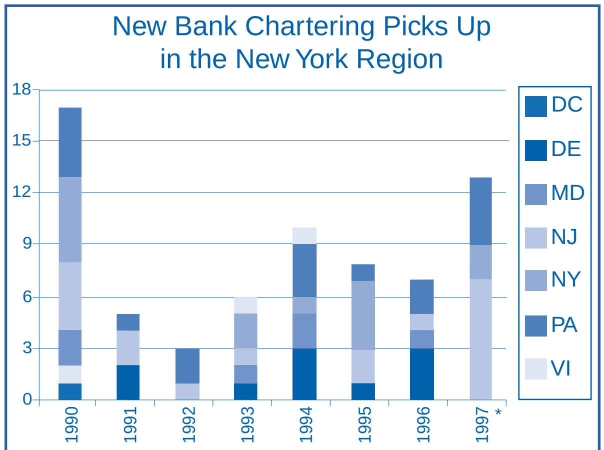
Failure to address these issues in any acquisition transaction could derail the anticipated benefits of a merger and could increase the risk profile of newly merged financial services companies, including insured institutions.

New Bank Charters Are on the Increase

The consolidation of the U.S. banking industry over the past decade has helped create a related trend—the rise of new bank charters. The turmoil that has accompanied industry consolidation seems to have opened up opportunities for new banks by spurring bank customers to reevaluate their banking relationships and by displacing bank employees. These new banks hope to provide competition in local markets where consolidation has resulted in limited choices for consumers and businesses. In the first three quarters of 1997, 141 new insured institutions opened nationwide, with particularly strong activity in the Atlanta and San Francisco Regions.

Chartering of new banks in the New York Region picked up in 1997. *Thirteen new banks opened in the Region in 1997 (through November), the highest number since 1990* (see Chart 2). Nine additional bank charters were approved through November 1997 but have not yet opened. The Division of Supervision in the New York Region also reported 14 pending applications for new charters, indicating that formation of new banks in 1998 could be equally brisk, if not more so. **New Jersey** and

CHART 2



Source: Bank and Thrift Call Reports * Through November 30, 1997

Pennsylvania, states that have been particularly affected by significant numbers of consolidations, saw the most new banks chartered over the past year. The number of insured institutions chartered in New Jersey has declined from 275 to 156, or 43 percent, since the beginning of 1990. In Pennsylvania, the number of insured institutions has declined from 473 to 330, or 30 percent, over the same period.

New banks face many hurdles and risks. They must have the financial strength and managerial experience to survive beyond the initial period of losses (generally two to three years on average) encountered as a result of start-up organizational and operating costs. *The same competitive forces that are influencing merger and acquisition activity in the banking industry can affect a new bank's ability to attract customers profitably.* Margins may be squeezed if new banks have to offer lower rates on loans or higher rates on deposits to bring in new accounts. With minimal sources of noninterest income, new banks tend to rely on the spread to make money. This makes operational efficiency of utmost importance. A February 1997 study, ***The Performance of De Novo Commercial Banks***, issued by the ***Comptroller of the Currency***, found operational efficiency to be a major factor in the success of new banks. The study found that the average newly chartered commercial bank's efficiency improves rapidly over the first three years of operation but doesn't match established banks' efficiency levels until year nine. Management, therefore, must establish proper controls over all areas of operations from the beginning. Discipline is needed to contain costs as well as minimize the tendency to turn to riskier assets to grow and improve margins.

The study further cited previous findings concluding that new banks' performance was most directly associated with factors within the control of bank managers—such as containment of wage costs and the initial growth rate of the bank—and was less affected by external forces such as market concentration. *This suggests that although competitive forces certainly play a part in the ability to generate income, a sound business plan and strong management are imperative to a new bank's ability to compete effectively and profitably over the long run.*

As consolidation in the industry intensifies, formation of new banks may be expected to continue. As banking services are delivered increasingly through technology and less through brick-and-mortar branches, the question becomes whether the market will support many more such institutions. Nevertheless, many consumers in smaller communities appear to prefer the personal service associated with community banks. A surprising number of consumers have demonstrated a willingness to move accounts from a recently acquired bank to a local, independent bank. Small established banks, as well as new banks, are taking advantage of such situations with increasing assertiveness.

Suzannah L. Susser, Regional Manager
Karen A. Wigder, Financial Analyst

For More Information

Mergers and Acquisitions in the Securities Industry, Moody's Investors Service Special Comment, October 1997.

The Performance of De Novo Commercial Banks, Robert DeYoung (Office of the Comptroller of the Currency) and Iftekhar Hasan (New Jersey Institute of Technology), February 1997, issued by the Comptroller of the Currency.

Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, Federal Reserve System Docket No. R-0841.

Riegle-Neal Scorecard, FDIC Division of Research and Statistics.

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta	______	Boston	______	Chicago	______
Dallas	______	Kansas City	______	Memphis	______
New York	______	San Francisco	______	All	______

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE MAIL
Postage & Fees Paid
FDIC
Permit No. G-36