Regional Outlook

Federal Deposit Insurance Corporation — Third Quarter 1997

FDIC Boston Region

Division of Insurance

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In Focus This Quarter

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◆ ***Retail Shakeout: Causes and Implications for Lenders*—Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions.** *See page 6.*

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Subprime Lending: A Time for Caution

- **Subprime lenders specialize in lending to borrowers with blemished or limited credit histories.**

- **The consequences of deficiencies in underwriting, servicing, and collection can be severe with subprime lending. Lenders that fail to dedicate the necessary resources in these areas likely will have trouble succeeding in the increasingly competitive market for subprime loans.**

- **Some institutions insured by the FDIC have failed to properly assess and control the risks associated with their subprime lending programs.**

What Are Subprime Loans?

Faced with strong competition and shrinking margins on loans to high-quality borrowers, some lenders are moving down the credit quality spectrum. The strategy to extend loans to borrowers perceived as less creditworthy is referred to as "subprime" lending. *Subprime lending is most commonly associated with auto, home equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories.* Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

Subprime loans also are referred to as marginal, nonprime, or below "A" quality loans. There are no established guidelines for determining the degree to which a borrower is considered subprime, so one lender's "B" customer could be another lender's "C" customer. Definitional variations aside, some general market parameters on ranking loans are presented in Table 1.

Table 1

Criteria for Loan Rankings

Grade	Payments Late 30 Days	Bankruptcy Filing
Prime	None	None
A-	Less than 2	None in 5 years
B	Less than 4	None in 3 years
C	Less than 6	None in 2 years
D	Constantly Late	None in 1 year

Sources: Duff & Phelps, Standard & Poor's, Mortgage Market Information Services

How Big Is the Market?

The lack of a standard definition for a subprime loan makes it difficult to accurately determine the extent of the market. However, some industry experts estimated that during 1996, subprime loans secured by residences, including both home equity and mortgage loans, amounted to between $100 billion and $150 billion compared to the estimated $800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between $75 billion and $100 billion, or about 20 percent of total auto loans outstanding.

Who Makes Subprime Loans?

In the past, subprime lending was primarily the domain of a limited number of finance companies. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of subprime lenders, however, has surged in recent years as more companies have been attracted by the significantly higher rates and fees earned on subprime loans. In some cases, yields on these higher risk assets have been as high as 15 percent to 30 percent. The new subprime participants include finance companies that traditionally served prime borrowers, new specialized subprime lenders, and banks.

The increase in the number of subprime lenders has been fueled by strong demand from investors for asset-backed securities (ABS). This method of funding enables the lender to effectively raise cash at a lower rate to fund loan growth. In addition, the subprime ABS market has attracted lenders that previously refrained from making subprime loans because they did not want to maintain these high-risk loans or the associated reserves on their balance sheet. By issuing securities backed by subprime loans, lenders now have the ability to originate subprime loans and sell them to ABS investors.

Favorable stock market conditions also helped to fund the growth of subprime lenders. Approximately 30 subprime lenders raised nearly $3 billion from stock offerings from January 1995 through April 1997, according to market watchers. This financing avenue may become less accessible, as investors' concerns over financial

problems of several major market participants have caused stock prices of subprime lenders to decline significantly during the first part of 1997.

Financial Difficulties of Some Subprime Lenders

Market participants have observed that, as in credit card lending, *increasing competition may be compelling some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share*. Financial difficulties reported by major subprime auto lenders Jayhawk Acceptance Corporation and Mercury Finance Company highlight these concerns.

Problems in subprime lending are not limited to auto loans. Lenders that specialize in subprime home equity loans and mortgages also are showing signs of stress. In April 1997, Moody's Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home equity loans. The reason was concern over the increasing level of delinquencies in the issuer's loan portfolio and the highly competitive environment for subprime home equity loans (see ***Financial Markets***).

Differences between Prime and Subprime Lending

There are key differences between the underwriting, servicing, and collection methods used for prime and subprime lending programs. The goal of the subprime underwriting process is to differentiate those subprime borrowers whose past credit problems were due to such temporary events as illness or job loss from the habitually bad credits. Subprime lenders often supplement a prospective borrower's credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. This process allows the lender to better determine the credit risk or "grade" of the borrower. If this determination is successful, the lender can better establish the price at which the loan will be profitable.

Servicing and collection of subprime loans tends to be more labor intensive and costly than in prime lending. Subprime lenders tend to monitor payments more closely than prime lenders. Some purportedly call their borrowers regularly to remind them when a payment is due. In addition, while prime lenders may be willing to work with late borrowers by adjusting minimum amounts or payment schedules, subprime lenders generally pursue collections more aggressively and repossess collateral more quickly.

Insured Institutions and the Subprime Market

Bank involvement in subprime lending is difficult to quantify because subprime loans are not delineated in bank and thrift Call Reports. *However, both large and small banks reportedly are participating in credit card, auto, home equity, and mortgage subprime lending.* Insured institutions have used various strategies to establish a presence in the subprime market. Some have:

- acquired or formed joint ventures with companies specializing in subprime lending;
- built subprime lending programs internally, using existing resources; and
- tapped a network of loan brokers with access to subprime borrowers. Smaller banks entering the market for subprime mortgages may use this method more commonly.

Through these strategies, insured institutions have:

- extended loans directly to subprime borrowers or purchased subprime loans from loan brokers;
- lent to subprime specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines; and
- serviced subprime loans or invested in asset-backed securities secured by subprime loans.

Risks Associated with Subprime Lending Need to Be Considered Carefully

According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because of the relatively high default rates on such loans, the FIL indicates that this type of

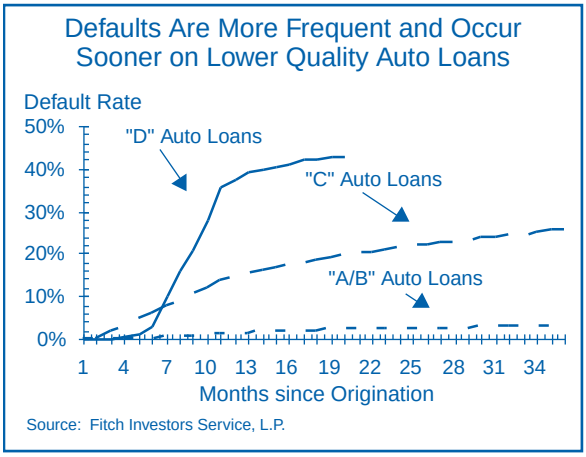
lending warrants particular caution and management attention.

Institutions need to be thoroughly aware of the increased risks and costs associated with lending to higher risk borrowers. Some of these risks include:

- *Delinquencies and defaults tend to be more frequent and occur sooner on lower quality loans* (see Chart 1).
- Loan loss reserves that would have been adequate for prime lending may not properly cover higher loss rates associated with subprime loans.
- Strains on underwriting and collection resources may emerge.
- Because selling collateral is more frequently the source of repayment on subprime loans, failure to accurately estimate recovery values could severely affect the profitability of subprime lenders. For example, several subprime auto lenders recently reported lower profits when the supply of better quality cars coming off leases depressed the prices they received on repossessed cars.

Insured institutions that rapidly increase subprime exposures also may need to reevaluate delinquency measurement methodologies. Rapid loan growth can make it more difficult to accurately track delinquency and default trends. Generally loans do not default immediately, but "season" or reach peak loss rates over a period of time. *Delinquency and default rates can be deceptively low if the proportion of new loans exceeds the proportion of seasoned loans in a lender's portfolio.* Calculating default rates over time for loans originated in a particular period or lending program, instead of as a percentage of total outstanding loan balances, helps reduce the distortion caused by rapid loan growth. This method of computing delinquency and default rates, known as "static pool" or "vintage analysis," is a common measurement tool among investment analysts.

Chart 1



Banks involved in subprime lending also should realize that the recent increase in subprime lending has occurred during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be more susceptible to downturns in the economy, which could further exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

In addition, banks that lend to subprime specialty lenders, who rely heavily on securitization, should evaluate the accounting treatment of securitization and the effect securitization may have on earnings (see ***Financial Markets***).

Conclusion

The extent of involvement by insured institutions in subprime lending is difficult to quantify. To be successful in subprime lending requires a commitment of resources and expertise. Conversely, deficiencies in assessing and controlling the risks of subprime lending can have serious consequences. Such deficiencies have surfaced at a number of FDIC-insured institutions. Striking an appropriate balance between the risks and rewards of subprime lending is a challenge for bankers and merits the continued attention of bank supervisors.

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Financial Sector Analysis Section
Debra L. Novak,
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Retail Shakeout: Causes and Implications for Lenders

- **Changes in the marketplace, technology, and finance are transforming retailing.**
- **These trends have given rise to rapid growth in the new "big box" store format.**
- **Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.**
- **The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.**

For the past two decades, construction of retail space has outstripped many indicators of demand such as growth in retail sales, population, and income. The broadest measure of the industry's health is sales per square foot, and, for shopping centers, it has fallen by around 35 percent in real terms since 1972. Chart 1 shows how growth in leasable shopping center space has exceeded growth in shopping centers' sales since 1972.

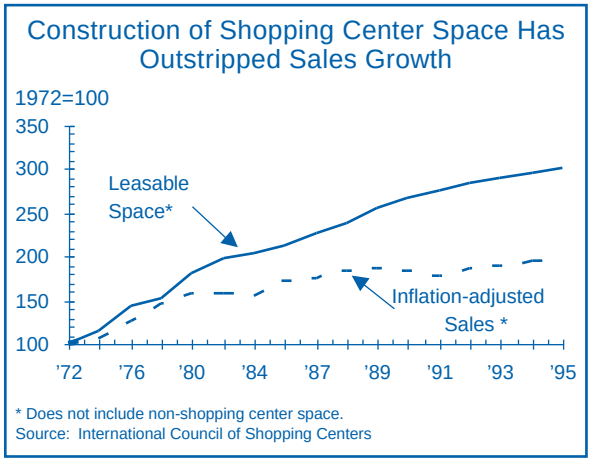
Based on signs of "overstoring," a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate, they are exposed to heightened credit risk as the shakeout unfolds.

New Forces Are Reshaping the Retail Landscape

A combination of demographic and economic forces has reduced growth in demand for retail goods from the boom days of the 1970s and mid-1980s. Meanwhile, technology is reconfiguring the way retail goods are marketed and delivered, and a low cost of capital has stimulated investment in new retail space and new retailing concepts.

A retail industry boom began roughly in 1970 when baby boomers and women began entering the work force in record numbers. At the same time, proliferation in general-purpose credit cards facilitated an extension in consumer borrowing power. As a result, there was a 98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

CHART 1



To meet this demand and serve expanding suburban communities, developers built shopping centers at a rapid pace. The number of shopping centers, from small neighborhood strip centers to huge regional malls, grew from about 13,000 in 1972 to over 41,000 in 1995.

Despite economic conditions that seem favorable for the retail sector, revenue growth has been painfully slow in the 1990s. Payrolls have seen net growth of 13.4 million jobs since mid-1991, while real disposable personal incomes and consumer confidence have risen commensurately. An optimistic household sector has shown a willingness to take on debt under these favorable conditions and has done so with the benefit of lower interest rates compared to the 1980s.

Even with generally positive economic conditions, retail demand has grown slowly in the 1990s (see Chart 2, next page). Annual rates of increase in real expenditures on many durable and, especially, nondurable goods have lagged behind rates of the previous two decades.

Slow growth in retail revenues can be explained in part by the fact that retail goods overall have risen in price at only around two-thirds of the general rate of inflation during the 1990s, while the appliance, electronics, and personal computer sector has seen actual price deflation.

An aging consumer base is another factor holding down retail sales growth. The total number of households headed by persons age 20 to 35—the age at which families are getting established and acquiring household durable goods—is the same now as it was in 1980. The lack of growth in this key demographic group has limited growth in retail demand and should continue to do so for the foreseeable future. The total population in the 20 to 35 age bracket is projected to decline slightly by 2007.

Other broad trends have contributed to slower retail sales growth. Retail sales as a percentage of personal income fell from 46 percent to 38 percent between 1967 to 1996 as consumers shifted more of their disposable income to the purchase of personal services, housing, education, travel, and entertainment. A ***Standard and Poor's Industry Survey*** reports that consumers have reduced their number of trips to shopping malls by 35 percent since 1980, while total shopping hours are down 70 percent.

Looking ahead, mail-order retailing through electronic media, including cable television and the Internet, may be poised to gain significant market share at the expense of shopping centers. "Virtual shopping malls" such as Amazon.com, an Internet bookseller, have made headlines with their initial successes, although analysts caution that widespread adoption of high-tech shopping may be some years down the road.

Technology has become a key to distribution and marketing. Faced with slower revenue growth, retailers have been investing in technology to cut their expenses and boost their bottom lines. For example, point-of-sale scanning delivers a vast amount of information that can be used to target marketing efforts and manage and control inventories—providing a distinct competitive advantage for large retail chains with vast marketing and distribution networks.

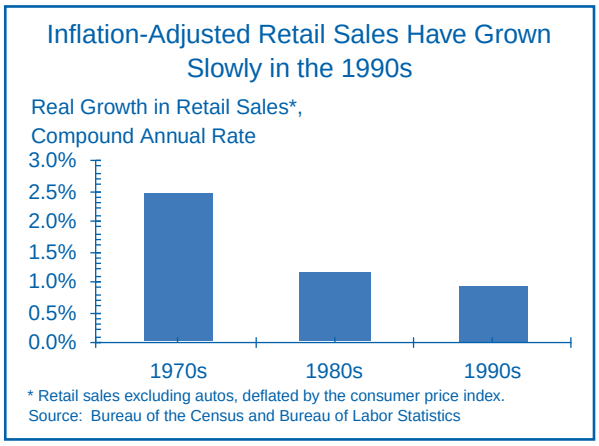
A low cost of capital has fueled investment. Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise have been infeasible. Since 1991, around 1.13 billion square feet of new retail space has been added nationwide representing an increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost $33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although they are known to be sizeable.

Growth of the "Big Box" Format

Leading retailers have responded to these forces with aggressive expansion in the "big box" store format. Big box retailers are typically discount stores and superstores, such as Circuit City, PetSmart, and The Home Depot, Inc., which tend to cluster in large strip malls called "power centers." In many towns and cities, the arrival of big box stores has left smaller, local retail establishments with only a small fraction of their former share of the local market.

The big box format has a number of advantages. Among the most important is the ability to offer a large, diverse on-shelf selection. This approach enables a single location to dominate that retail category in the local market, which is why the big box chains are often referred to as "category killers." Large retail chains also have more leverage over suppliers. They can negotiate more favorable prices and demand cooperative advertising from manufacturers. Large retailers typically have the financial resources to invest in the latest distribution methods and technology. Finally, unlike smaller traditional retailers, these large chains can obtain financing through the capital markets.

Chart 2



Industry Consolidation to Continue

Rapid expansion among the large retail chains has contributed to a highly competitive retail sector marked by intense battles for domination of the major retail categories. The result of this competition, analysts say, will be consolidation in the industry as weaker chains give way to market leaders.

One sign of this consolidation is in multibillion dollar acquisitions, such as Federated Department Stores' acquisition of R.H. Macy. The five largest department store chains (JC Penney, Federated, May, Dillard, and Nordstrom) now account for 87 percent of department store sales nationwide. The top three discount department store chains (Wal-Mart, K-Mart, and Target) account for 87 percent of full-line discount department store sales.

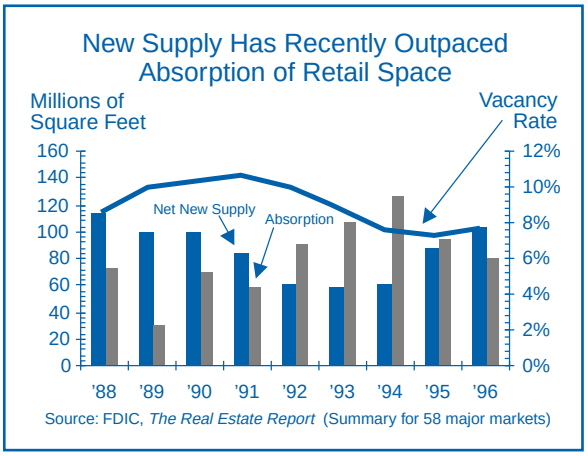
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more likely to be forced into bankruptcy. ***Dun & Bradstreet*** reports that domestic business failures among retail establishments rose in 1995 by 2.8 percent to 12,952. While most of these failures were individual stores and small chains, a number of larger chains also filed for bankruptcy during 1995, including Barney's, Bradlees Inc., Caldor, The Clothestime Inc., Edison Brothers Stores, Elder-Beerman, Herman's Sporting Goods, Jamesway, and Today's Man.

As the retail shakeout moves forward, any credit losses on commercial and industrial loans to retailers are more likely to arise from bankruptcies and restructurings than from mergers and acquisitions. Unfortunately, it is difficult to say in advance exactly how consolidation in the industry is likely to take place.

Overbuilding Is a Risk for Retail Real Estate

Retail industry analysts are particularly concerned about the potential for overbuilding of retail space. Because of this concern, lenders and examiners should be alert to possible credit quality problems with commercial real estate loans secured by retail properties.

CHART 3



Although a vacancy rate of 7.7 percent does not suggest that the U.S. retail market is vastly overbuilt at present, there are warning signs. One is that the U.S. aggregate vacancy rate has begun to tick upward since 1995 as net completions of new retail space have caught up to and surpassed the absorption of that space by retailers (see Chart 3). Another frequently cited indicator of overbuilding is a falling ratio of sales per square foot in the industry, reflecting the fact that additions to retail space have outpaced sales growth for some time. In any case, local market conditions may be somewhat more volatile than the national figures would suggest, particularly in areas where a great deal of construction activity has recently taken place (see inset, ***Retail Real Estate Markets a Mixed Bag in the Boston Region***).

Besides market conditions, underwriting is the other major determinant of credit quality in retail real estate lending. Market analysts report that many of the problems resulting from local market downturns have been on loans with 1980s-vintage underwriting, particularly those with high loan-to-value ratios. Analysts also voice concern that the rapid expansion of space may be putting downward pressure on lease rates. *In light of an ample supply of space and a number of large chains continuing to add space, any valuations that assume future growth in lease rates should be closely reviewed.* The viability of rapid expansion on the part of the large retail chains would undergo a particularly severe test in the event of a recession.

Richard A. Brown, Chief, Economic Analysis Section
Diane Ellis, Senior Financial Analyst

Retail Real Estate Markets a Mixed Bag in the Boston Region

The last recession was preceded by rampant overbuilding of commercial real estate properties, particularly in eastern Massachusetts and southern New Hampshire. Since that time, retail vacancy rates generally have improved across the Boston Region. Despite the general trend, **Hartford**, **Connecticut**, may be seeing some overbuilding, as net new supply has consistently outstripped absorption rates in recent years.

Table 1 shows the recent trend in vacancy rates for the three major markets where data were consistently available. The 1996 average 2.5 percent vacancy rate for the combined Boston and Brockton markets is the lowest rate recorded there in over a decade. Continued positive trends in the eastern Massachusetts economy since the last recession have allowed existing space to be absorbed, while there has been only limited new construction. As a result, vacancy rates are currently well below the peak reached in 1991 and seem likely to remain so for the next several years.

Like eastern Massachusetts, southwestern Connecticut has seen a general improvement in retail vacancy rates across its major metropolitan areas during the past three years (see Table 1). However, Hartford, which has suffered longer than most cities in Connecticut owing to structural declines in insurance and defense, reached an all-time high retail vacancy rate in 1996. This trend is contrary to the modest improvement in office and industrial vacancy rates seen in that market over the past few years.

Chart 4 shows the recent trend in Hartford's retail real estate market. Net new supply has been coming onstream far more rapidly than it has been absorbed by retailers. As a result, the city's vacancy rate has climbed steadily, peaking at 7.5 percent in the fourth quarter of 1996 (averaging 6.8 percent for the year). Prior to the last recession, Hartford's retail vacancy rate hovered around 1 percent, but it jumped to about 4 percent in 1991. Rather than declining, as has been the case for most other markets across the Region during the recent recovery, Hartford's under-utilization of retail space continued to worsen between 1991 and 1996.

Norman Williams, Regional Economist

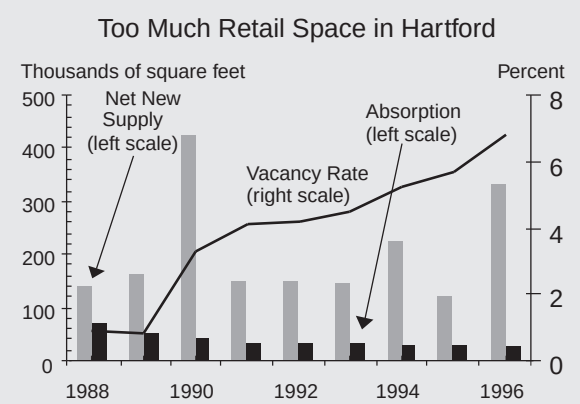
Table 1

Retail Vacancy Rates: Low in Boston, Rising in Hartford

	1994	1995	1996	Last Peak
Boston/Brockton	3.4	3.1	2.5	7.3 (1991)
Hartford, CT	5.2	5.7	6.8	Current
Stamford, Bridgeport, & New Haven, CT	6.0	5.7	5.5	7.2 (1992)

Source: FDIC, The Real Estate Report

Chart 4



Source: FDIC, *The Real Estate Report*

Boston Region: Economic Update and Focus on Northern New England

- **The New England economy continues to do well, mirroring trends in the national economy, and the outlook for insured institutions remains generally positive.**
- **New Hampshire is the Region's best performing economy by many measures.**
- **Maine has lagged the other northern New England states in part because of the makeup of its manufacturing sector.**
- **Owing to New Hampshire's stronger links to the Massachusetts economy, its insured institutions have seen more volatile asset growth and earnings than those in the other northern New England states.**

Region's Economy Remains Healthy, Mirroring Nation in Job Growth

Employment: Nonfarm job growth in New England matched the national pace during the first four months of 1997 (see Table 1). However, some of the Region's apparent strength in this year-ago comparison can be attributed to harsh weather early in the first quarter of 1996, which suppressed job growth during that period.

To eliminate the influence of 1996's weather on year-over-year comparisons inherent in Table 1, it is useful to look at the recent month-to-month trend in seasonally adjusted employment growth, expressed at an annual rate. Using this method, nonfarm job gains in New England averaged 1.3 percent during the first four months of the year—a much slower rate than the 2.5 percent at the national level. However, in just the past few months the pace of job growth has strengthened in New England, averaging 2.2 percent during March and April, versus 2.5 percent for the nation.

Income: As job gains continue in the Region, so does growth in income. After exceeding the nation in 1995, the advance in New England personal income weakened somewhat last year but still rose a respectable 4.9 percent over the prior year (versus 5.4 percent for the nation). The strongest gain was in **Massachusetts**, which matched the national rate. Income growth was slowest last year in **Maine** and **Rhode Island** (both just under 4 percent).

Residential Construction: Home building, which helps drive economic activity through increased construction wages and greater consumer spending linked to new home sales, also continued to advance in the first three months of 1997. Although a year-over-year comparison of residential permits is unduly influenced by the harsh winter weather in early 1996, New England's first-quarter activity was the strongest it has been for that period in seven years. The volume of residential construction remains at about 40 percent of its late 1980s peak, with applications for multifamily dwellings at only 20 percent of the 1988 level (when rampant overbuilding of condominiums preceded the last recession). This modest growth should be sustainable in the absence of a national recession.

Implications: Thus far this year, the Region's economic health remains favorable. Moderate rates of growth in employment, income, and spending should allow

Table 1

New England Job Growth Matches U.S.

Nonfarm Employment, Not Seasonally Adjusted (% change over prior year)

	Jan-April 1997	1996
United States	2.2	2.0
New England	2.3	1.7
Connecticut	1.9	1.4
Maine	1.3	0.3
Massachusetts	2.7	2.0
New Hampshire	3.5	3.7
Rhode Island	1.3	0.4
Vermont	1.6	1.8

Source: Bureau of Labor Statistics

insured institutions to increase lending and revenue this year while limiting the potential for a widespread deterioration in credit quality.

Focus on Northern New England

This article focuses on northern New England. **Maine** in particular has generally seen a slower pace of economic growth than either **New Hampshire** or **Vermont**. Some underlying factors influencing growth, such as manufacturing employment trends, are examined, as are the implications for insured institutions.

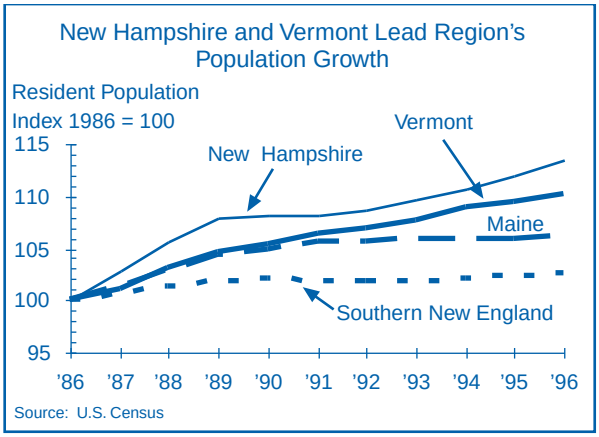
Population Trends: In New England, the severity of the last recession resulted in significant net domestic out-migration, which impeded population growth relative to the rest of the nation. This trend continues in the Region's southern states, although the amount of domestic out-migration has been declining steadily in recent years. Population trends are tied to job and income growth and thus directly affect a state's economic performance.

Chart 1 points out recent trends in population for the northern New England states relative to the rest of the Region. Vermont, which had the fewest job losses during the last recession, saw only modest net domestic out-migration in 1991 and 1992. As a result, population growth was not significantly impeded in that state. Although not shown on Chart 1, the national population track has closely mirrored Vermont's since 1986.

New Hampshire experienced a more pronounced outflow of persons to other states than Vermont (note the leveling-off of population in the early 1990s), but growth accelerated after 1991. New Hampshire's lack of personal income and sales taxes has helped it to draw residents from neighboring New England states, including some 16,000 from Massachusetts between 1992 and 1994. For employers, New Hampshire's appeal lies in the fact that it is an average-cost state (labor, energy, taxes) in a high-cost region.

Maine began seeing net domestic in-migration in 1996, after several years of net departures, but its northern rural counties remain susceptible to population outflows. As evident in Chart 1, Maine's population was relatively unchanged between 1991 and 1996 (up 0.6 percent, similar to southern New England for that period). Meanwhile, New Hampshire's population grew 5

CHART 1



percent during the past five years, and Vermont's rose by almost 4 percent.

Employment Trends: Strong gains in jobs and income have coincided with New Hampshire's population growth, making it the Region's best performing economy. Between 1992 and 1996, nonfarm payrolls rose an average of 3.5 percent per year in New Hampshire, versus a 2.4 percent rate for the nation during that time. In Vermont, the average pace of job growth was 2.3 percent annually, while Maine was the weakest northern state during this period, with gains averaging only 1.3 percent. By comparison, growth was about 1.6 percent in southern New England.

Differences in Manufacturing Sectors Help Explain Divergent Growth Rates

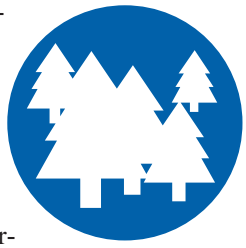
Maine's slower job growth in recent years is partly due to the dominance of declining defense and old-line factory industries in its manufacturing sector. By contrast, New Hampshire and Vermont have advanced more rapidly thanks to the strong presence of high-growth technology-related manufacturing industries.

New Hampshire: Last year New Hampshire's manufacturing payrolls rose 1.9 percent, placing it fourteenth among the 50 states. Almost 19 percent of New Hampshire nonfarm jobs are in manufacturing, versus about 16 percent nationwide. New Hampshire's leading factory employers are electrical machinery and computers, electronics, and instruments industries, which together comprise almost half the factory jobs in the state. A recent ***American Electronics Association*** study

pointed out that between 1990 and 1995, New Hampshire had the largest number of high-tech workers per capita of any state. Electronics and machinery (including computers) account for about half the value of New Hampshire's annual exports.

Vermont: Vermont saw factory payrolls rise 1.8 percent in 1996, with factory jobs accounting for about 17 percent of the state's nonfarm employment. Vermont manufacturing is fairly diversified, with one-third of jobs in nondurable goods (mostly paper, printing, and food processing) and two-thirds in durable goods industries. Still, 30 percent of Vermont's manufacturing jobs are in electrical machinery (including computers) and electronics, owing primarily to IBM's strong presence in the state. In Vermont, output of semiconductors and related devices (primarily from IBM) accounts for 82 percent of the value of state exports each year.

Maine: Maine contrasts sharply with New Hampshire and Vermont. Maine had the largest percentage decline in industrial jobs of all the states in New England last year and lost more manufacturing jobs (in percentage terms) than all states but Alaska, Mississippi, and Delaware. Except for a modest rebound in 1994, manufacturing employment has steadily declined in Maine since 1988. About 16 percent of Maine's jobs are in manufacturing today.



Maine's principal goods-producing employers are the paper and allied products, transportation equipment (naval-defense related), and lumber and wood products industries. These industries employ about 42 percent of the state's factory workers. In 1994 (latest available), Maine was four to six times more dependent than the national economy on paper, lumber, and forestry payrolls. The state's reliance on earnings from naval defense (transportation equipment) manufacturing was about three times the national average in 1994. Maine does have a high-tech presence, including the National/Fairchild Semiconductor facility in Portland, but employment in this industry is relatively modest.

Computer Chips Versus Wood Chips: Globally, technology-related manufacturing, especially electronics, has been expanding thanks to rapidly growing demand for computers, telecommunications gear, and related products. New Hampshire and Vermont have benefited from this trend, as reflected in the significance of technology-related jobs in each state.

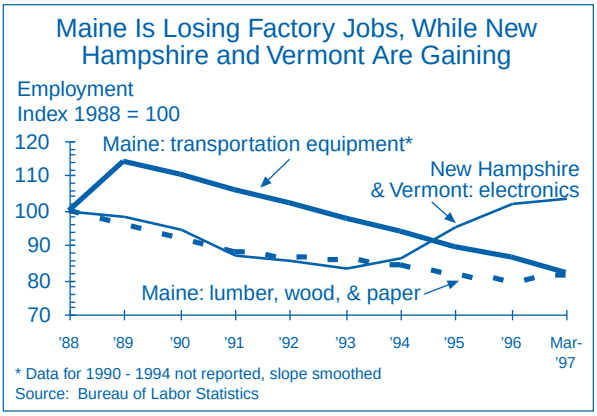
In contrast, Maine's economic growth has been held back, as transportation equipment employment has withered under declining federal defense budgets. Also, forest products firms have cut payrolls for several reasons. Limited growth in demand coupled with increased worker productivity has reduced the need for large workforces. Also, jobs have been cut in an attempt to become leaner during an era of uncertainty over changing environmental regulations, limits on timber harvests, and rising risks and costs related to compliance with environmental regulations. Chart 2 points out the recent divergence in employment growth between the electronics industries in New Hampshire and Vermont and the forest products and defense (transportation equipment) industries in Maine.

How Insured Institutions Have Fared

As the previous discussion pointed out, Maine's economy has generally fared less well than the other northern New England states, particularly New Hampshire. Although asset growth at insured institutions has been less robust as a result, these firms also may be less susceptible to any future downturn in the dominant economies of southern New England.

A good deal of New Hampshire's growth in recent years has been driven by the expanding Massachusetts economy. Two-thirds of New Hampshire's labor force is located in three southeastern counties bordering the greater Boston area. This strong tie to Massachusetts has helped New Hampshire's institutions grow more

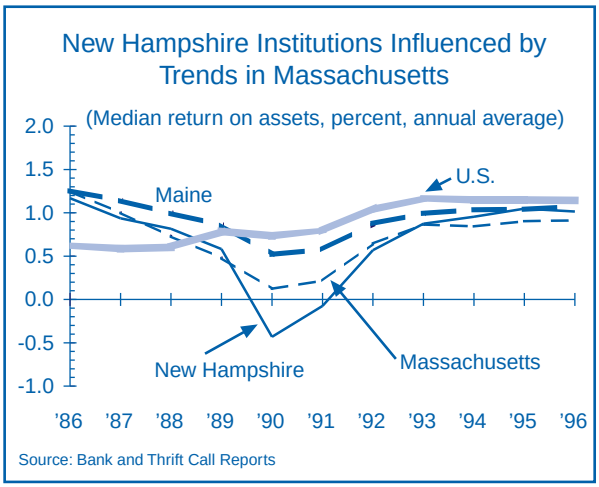
CHART 2



rapidly than those in Maine and Vermont during the past few years. Between 1994 and 1996, assets grew only 2.9 percent in Maine and 4.4 percent in Vermont, but rose 7.4 percent in New Hampshire.

If recent history is a reliable indicator, New Hampshire's stronger asset growth also could be more tenuous than recent gains in Maine and Vermont. During the last recession it was New Hampshire's insured institutions that suffered the most of any state in northern New England. This was primarily due to exposure to an overbuilt commercial real estate market, fueled by a rapidly expanding Massachusetts economy.

CHART 3



In 1991, 12 banks in New Hampshire failed, representing 25 percent of the state's prior year-end assets. Profitability, as measured by median return on assets (ROA), fell from an average of 0.8 in 1988 to a negative 0.4 in 1990 (see Chart 3). Between 1988 and 1992, assets in the state fell 20 percent—banking assets in Massachusetts fell about 17 percent during this time.

By contrast, fewer institutions in Maine and Vermont faltered, because of those states' weaker ties to Massachusetts. Median ROA in Maine fell from 0.9 in 1988 to 0.5 in 1990 and had recovered fully by 1992. Vermont's median profitability also stayed out of the red during the early 1990s.

Implications: New Hampshire's strong economy in recent years has allowed its remaining insured institutions to recover significantly from the last recession. However, its insured institutions are exposed not just to conditions in their own state's economy but also to developments in the Massachusetts economy. Institutions in Maine and Vermont, on the other hand, would be less affected by any future downturn in the Region's dominant economy.

Norman Williams, Regional Economist

Financial Markets

- **Deteriorating credit quality trends in the rapidly growing home-equity backed securities market could portend trends in bank residential mortgage lending.**

- **Financial asset securitization investment trusts, known as FASITs, promise to change the asset-backed securities market significantly and could make securitization more accessible to community banks.**

- **The Treasury yield curve is steeper and higher than it was at year-end 1996.**

- **During the first quarter of 1997, the Boston Regional Bank Index outperformed the S&P Composite Bank Index. The Boston Region's Community Bank Index moved ahead fairly steadily but gained less than the S&P 500 and the other bank indices.**

Trends in the Home-Equity Asset-Backed Market Are Important to Banks

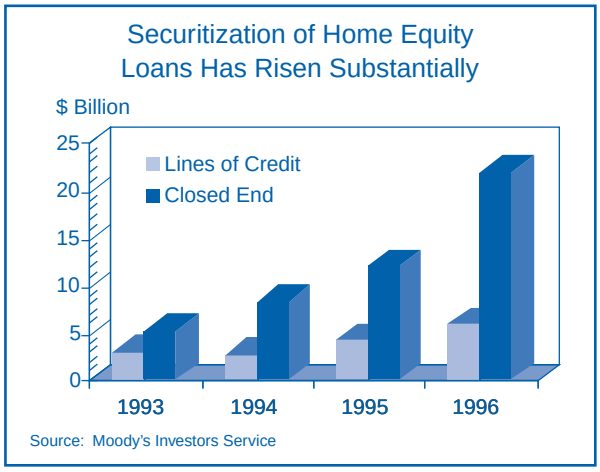
The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has been accompanied by abnormally early and high levels of delinquencies. Banks that are investing in HEL ABS, considering securitizing HELs, or lending significantly for debt consolidation should be aware of credit quality developments in the HEL ABS market.

The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market. The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, know as cash-out refinancing, grew substantially when home-equity borrowers were motivated by lower rates to refinance their first mortgages for amounts greater than the remaining principal balance instead of adding a second mortgage.

Debt consolidation is the primary reason for home-equity borrowing. Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens. According to the ***Consumer Bankers Association 1997 Home-Equity Loan Study,*** debt consolidation accounted for 36 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior to 1992, home improvement was the primary reason for home-equity borrowing. This trend toward debt consolidation as the reason for home-equity borrowing has significant risk implications because, unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance the lender's collateral value.

The rapid growth of the HEL securitization market has been attended by signs of relaxed underwriting. Adverse credit quality trends have been particularly prominent for loans that were originated in 1995. Chart 2 (next page) shows the total delinquency rates for closed-end loan pools originated in 1995 versus 1994. The sharp upward path of delinquency rates for loan pools originated in 1995 raises concern that aggressive competition for volume, and apparently relaxed underwriting standards, could lead to unprecedented default levels. *Furthermore, HEL originations in 1996 more*

CHART 1



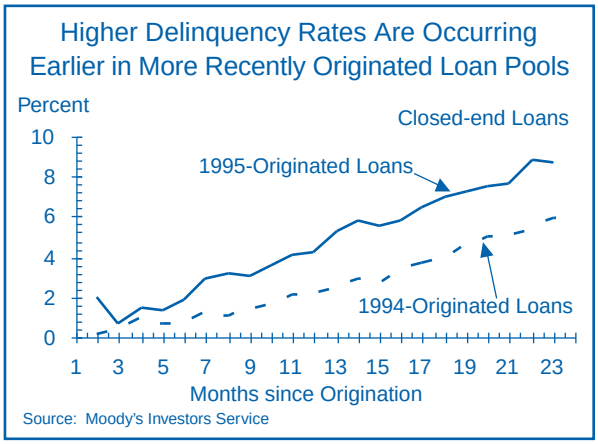
than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.

The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The trends would be obscured because banks report all first mortgage lending on 1 to 4 family residential properties without distinguishing between purchase mortgages and cash-out refinancings. The unfavorable trends in the HEL ABS market suggest that banks that engage in significant cash-out refinancing and other forms of home-equity lending should be able to monitor trends in the credit quality of these loans separate from purchase mortgage loans.

A Combination of Several Factors Could Induce More Banks to Securitize HELs

Although the present volume of bank-originated HEL securitizations is relatively small, banks have recently entered this finance company-dominated market, and a combination of several factors is likely to cause more to follow. First, home equity lines of credit are currently growing at rates exceeding total consumer lending, and, by and large, the deposit growth to fund this lending is less than robust. In addition, according to ***Moody's Investors Service,*** investor demand is high for bank-originated home-equity line of credit securitizations because bank-originated lines are perceived to have lower credit risk. The funding benefits and profitability of securitizing bank-originated home-equity lines of credit could entice more banks into the securitization market. Finally, the combination of these factors with the potential cost savings provided by using the new financial asset securitization investment trust (FASIT) structure (see discussion below) could produce momentum that will result in banks, large and small, securitizing home equity loans in significantly increased amounts.

CHART 2



Securitizing HELs can change the balance sheet and income statement of the securitizer significantly, resulting in significant servicing assets and gains on sale. Beginning in 1997, when a company sells loans, it must comply with the requirements of Financial Accounting Standard (FAS) 125. If the company retains servicing rights on the assets sold, FAS 125 requires the seller to book an asset related to the gain on sale that represents the future income derived from servicing the loans. This asset is similar to mortgage servicing rights in that it represents the present value of future expected cash flows derived from loan servicing. One major home-equity securitizer, which indicated that FAS 125 would not materially affect its financial statements, reported servicing assets at almost 90 percent of equity, and gains associated with the sale of serviced assets at 71 percent of total revenue.

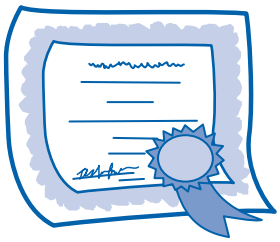
The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results in charge-offs or early repayment through foreclosure of serviced assets, could require the adjustment of the valuation assumptions and the write-down of the servicing assets.

FASITs Promise to Change the ABS Market

The Small Business Job Protection Act of 1996 created two new sections of the Internal Revenue Code that create and govern FASITs. The FASIT provisions, patterned in part on the real estate mortgage investment conduit (REMIC) rules issued in 1986, are intended to provide tax certainty for ABS issuers and purchasers and enhance the flexibility of asset securitizations. The FASIT provisions take effect on September 1, 1997.

The advent of the FASIT is likely to change the ABS market in important ways. First, the FASIT will clarify the tax treatment of securitizations. Because of the current tax ambiguity, designing ABS structures to avoid taxation is administratively costly, and it restricts the forms that securitizations can take. The higher administrative cost associated with current securitization techniques establishes a practical minimum size for asset pools that can be feasibly securitized. With FASITs and the reduced costs associated with tax clarity, the economically feasible pool size may be significantly smaller. *The lowering of this threshold could result in more community banks entering the securitization market.*

ABS issuers believe that the market for their product has been hampered by the restrictive nature of current asset-backed tax ambiguity, which prevents them from responding to investor preferences for varying maturities, coupon types, and prepayment and credit risk profiles. FASITs allow sponsors the flexibility to create multiple-class securities that satisfy these preferences with the certainty that the securities will count as debt and that the FASIT will not be treated as a taxable corporation. This combination of flexibility and tax certainty could lead to the kind of innovations in ABS structures that followed the 1986 REMIC legislation, which brought analogous benefits to the mortgage-backed market.



FASITs make possible additional innovations. FASITs will bring to the ABS market the ability to add and remove assets throughout the life of a securitization. This feature could be applied by securitizing revolving construction loans and then replacing the revolving loans with permanent financing when construction is completed. A FASIT also will be able to contain a mixed pool of assets such as real estate, non-real estate assets, and unsecured credit, allowing exposures to very different markets from the same security. Finally, a FASIT can hold swaps and other hedging instruments. Using this feature, an issuer could combine a mortgage passthrough security with a hedging instrument that is designed to offset mortgage prepayment risk, such as a reverse-index amortizing swap.

The increased flexibility that the FASIT promises to bring the ABS market comes with the potential for greatly increased complexity and risk. Banks that invest in FASIT securities will need to understand fully not only the risk characteristics existing at the outset of security but also the risk that could arise throughout the security's life if assets are to be removed and replaced.

Changes in Interest Rates and Bond Values

The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained there for the next 23 days. The FOMC met again on May 20, 1997, and left the target rate unchanged.

The model portfolio responded to the rise in rates, but only modestly (see Table 1). The relatively short weighted average maturity of the portfolio served to moderate the effect of the 54 basis point rise in the five-year Treasury between December 31, 1996, and March 31, 1997. As discussed in ***Regional Outlook***, second quarter 1997, changes in the value of the model portfolio correlate more with changes in the five-year Treasury rate than with the 30-year bond rate.

The yields along the April 30, 1997, yield curve imply that the market expects the curve to continue to flatten through the remainder of the year with short rates rising somewhat. In order to gauge what affect a 25 basis point rise in the yield curve could have on bank fixed-income portfolios, the model portfolio has been "shocked" to

CHART 3

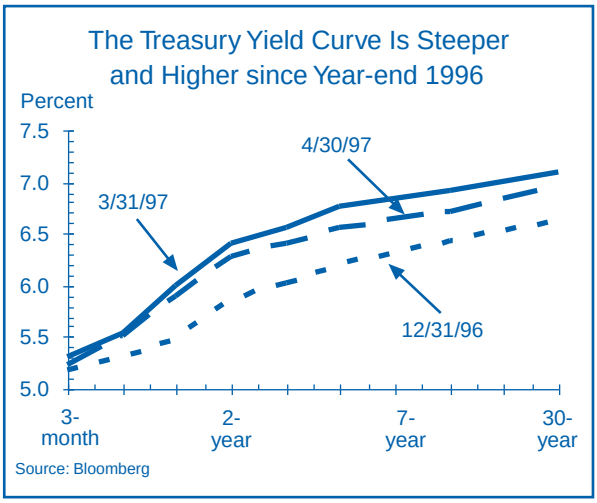


Table 1

Type of Security	Par Value	Percent of Portfolio	Maturity or WAL as of 12/31/96	Percent Change from 12/31/96 to 3/31/97	Change Resulting from a 25 bp Rate Increase on 5/28/97
U.S. Treasury 5.6%	2,000	20%	1 YR	-0.30%	-0.16%
FNMA Agency 5.8% Callable	1,200	12%	2 YR	-0.50%	-0.38%
State County Municipal GO 4.8%	800	8%	11 YR	-2.05%	-2.03%
FNMA Mortgage Passthrough 7.5%	3,000	30%	8 YR	-1.78%	-1.44%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5 YR	-1.27%	-0.50%
Credit Card Asset-Backed Security	1,000	10%	5 YR	-0.09%	0.00%
TOTAL	10,000	100%	4.85 YR	-1.08%	-0.77%

Note: Portfolio composition based on estimates derived from aggregated Bank Call Report information.

simulate the effect of an instantaneous 25 basis point shift in the yield curve on May 28, 1997.

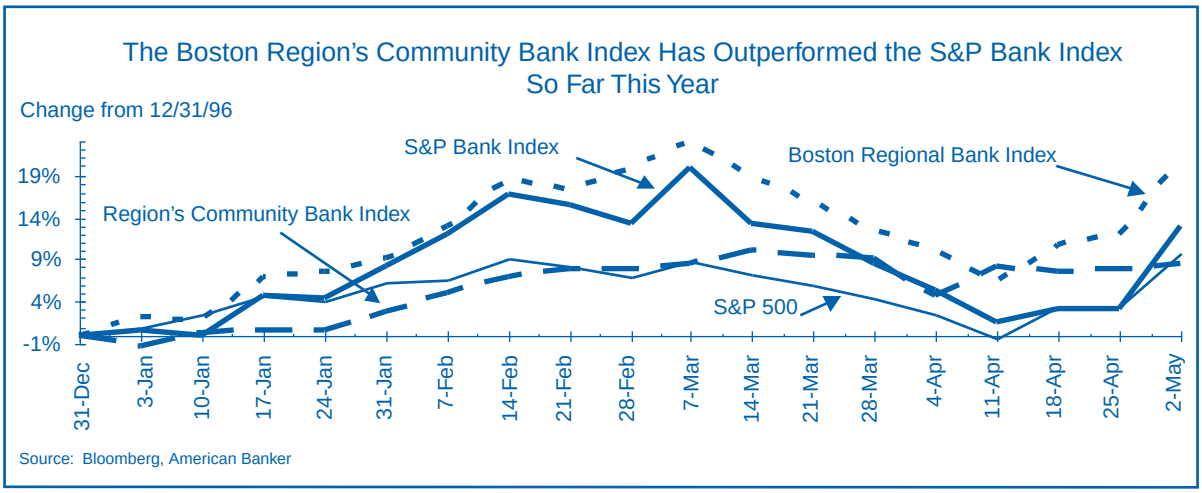
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate changes owing to its longer maturity. The mortgage passthrough security also is more sensitive to rising rates because its weighted-average life (WAL) extends as rising rates discourage the underlying mortgage holders from prepaying their loans. The decline in prepayment rates results in extending the maturity of the security while rates are rising, a combination unfavorable to the security's value.

The Boston Regional Bank Index Outperformed the S&P Composite Bank Index and the S&P 500 during the First Quarter of 1997

The Boston Regional Bank Index's nearly 21 percent gain through May 2, 1997, was sufficient to outperform the S&P Composite Bank Index's gain by more than 7 percentage points (Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The Boston Region's Community Bank Index was spared much of the influence of a gyrating market, rising in value fairly steadily to an 8.5 percent gain through May 2, 1997.

Allen Puwalski, Banking Analyst

Chart 4



Regional Banking Conditions

- **First-quarter results for the Boston Region saw a continuance of the strong performance produced in 1996.**
- **Consumer credit problems appear to be worsening.**
- **Surging commitments suggest a pickup in loan activity; however, lackluster core deposit growth may constrain on-balance-sheet loan growth.**
- **An increasing percentage of the Region's insured institutions are using derivatives to manage exposures to various market risks.**

The Earnings Engine Roars Onward

The Region's insured institutions started 1997 with more of the same strong financial performance that characterized 1996. In the aggregate, first-quarter earnings topped $1 billion in the Region for the first time, resulting in an annualized 1.26 percent return on assets (ROA), comparable to the 1.27 percent earned in the prior quarter. Commercial and savings institutions had ROAs of 1.41 percent and 1 percent, respectively, as compared with national average ROAs of 1.26 percent and 0.96 percent, respectively. Only 2 percent of the Region's insured institutions posted losses during the quarter.

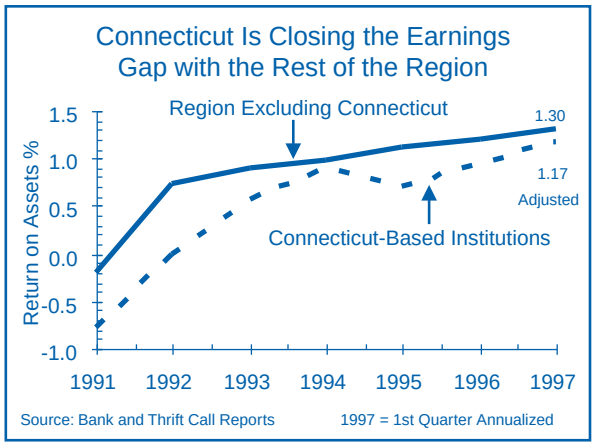
On a statewide basis, New Hampshire-based institutions had the strongest ROA at 2.02 percent, bolstered by the strong reported earnings of the state's credit card institutions. Connecticut-based institutions continued to trail the rest of the Region owing to persistently higher levels of nonperforming assets and provisions for loan losses, a result of the slow pace of economic recovery in that state (see the second-quarter 1997 ***Regional Outlook*** for a discussion of the Connecticut economy). Results for the first quarter also were held down by a large restructuring at a major institution.

Adjusting for this large one-time charge, Connecticut-based banks earned a collective ROA of 1.17 percent. These performance results suggest that insured institutions in Connecticut are rapidly closing the earnings gap with institutions in the rest of New England (see Chart 1).

The Region's strong earnings relative to the nation as a whole are largely attributable to lower provisions for loan losses. Lower provision expenses are the direct result of improved asset quality and a concomitant drop in the level of the allowance for loan and lease losses to gross loans. In December 1991, aggregate loan loss reserves for the Region were 2.94 percent of gross loans and have dropped every subsequent quarter to the present level of 1.79 percent. This level of reserves is in line with the national average. Lower relative reserve levels have been driven in part by charge-offs in excess of provision expenses. On a cumulative basis, net charge-offs have exceeded provision expense by $1.7 billion since year-end 1991.

The Region's total past-due loan ratio of 2.4 percent is now lower than the national average for the first time in the 1990s. Delinquencies were highest at New Hampshire-based institutions (3.3 percent) due to a high concentration of consumer loans (28 percent of total loans versus 9 percent for the rest of the Region). In Massachusetts, whose insured institutions hold two-thirds of the Region's assets, delinquencies were only 2.1 percent of total loans.

CHART 1



Consumer Loan Problems Persist

Consumer loans remain an area of concern for the industry. Nationally, net charge-offs on bank credit card portfolios rose to 4.95 percent of average loans (versus 4.21 percent in net credit card charge-offs for banks in the Region) and have risen every quarter since early 1995. ***Fitch Investors Service*** reported that the gross charge-off rate on securitized credit card receivables reached 6.95 percent in May, well above levels attained during the recession of the early 1990s (see Chart 2). Losses on other consumer loans are rising as well. As reported in the first-quarter 1997 ***Regional Outlook,*** bankruptcy rates continue to rise and are an important factor driving increases in consumer loan charge-offs. The ***Administrative Office of the U.S. Courts*** recently announced that bankruptcy filings for the 12-month period ended March 31, 1997, totaled 1.25 million, an all-time high. This level of filings is a 27 percent increase from the prior 12-month period. Filings for the most recent quarter were 335,000, which also is a record high. The sharp rise in bankruptcy filings has prompted the Judicial Conference of the United States to transmit a proposal to Congress to create 18 additional bankruptcy judgeships to deal with the rising backlog of cases.

Implications: Rising consumer bankruptcies and consumer charge-off rates are occurring during a time of economic prosperity. During the last recession, credit card losses rose to approximately 1.5 times their pre-recession levels. It is reasonable to expect bankruptcy filings and consumer loan losses to go even higher under worsening economic conditions. Such a scenario would undoubtedly have a negative effect on other sectors of bank loan portfolios as well.

Commitments May Portend Faster Loan Growth and Tighter Liquidity

Total unused loan commitments in the Region advanced at an annualized 30 percent rate during the past six months (see Chart 3). Credit card lines have been a major contributor to this growth rate (up 39 percent). However, "other unused commitments," which encompasses nearly 60 percent of all unused loan commitments, have grown 32 percent over this same time frame. This category includes commitments for commercial loans and credit lines and residential real estate, but excludes home equity lines.

A pickup in either loan closings or drawdowns on existing lines may place additional strains on liquidity at some of the Region's insured institutions. The Region's institutions are becoming increasingly dependent on noncore sources to fund asset expansion. For example, core deposits (which exclude certificates of deposit over $100,000 and foreign deposits) have fallen $9 billion since December 31, 1992, a 5 percent decline. Over that time, total assets grew $43 billion (to $322 billion), and borrowings and large deposits grew $41 billion.

Implications: While the recent sharp rise in loan commitments suggests that loan production activity is increasing, it may not directly translate into loan balances on the books of insured institutions. Commitments for refinancings of existing debt or for loans originated for sale are two reasons for this rise. However, the increase in commitments does indicate that insured institutions have ample opportunities to book new business. Whether they will do so remains to be seen. Many institutions have looked to the secondary markets to sell new production rather than booking new,

CHART 2

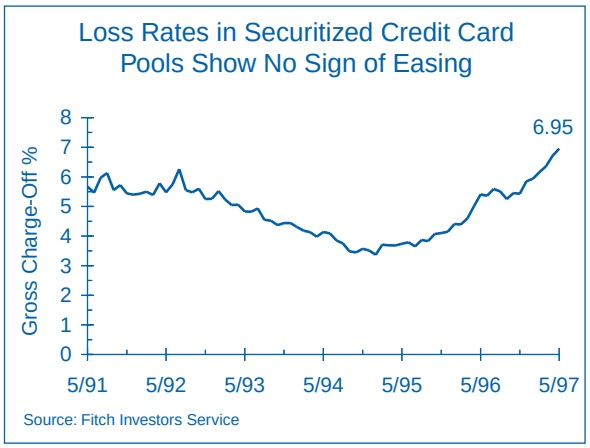
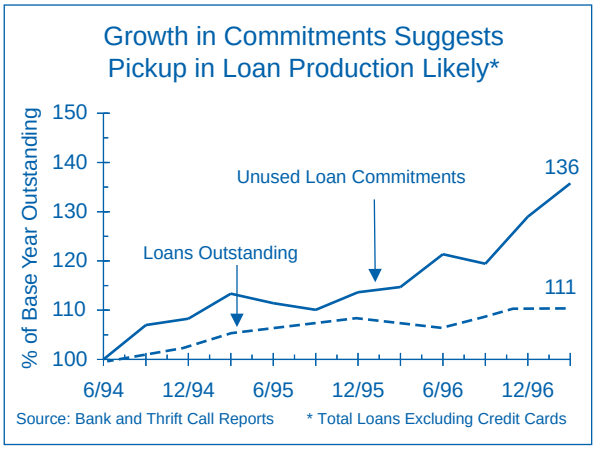


CHART 3



competitively priced business at relatively thin spreads, because of the higher costs associated with noncore funding.

Spotlight on Derivatives

Derivatives have received extensive media coverage over the past few years, primarily in a negative light, because of substantial losses incurred by some entities actively involved in the use of these instruments to enhance returns. Some mutual funds incurred substantial losses, and the share price of some money market funds dipped below the $1.00 per share value because of substantial derivative losses. (The $1.00 mark is considered a psychological barrier, below which consumers tend to lose confidence.) Many financial institutions realized a more significant decline than expected in the value of their holdings when rates rose sharply in early 1994. Nevertheless, most financial institutions appear to have used derivatives responsibly, generally to reduce exposures to various market risks. This section will focus on the derivative activities of the Region's insured institutions.

On-Balance-Sheet Items: Between 1991 and early 1994, the Region's insured institutions gradually began to shift their investment securities mix away from U.S. Treasury and mortgage pass-through instruments into mortgage derivative products such as collateralized mortgage obligations and real estate mortgage investment conduits. During this period, the percentage of total securities invested in mortgage derivatives increased from approximately 9 percent to 14 percent. This percentage has remained fairly constant since 1994.

Some evidence exists that investments in mortgage derivative products pose less risk now than in early 1994, when rising interest rates illuminated the inherent risks associated with some of these investments. Insured institutions did not begin reporting "high-risk" mortgage-backed securities (MBS), as defined by the Federal Financial Institutions Examination Council, until March 1995. At that time, 48 institutions in the Region reported holding $354 million of high-risk MBS, 4 percent of total reported mortgage derivative investments. These holdings have declined steadily since, and as of March 31, 1997, 27 institutions (out of 473) reported holdings of $111 million (down 69 percent), only 1 percent of total mortgage derivatives.

Separate disclosure of structured notes (nonmortgage securities containing embedded derivatives) also was instituted with the March 1995 Call Report. At that time, nearly one-third of the Region's institutions reported holding $1.4 billion of structured notes, 2 percent of total securities. Investment in these instruments has followed a pattern similar to that noted for high-risk MBS; they now total $583 million (down 59 percent), less than 1 percent of total securities.

The downward trends noted in high-risk MBS and structured note investments, coupled with the stabilization of investment in mortgage derivatives, are partially related to the significant decline in the issuance of these instruments. However, the trends also suggest that insured institutions have consciously pulled away from derivative investments as understanding and awareness of the risk/reward relationships associated with them have improved. The improved earnings of the industry also may be a factor, as institutions appear less inclined to seek enhanced returns by taking on the additional risks imbedded in structured securities.

Trends in the asset-backed securities (ABS) market and the composition of investment portfolios also suggest that insured institutions are not aggressively expanding investment in structured securities. As discussed in the second-quarter ***Regional Outlook,*** ABS issuance has been rising rapidly over the past three years. Insured institutions do not separately disclose ABS investments; they are typically reported as "other domestic debt securities." Nationally, "other domestic debt securities" held by banks have declined 24 percent in volume over the past three years, from 4 percent to 3 percent of total securities. Similar trends are noted in the Region, where the decline has been 33 percent over the same period. It is difficult to ascertain the mix of "other domestic debt securities," and it is possible that there has been a shift within this category toward ABS. However, the decline in "other domestic debt securities," in both nominal dollars and as a percentage of total securities, suggests that most insured institutions have not aggressively entered the ABS market.

Off-Balance-Sheet Items: The notional dollar amount of exposure to off-balance-sheet derivatives in the Region as of March 31, 1997, was $291 billion (bank Call Report filers only), 97 percent of which was concentrated in five institutions that actively trade off-

balance-sheet derivatives. Interest rate contracts represented 59 percent of that total, foreign exchange accounted for 40 percent, and equity and commodity contracts comprised the remaining 1 percent. Approximately two-thirds of the total was held for trading. Excluding the five banking organizations that actively trade derivatives, 99 percent of the remaining organizations' exposure was in a *nontrading* capacity. In all, 58 banking organizations (72 institutions) reported off-balance-sheet derivative exposures as of March 31.

Since year-end 1992, the number of organizations entering into off-balance-sheet contracts has increased from 7 percent of all organizations in the Region to 13 percent. Greater participation in these types of contracts seems to indicate a desire to manage exposure to market risk more effectively, as opposed to pure speculative activities. Interest rate contracts are the most commonly used derivatives. Of the 72 institutions holding derivatives, 59 held at least one form of interest rate contract (see Table 1). Excluding the five large trading organizations, 97 percent of the remaining organizations' notional exposures are concentrated in interest rate contracts.

The most common ways the Region's insured institutions hedge exposure to interest rate volatility are through the purchase of options (38 institutions), predominantly caps and floors, and the use of interest rate swaps (31 institutions). Forward contracts are reported by 14 entities, many of which appear to be related to mortgage banking operations.

Implications: The funding mix of the Region's institutions is shifting to a greater reliance on market-based funding. This shift means that incremental asset growth is being booked at thinner spreads than in the past, with funds bearing higher rate sensitivity. Accordingly, it appears likely that institutions will continue using off-balance-sheet instruments as a means to protect and stabilize net interest margins. As long as these and other derivative instruments are used for hedging purposes and not for speculative purposes, the Region's insured institutions will be better able to endure periods of increased interest rate volatility.

Daniel Frye, Senior Regional Analyst

Table 1

Institutions Reporting Off-Balance-Sheet Derivatives as of March 31, 1997

Contract Type	Interest Rate	Foreign Exchange	Equity	Commodity	Any Exposure*
Futures	3	1	1	2	5
Forwards	14	9	0	3	21
Written Options	7	3	12	1	18
Purchased Options	38	3	3	1	40
Swaps	31	2	0	0	31
Any Exposure*	59	9	13	3	72
Trading Capacity*	9	9	6	2	17

*Totals do not add due to duplications between classes and types.
Source: Bank Call Reports

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