Regional Outlook

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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 13.*

By Allen Puwalski

Regular Features

◆ ***Regional Economy*—The cyclical expansion is showing signs of age…this highly industrialized Region is quickly affected when expansions end…the contribution of rapid economic growth to the profitability of banks and thrifts may fade…borrowers and lenders may need to plan for a future in which downside risks could exceed upside potential.** *See page 16.*

By the Chicago Region Staff

◆ ***Regional Banking*—Many banks and thrifts in the Chicago Region have reduced the coverage of reserves set aside for future loan losses, and many have increased their concentrations in traditionally riskier loan categories...an improvement in traditional credit quality indicators may support some of the reduction in allowance for loan and lease losses (ALLL) coverage, but managers of insured institutions must consider additional factors when determining an acceptable range for the ALLL.** *See page 21.*

By the Chicago Region Staff

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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.)

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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.**

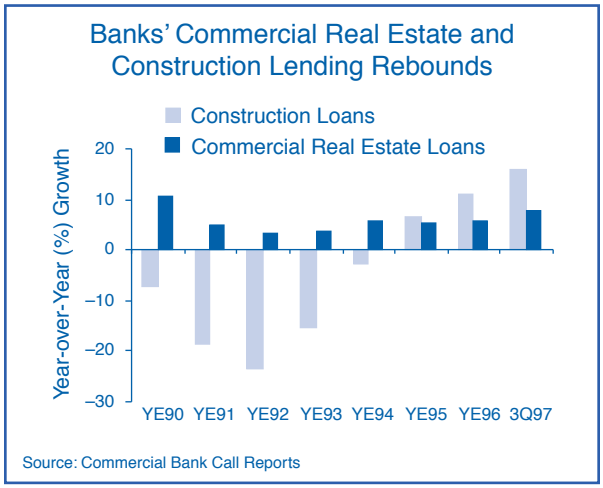
- **Considerable evidence suggests that a large percentage of insured institutions are easing commercial real estate and construction lending underwriting standards.**

- **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 leading 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.

CHART 1



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

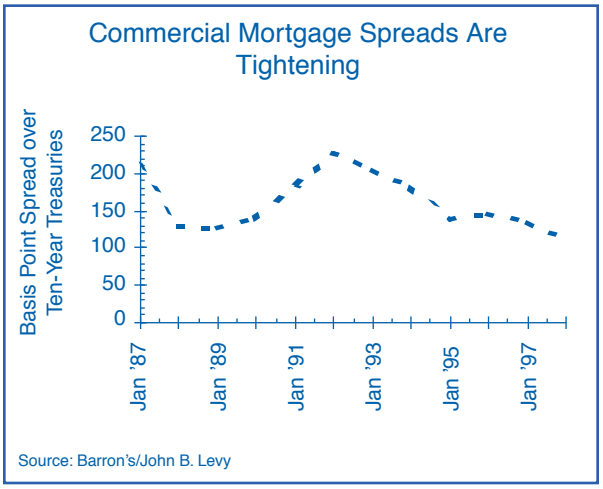
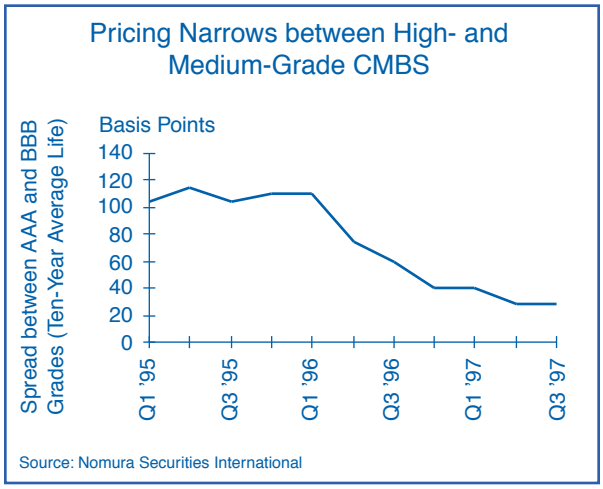


CHART 3



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.

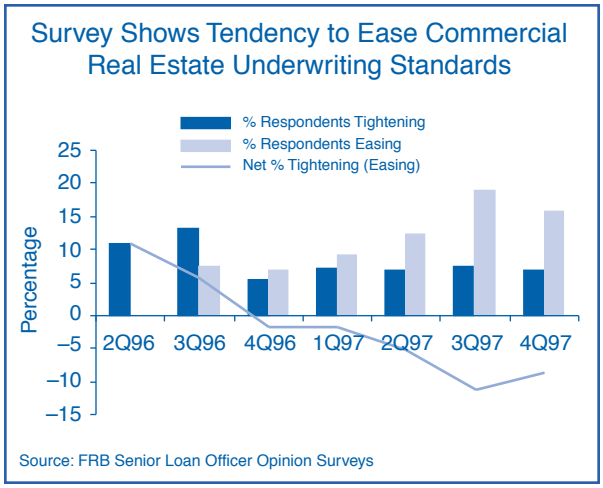
ACLI data suggest that recent commercial mortgage originations are better supported by borrower equity and property cash flows than they were in the late 1980s. It is important to recognize, however, that LTV and DCR ratios are driven largely by market conditions and expectations. Property valuations 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]:

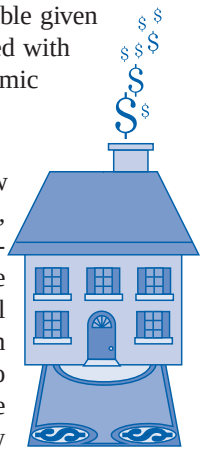
- The percentage of banks frequently or commonly originating C&D loans tied to speculative projects (that is, projects lacking meaningful preleasing or presales, or loans without a formal take-out commitment for permanent financing following completion of construction) rose markedly, from 11 percent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

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Selected Articles for Further Reading

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

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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.

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 actu-

al 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

[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.***

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

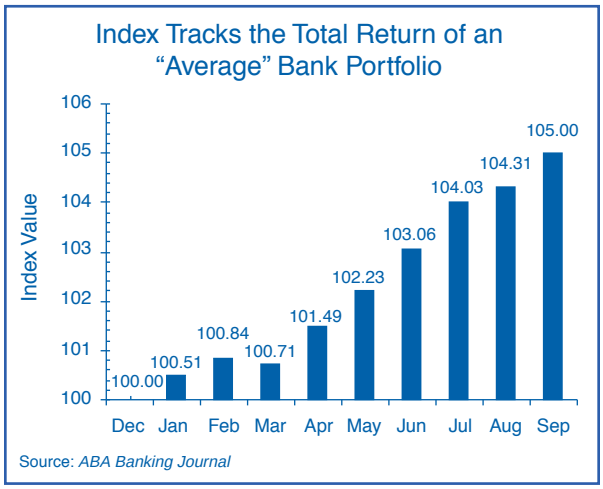
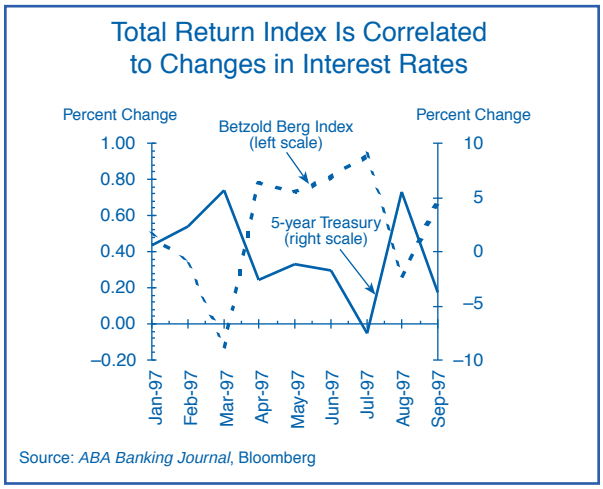


Chart 2



Region's Cyclical Sensitivity Highlights Importance of Looking and Planning Ahead

- **Historically, economic activity in the highly industrialized Chicago Region has slumped earlier and more steeply than in the nation as a whole when cyclical expansions ended.**
- **The Region's economy remains strong, but room for further robust growth may be limited. Thus, the contribution of rapid economic expansion to the profitability of banks and thrifts may fade.**
- **Therefore, as the cyclical expansion continues to age, borrowers and lenders may need to plan for a future in which the downside risks may exceed the upside potential.**

As this cyclical expansion starts its eighth year in April, the Chicago Region is displaying some conditions typically experienced in the later stages of expansions, including slower job growth and flat manufacturing employment, low unemployment, lackluster growth in single-family housing starts, and rebounding activity in commercial real estate markets, conditions discussed in previous issues of ***Regional Outlook***. Because the Region's industrial composition heightens its sensitivity to shifting cyclical conditions, it is important to monitor such indicators for signs of strength or weakness.

Industrial Composition Heightens the Region's Cyclical Sensitivity

In the Chicago Region, the role of manufacturing activity—which is among the sectors most affected by cyclical ups and downs—is considerably greater than for the nation as a whole. The manufacturing sector generates 27.2 percent of the Region's income, which is 51 percent higher than manufacturing's share for the nation as a whole.

Table 1

The Chicago Region's Economic Profile Relative to the Nation's
Region's or state's share of earnings relative to national share (as a ratio); 1.0 means share is same as national share.

	Region	IL	IN	MI	OH	WI
Manufacturing	1.51	1.10	1.78	1.83	1.52	1.57
Durable-Goods Manufacturing	1.72	1.08	2.09	2.41	1.72	1.59
Motor Vehicles & Equipment	3.84	0.65	4.10	10.33	2.78	1.24
Primary Metals	2.41	1.25	5.09	1.46	3.72	1.48
Fabricated Metals	2.13	1.56	1.93	2.70	2.36	2.20
Nonelectrical Machinery	1.79	1.61	1.52	1.76	1.82	2.58
Furniture & Fixtures	1.58	0.67	2.34	3.06	0.85	1.77
Stone, Clay, Glass	1.33	0.87	1.54	1.18	2.03	1.03
Nondurable-Goods Manufacturing	1.17	1.12	1.29	0.92	1.20	1.54
Rubber & Misc. Plastics	1.91	1.37	2.46	1.78	2.43	1.79
Paper & Allied Products	1.36	0.92	0.88	0.85	1.24	4.37
Chemicals & Allied Products	1.23	1.16	1.98	1.03	1.41	0.52
Wholesale Trade	1.03	1.15	0.89	0.98	1.03	0.96
Construction	0.99	0.97	1.13	0.89	0.97	1.11
Retail Trade	0.96	0.89	1.02	0.91	1.02	0.99
Transportation & Utilities	0.89	1.07	0.90	0.72	0.83	0.87
Finance, Insurance, & Real Estate	0.88	1.01	0.75	0.84	0.86	0.81
Services	0.85	1.16	0.68	0.65	0.74	0.81
Government	0.84	0.83	0.80	0.83	0.85	0.89
Agricultural Services, Forestry, & Fisheries	0.71	0.71	0.66	0.67	0.68	0.89
Mining	0.38	0.40	0.43	0.27	0.51	0.16

Source: U.S. Department of Commerce, Bureau of Economic Analysis, via Haver Analytics, Inc.

Within the Region's manufacturing sector, production of durable goods is more dominant than production of nondurable goods. Topping the list by a large margin is output of motor vehicles and equipment. This industry's concentration in the Region is 3.8 times that for the nation (see Table 1), while in **Michigan** it is 10.3 times greater. The Region's share of income from the production of primary and fabricated metals is more than twice that for the nation, while the Region's shares associated with rubber and plastics and with nonelectrical machinery are slightly less than twice those of the nation.

This heavy dependence on manufacturing activity heightens the Region's sensitivity to business cycles, especially around the peak and trough turning points at the end of expansions and recessions. Chart 1 illustrates that economic output in the Chicago Region typically

- rebounds more vigorously than the nation for a year or two after a recession;
- grows in line with or slightly slower than the nation during the middle stage of an expansion; and
- slows sooner toward the end of an expansion and then experiences a steeper drop in output when a recession develops.

Traditionally, areas dominated by manufacturers of durable goods for consumers (e.g., vehicles, appliances, furniture) experience cyclical downturns and upswings earlier than areas dominated by manufacturers of durable equipment for businesses (e.g., engines, industrial machinery).

The impact of cyclical changes can be magnified when diversity in an area's economic base is limited. According to a Diversity Index calculated by the ***Division of Insurance***, considerable variation exists among states in this Region (see Chart 2, next page). At one extreme, **Illinois** has an index reading of 93 and ranks as having the most diverse economic base among all 50 states. (A state or Region with the same mix of earnings from various sectors as the nation in 1996 would have an index value of 100.) In contrast, Michigan's heavy concentration of activity associated with motor vehicles and related equipment causes it to have an index reading of 40.8, making it the fifth least diverse state in the nation.

Implications: *This Region's industrial composition and heavy reliance on manufacturing make it among the first to be affected by cyclical shifts.* By the time a recession is recognized on the national level, many industries in this five-state Region already will have started trimming their payrolls and production schedules. In turn, weakening economic conditions reduce the ability of many households and businesses to assume additional debt and, in some cases, to meet the terms of outstanding obligations.

CHART 1

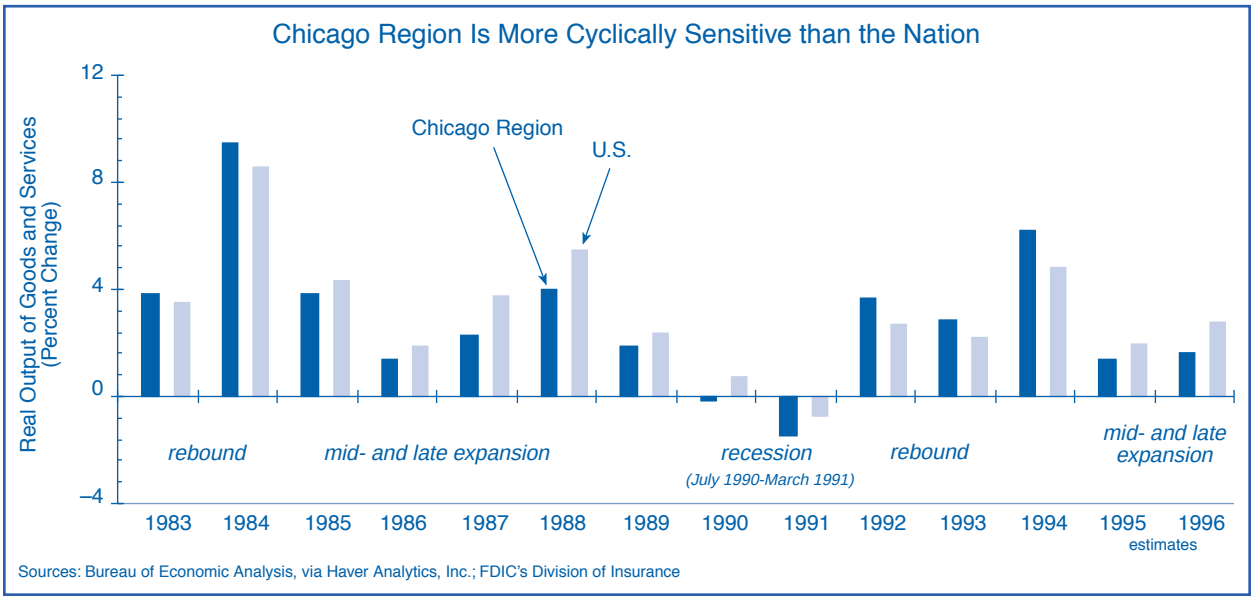
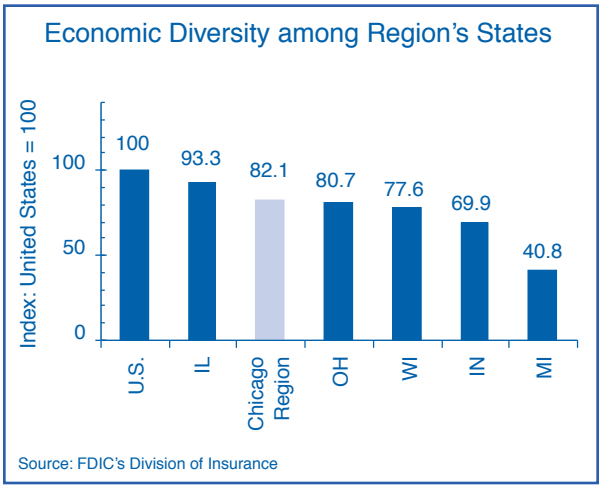


CHART 2



Since banks and thrifts generally have limited control over the economic environment within which they operate, they may need to take steps to moderate how adverse changes in economic conditions might affect their performance. Proactive institutions

- identify economic sectors to which they are vulnerable;
- assess the risks associated with those vulnerabilities; and
- structure their operations to moderate effects that are reasonably possible in the short and intermediate terms.

A prerequisite for such planning is knowing where the economy currently stands and estimating where it may be headed.

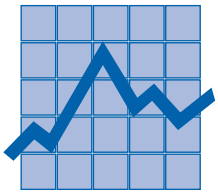
Expansion Continues but Growth Is Slowing: Warning Signs to Watch For

When the current expansion will end is a question that forecasters wish they could answer. *A consensus forecast for 1998 calls for real gross domestic product (GDP) growth to slow to around 2-1/2 percent,* more than a percentage point less than in 1997. Forecasts of slower growth partly reflect the nation's inability to grow robustly in light of current tightness in labor markets and production facilities. In addition, growth in demand for many cyclically sensitive products such as motor vehicles and new single-family homes is waning, and the current turmoil in Asian financial markets and economies also may trim U.S. growth a bit.

In terms of longevity, the current expansion will start its eighth year in April, making it the third longest of the ten cyclical expansions since 1945. The longest lasted 106 months (1961 to 1969), and the next longest lasted 92 months (late 1982 to mid-1990). *But advancing age alone does not doom a cyclical expansion. Rather, as expansions age, their growth momentum slows and becomes increasingly vulnerable to various imbalances, which typically dampen growth but do not necessarily end it.* Examples of such imbalances include:

- a significant amount of unplanned inventory accumulation;
- escalation of speculative behavior or unsupportable price gains in the financial, real estate, or other markets;
- extreme tightness in labor markets or production capacity, which leads to rapid increases in wages and prices, production bottlenecks, or both;
- adoption of the attitude that the good times will go on forever, causing households and businesses to let down their guard or undertake riskier behavior; and
- growing difficulties of borrowers with respect to handling their debt loads.

To date, none of these imbalances appears severe enough to threaten the expansion's continuation in either the Region or the nation as a whole. *However, noticeable and simultaneous intensification of several of them would be cause for concern, not only in their own right but also because such a development would heighten the odds of policymakers responding by raising interest rates.* That action, in turn, would further curb the strength of demand for many types of durable goods produced in this Region, whose purchase is typically financed by credit or debt.



Implications: *The consensus outlook represents both continuation of the expansion and its increasing vulnerability.* It is this vulnerability and the attendant mix of potential imbalances that create challenges for financial institutions in the later stage of an expansion.

So far, tight labor markets and high output levels have not triggered accelerating inflation or rising short-term interest rates, as occurred late in previous expansions. But such conditions may yet arise, which suggests that *the recent levels and stability of interest rates should not lull lenders or borrowers into a sense of complacency*. Indeed, insured institutions likely will benefit from periodic review and updating of their interest rate and market risk controls.

In addition, fluctuations in loan demand and increasing pressure on credit quality tend to develop at this stage in a cycle. Already there has been a considerable slowdown in growth of consumer loans outstanding, which closely follows shifts in employment growth during a business cycle (see Chart 3, where the shaded bar indicates a recession). With a lag, growth in commercial and industrial (C&I) loans tends to follow suit, as do real estate loans, although their relationship is considerably less tight.

Deteriorating credit quality also becomes a growing concern late in an expansion. Looking only at the previous cycle and consumer-loan portfolios, we see that the warning time was short between when real GDP growth started to plunge and past-due loans started rising rapidly (see Chart 4). *All told, about half the deterioration in the Region's consumer loan portfolios occurred before the national recession began in July 1990.* Any similar rise ahead will occur on top of the recent surge in past-due consumer loans, which has occurred partly because of bankruptcy legislation and behavioral changes rather than economic conditions.

With respect to both commercial and industrial loans and real estate loans, noticeable increases in past-due loans preceded the onset of the last recession by only two quarters (see Chart 5). Even so, more than 40 percent of the increase in the past-due rate for C&I loans took place before the recession officially began.

Although the current past-due rate on C&I loans is low, experience suggests that some late-expansion develop-

CHART 3

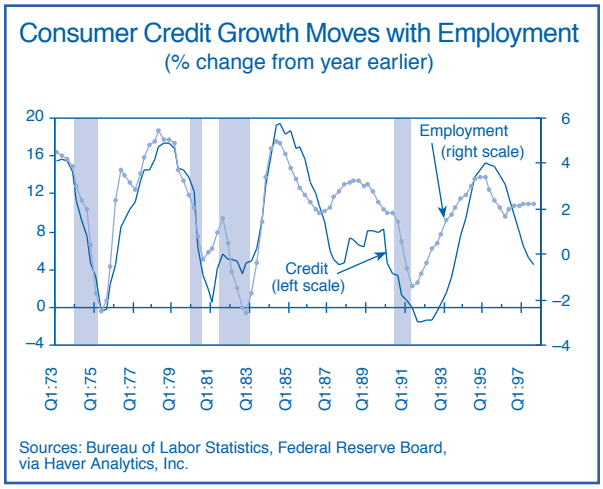


CHART 4

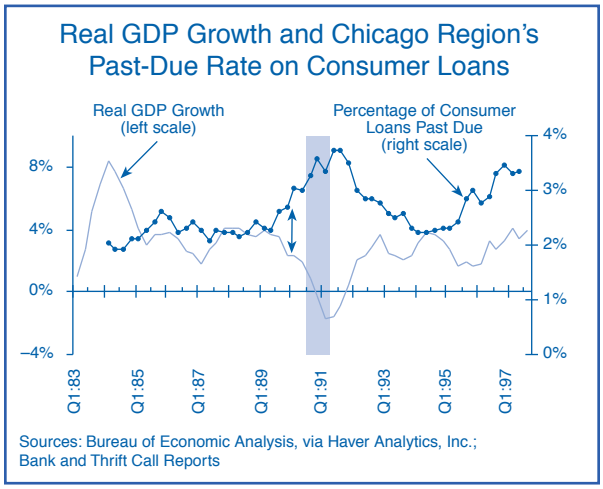
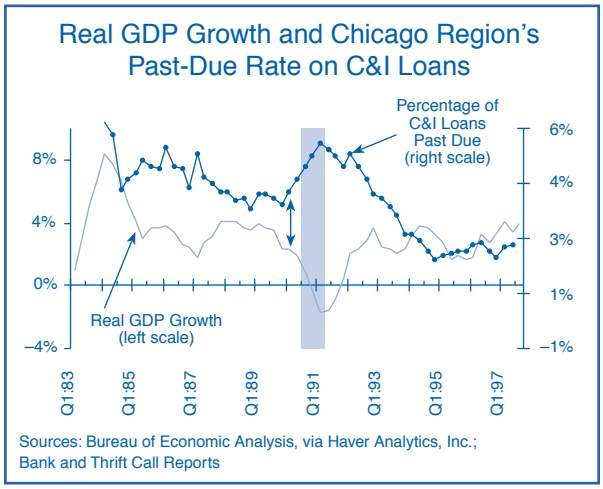


CHART 5



ments can result in a build-up of credits with the following characteristics:

- operating lines that are increasingly used to carry additional inventory, especially when the inventory build-up was unplanned;

- credit lines that are extended on the basis of rising collateral values rather than customers' cash flows; and

- loans that are made under relaxed underwriting standards, in response to strong competitive conditions or a desire to maintain market share.

Institutions with large volumes of such credits may be vulnerable and face rising risks, as some of their borrowers may lack the financial flexibility and resources needed to deal with an economic downturn.

Chicago Region Staff

Allowance for Loan and Lease Losses (ALLL): Trends to Consider

- **Many banks and thrifts in the Chicago Region, including many that have increased their concentrations in traditionally riskier loan categories, have reduced the coverage of reserves set aside for future loan losses.**

- **An improvement in traditional credit quality indicators may well support some of the reduction in ALLL coverage now in evidence. However, managers of insured institutions must consider additional factors when determining an acceptable range for the ALLL.**

- **Management must be able to evaluate the risks of new higher risk lending products, growth and changes in loan portfolio composition, and eased underwriting standards and terms where applicable.**

Overview

Chicago Region banks and thrifts continue to report strong conditions (see Chart 1). Through the third quarter of 1997, they

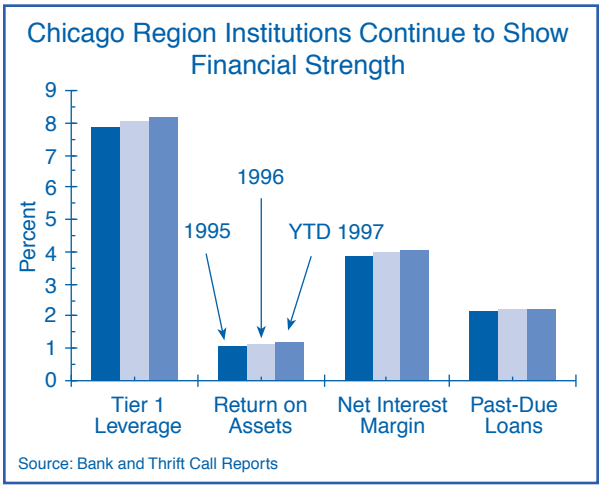
- increased aggregate leverage capital to more than 8 percent of average assets;

- recorded a solid aggregate return on assets of 1.21 percent; and

- maintained good overall asset quality—although many institutions are seeing modest growth in past-due loans.

While this performance is impressive, it should not result in a false sense of security. Banks and thrifts may well need the financial flexibility afforded by their current condition in order to meet challenges ahead. Many of these challenges, such as changing technologies, competition, and funding patterns, have been discussed in previous editions of this publication. This edition discusses similar issues, such as dealing with the Year 2000 problem (see ***Y2K***).

CHART 1



In addition, the Region's banks and thrifts have to plan for the possibility of adverse changes to the economy. Planning is especially important at this stage of an expansion because of the Chicago Region's tendency to slump earlier and more steeply than the nation when expansions end (see ***Region's Cyclical Sensitivity Highlights Importance of Looking and Planning Ahead***).

Many analysts are now focusing on credit quality trends to see if insured institutions will be prepared in the event of a downturn. In that regard, last quarter's ***Regional Outlook*** specifically cited the following as areas of interest or concern in the Chicago Region:

- continuing weaknesses in consumer loan portfolios;

- possible migration of consumer lending problems to home equity and residential real estate portfolios; and

- effects of eased underwriting on commercial and commercial real estate loans—especially in cases where growth has been significant or past-due levels are already high.

This quarter we focus on a related topic, trends related to ALLL.

ALLL Coverage of Total Loans Has Declined over the Past Few Years

Despite the fact that aggregate provisions have more than covered net loan losses at Chicago Region institutions for the past several years, they have not kept pace with overall loan portfolio growth. Therefore, the ALLL for the Region as a percentage of total loans has declined from 1.67 percent at the end of 1993 to 1.45 percent at the third quarter of 1997 (see Chart 2).

Declining allowance coverage is a broad-based trend. About 61 percent of the Region's banks and thrifts with differing asset sizes, geographic location, and business concentrations have experienced declines in ALLL coverage to total loans since year-end 1993.

Traditional Measures of Problem Loans Support Current Trend, but Other Factors Need to Be Considered

Some observers believe this trend toward lower ALLL coverage of gross loans will continue. They point out that traditional measures of credit quality, such as noncurrent loan and net loan charge-off rates, have improved from those noted in the early 1990s (see Chart 3). Therefore, even though ALLL coverage of gross loans has declined, coverage of noncurrent loans approximates 170 percent for the Region—down from the high of 190 percent two years ago but still over twice what it was at the start of the decade.

CHART 2

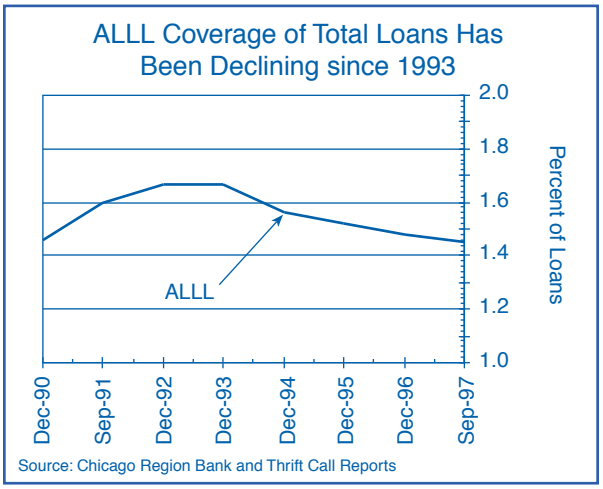
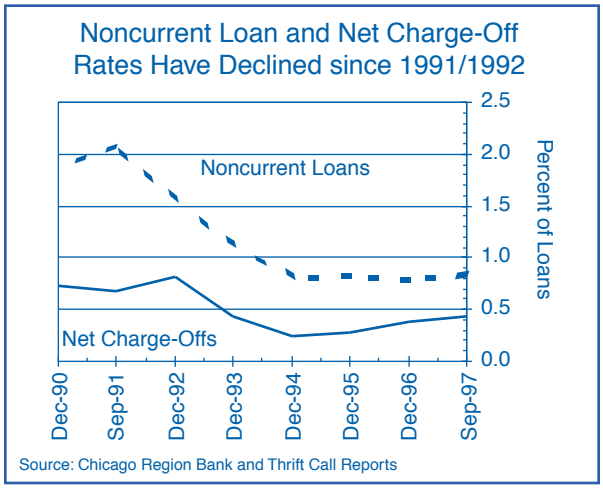


CHART 3



Unfortunately, noncurrent loan rates tend to be a lagging indicator of credit quality. Therefore, prudent managers need to consider additional factors in determining an acceptable range for the ALLL. These factors include (but are not limited to) historical performance of significant portfolio segments, concentration levels, any new loan products, and operating environment.

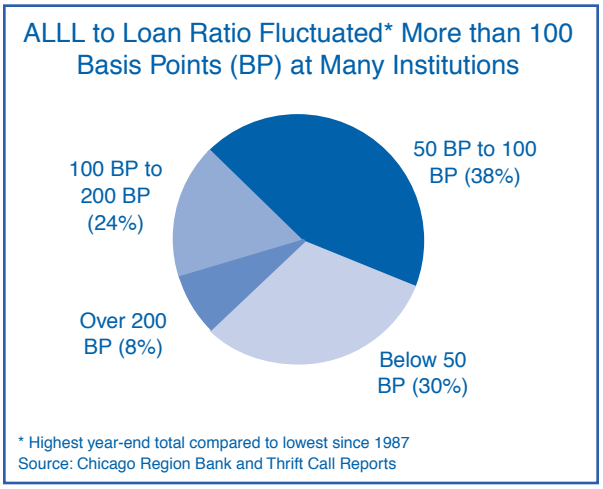
In considering these other factors, bank and thrift managers may want to be especially aware of the issues discussed below.

Volatility of Reserve and Charge-Off Levels at Individual Institutions

Reserve and charge-off levels for some institutions tend to be somewhat volatile over time. For example, Chart 4 indicates that over 32 percent of currently operating banks and thrifts in this Region have seen their *ALLL coverage of gross loans* fluctuate by over 100 basis points (from highest to lowest year-end) since December 1987. Furthermore, 30 percent of all institutions have seen *annual charge-off rates* fluctuate by over 100 basis points during the same period.

Banks and thrifts that exhibit such volatility may benefit from identifying the specific causes and estimating their vulnerability to future similar occurrences. For example, during the past few quarters, the average charge-off rate for credit card loans in the Region has significantly increased; it exceeded 6.75 percent (annualized rate) during the third quarter of 1997. This increase is attributed, at least in part, to a significant rise

CHART 4



in personal bankruptcies, and some analysts believe that the level of bankruptcies will not decline in the near term. Many institutions with large consumer credit exposures have had to incorporate these changing conditions into their ALLL provisioning decisions.

Higher Risk Loan Products

Another area to consider is the introduction of new loan products. Some institutions have increased their exposures to higher risk loan types such as subprime auto lending and high loan-to-value (LTV) mortgages and home equity loans.

Performance problems on these credits tend to be higher than for more traditional lending portfolios. For example, a recent Office of Thrift Supervision publication indicates that mortgage loans are much more likely to become seriously delinquent as LTV ratios rise above 90 percent (see Chart 5). Individual institutions need to take a hard look at the adequacy of reserves for these loans, given that their higher risk profile could be exacerbated by an adverse change in economic conditions.

Loan Portfolio Composition Changes

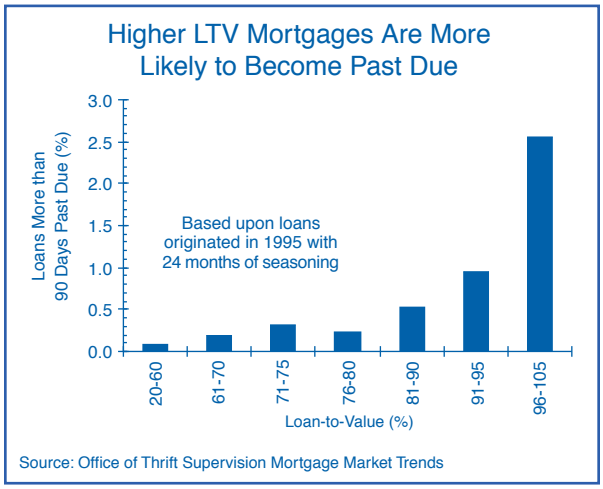
Loan portfolio composition is another area of change that many institutions in this Region need to review. Some institutions have lessened their credit risk profile by increasing the proportion of lower risk loans they hold, such as traditionally underwritten residential mortgages. On the other hand, a significant number of Chicago Region institutions have registered very strong commercial and commercial real estate loan growth recently. As a result, since 1994, over half have increased the proportion of their loan portfolio that is allocated toward such loans, with about 250 (out of a total of 2,170) showing a significant increase of 10 percent or more. Since these types of credits traditionally have exhibited higher risk—especially when issued late in an economic cycle—it is interesting to note that only about half the institutions recognizing a significant shift increased their reserve coverage during that period. While current reserve levels may well be justified, institutions experiencing these changes may want to review their risk assessment procedures related to these portfolios.

Survey Results Show Changes in Loan Underwriting

Finally, institutions need to consider how changes in their underwriting practices may have affected credit risk in their portfolios. Such consideration is especially important in the current environment, where various underwriting surveys reflect an easing of terms and standards.

- The Federal Reserve recently released the results of its national ***November 1997 Senior Loan Officer Opinion Survey on Bank Lending Practices***. Among other things, the survey noted that increased competition has apparently led some banks to lower interest rates charged, increase the maximum size of credit lines, and adjust loan covenants on commer-

CHART 5



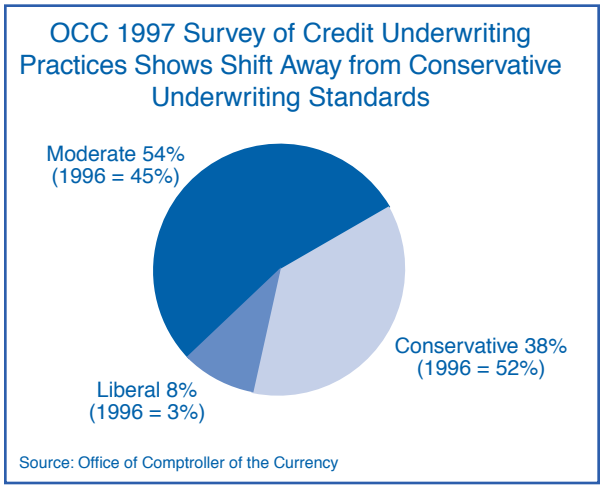
cial and industrial loans during the previous three months.

- The Office of the Comptroller of the Currency's (OCC's) national ***1997 Survey of Credit Underwriting Practices*** indicates that there has been a discernible shift in underwriting standards since 1996, and most of the surveyed banks now have moderate or liberal underwriting standards. The survey notes that the trend toward eased standards was most pronounced in middle-market loans, syndicated and national credits, and commercial real estate (see Chart 6).

- The FDIC's ***Report on Underwriting Practices*** for April to November 1997 states that, on a national basis, lending for commercial real estate and construction should be closely monitored. It also indicates that slightly more banks recently examined in the Chicago Region had loosened rather than tightened underwriting standards.

Eased underwriting terms and standards are always a potential concern, but even more so at this stage of an economic expansion and when growth rates for such credits are high. In the Chicago Region, more than 30 percent of all insured institutions had growth rates exceeding 20 percent in the commercial and commercial real estate lending categories over the past year. Certainly, management needs to ensure that changes in credit risk profile of the loan portfolio caused by easing of underwriting standards are incorporated into its ALLL adequacy reviews.

CHART 6



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