

Strategies to Hedge the Unique Asset/Liability GAP Inherent to Black-Owned Banks

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ABSTRACT

An analysis was conducted on the strategies implemented by Black-owned banks (BOBs) to service the credit needs of their communities. The analysis was based on financial statements from annual reports, regulatory agencies, and studies on the subject of banking in communities of color. Commonly used accounting and finance measures were used to evaluate the relative performance and risk exposure of the BOBs and their peers. The results from the analysis revealed that BOBs loaned less and invested more of their assets than their peers. Although the BOBs faced lower demand for their services and increased competition, they achieved superior profitability compared to their peers in 1992.

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Table of Contents

Abstract.....	2
List of Tables.....	4
Chapter One:Introduction.....	5
Background of Black-Owned Banks (BOBs).....	5
Analysis: Comparison Between the BOBs and Their Peers.....	6
Competition.....	7
Customer Base.....	8
Market and Regulatory Environment.....	9
Boston Bank of Commerce (BBOC) Case.....	11
Boston Bank of Commerce Background.....	11
GRNA Customer Base:.....	13
Competition.....	14
Recommendation.....	18
Introduction to Target BOBs.....	20
The BOBs: Performance Measures & Comparisons.....	20
Methodology.....	21
Analysis of the Top 7 BOBs and 12 of Their Peers.....	21
Chapter Two : Findings.....	29
Liquidity Risk.....	29
Credit Risk.....	30
Interest Rate Risk.....	31
Chapter Three: Recommendation and Conclusion.....	34
A Strategy for Profitably Extending More Credit.....	34
Compensation for Additional Risk.....	36
The BOBs' Credit Risk Exposure.....	37
The BOBs' Interest Rate Risk Exposure.....	38
Conclusion.....	41
References.....	44
Appendix.....	45

List of Tables

Table 1: Selected Assets & Liabilities of the BOBs, Other Minority-Owned, and Majority Banks in the Asset Size Range of \$50 to \$300 Million.....	6
Table 2: Geographic Breakdown of BBOC's Mortgage and Business Loans.....	12
Table 3: Mortgage Lending By BBOC & Its Four Mainstream Competitors, 1989-1992.....	12
Table 4: Bank Facilities Located Within Boston's Greater Roxbury Neighborhood Area.....	15
Table 5: The Top 10 Black-Owned Banks, Ranked by Assets.....	20
Table 6: Comparison of The Banks' GAP Measures.....	33
Table 7: BOB Asset Allocation.....	35
Table 8: Swap Transaction to Exchange Fixed Payment for Floating.....	40
Table 9: Interest Rate Hedge with Locked In Spread Using Swaps.....	40

Chapter One

Background of Black-Owned Banks (BOBs)

There are currently 77 Black-owned and/or Black-operated financial service companies in the U.S. Most of the Black-owned banks (BOBs) which consist of both savings and commercial banks are located in urban areas where unemployment rates are higher and income levels are lower than the national averages. While the largest of these banks are financially stable, the group as a whole is vulnerable to economic downswings because of their customer base. When the general economy improves, the Black nation has tended to be slow in reaping the benefits. But, when the economy trends down, this population segment is first to suffer from the negative effects and at disproportionately larger levels.

Beginning in the early 1900s, BOBs emerged in the South to fulfill the credit needs of minority communities which were unable to obtain banking services the majority community. During the Civil Rights era of the 1960s and 1970s, a second wave of BOB emerged (Cline, 1990). Traditionally, BOBs have been conservative and slow to adopt innovative marketing or new technologies. In general, from the 1900s to today, the growth of these institutions has been stunted by their economically vulnerable customer base, the counterproductive effects of desegregation, and the rapidly changing financial services industry.

The most recent challenges to the viability of BOBs comes from the Federal government's Community Reinvestment Act (CRA) and the emergence of non-banking competitors. The federally enforced CRA has forced many mainstream banks to offer credit services to minority communities creating new competitors and tightening margins for BOBs. In Boston, Massachusetts for example, within two years after establishing a community banking division within Boston's predominately "minority" community, Bank of Boston held over \$250 million in deposits while the area's only BOB which had been serving the same community for the prior ten years held only \$75 million in deposits (Wilkerson and Williams, 1993). Non-banking firms such as check cashing stores have also taken market share from BOBs within this target market.

The desegregation era of the 1960s and the CRA movement begun in the late 1980s completely changed the nature of banking in Black communities. Once monopolists, the BOBs have been slow in responding to the competitive pressures of new entrants into their target area. Given the right to choose, many Blacks, after desegregation no longer did business with their local BOB. Also, many of the larger mainstream banks found that they do have the ability to earn

profits from the Black customer base they had long ignored. BOBs suffered as demand for their services declined while the threats from their new competitors increased.

In addition to BOB specific challenges, the banking and thrift industries, in general, have been changing quite rapidly over the last ten years. The changes are as a result of deregulation, globalization of capital markets, and greater interest-rate volatility. Since the last decade, banks have been trending towards consolidation through “massive restructuring” which has resulted in an increase in merger, acquisition, and divestiture activities as well as a rise in internal restructuring (Copeland et al., 1994).

Analysis : Comparison Between the BOBs and Their Peers

Minority-owned banks in general, and BOBs in particular were created to meet the credit needs of the “disenfranchised” minority community. For many generations, the community BOB was the only lending source available to Blacks, outside of family and friends. Prior to the Civil Rights’ desegregation policies, BOBs enjoyed a monopolistic relationship within their service areas. Today, BOBs battle in a highly competitive industry dominated by technologically superior and better capitalized competitors. As of year end 1992, there were 19 BOBs with assets between \$50 to \$350 million dollars. Only one bank held assets valued at over \$300 million. The combined asset value of these top BOBs was \$2.4 billion, averaging \$126 million per bank (Hayes, 1994). Only two of the 19 banks are located outside of the nation’s 15 largest metropolitan areas. While the number of BOBs are few, they have thousands of competitors. Also in 1992, there were 45 other minority-owned banks and 4,741 mainstream (non-white owned) banks within the asset value range of \$50 to \$300 million (Federal Reserve Bank, 1992).

Table 1. Selected Assets & Liabilities of the BOBs, Other Minority-Owned, and Majority Banks in the Asset Size Range of \$50 to \$300 Million*

Company	Assets	Loans	Loans/Assets	Deposits	Deposits/Assets
Average of Top 19 BOBs	126,032	69,045	51.77%	108,867	88.15%
Ave. Majority Bank	111,461	60,364	54.16%	98,178	88.08%
Average Minority Bank	105,917	57,573	54.36%	95,468	90.13%

* Carver Federal Savings with asset value of \$320 million is included in the Top 19 BOBs.
Sources: Black Enterprise by B.E. Research June 1993 and the Board of Governors of the Federal Reserve System.

As shown above in Table 1, based on a rudimentary comparison of the averages of the top 19 BOBs to that of their minority-owned and mainstream peers, there are only slight differences in all of their financial structures.

Competition

As some Blacks emerged into the American mainstream as a result of the advancements accomplished during the Civil Rights Era, many also sought financial services from mainstream institutions. Many Blacks opted to obtain their financial services from banks outside of their own communities. Interestingly, the competitive threat to BOBs was not as a result of mainstream banks moving into their niche service areas. Instead, the monopolistic position of the BOBs was dismantled when their own Black customers began taking their business outside of the community to the traditional banks. Desegregation brought new challenges to BOBs. While more Blacks had new access to the economic ranks of middle America, BOBs had to compete against better capitalized and more “prestigious” banks for the “best” Black customers.

Until the 1990 amendments to the CRA were enacted, the act was largely ignored by mainstream banks. The original act served to only “encourage banks to distribute loans equitably in all communities they serve”. The new law coaxed the banks into compliance by including stricter enforcement, requiring public disclosure of ratings, and discussing each bank’s performance in meeting the credit needs of the various communities that they serve. These changes sought to ensure that deposits from the local community would be reinvested for local community and housing development (National League of Cities, 1991). Since 1990, many mainstream banks have made commitments to provide credit services of vary degrees to communities of color within their service area. This heightened degree of compliance by mainstream banks represented the second major attack against the entire Black banking industry.

To a lesser extent, non-bank competitors have also stolen market share from BOBs. Check cashing businesses have often been cited as major competitors to BOBs. The fact is that most customers that use the check cashing businesses are not general users of banking services anyway. But, by not coming to the BOB to cash checks, the probability of being able to “grow” individuals into the “retail banking type” (that is a user of checking or savings accounts) is lower difficult (Smith, 1993). Like their industry peers, BOBs also face increased competition from other non-bank competitors such as Sears and Dean Witter.

Customer Base

Historically, the customer base for BOBs has been mainly members of the Black community. Simply, since the abolition of slavery, this community has been undereducated, underemployed, and denied access to capital. Through the decades, the Black nation has made advancement through self-empowerment as well as through government sponsored initiatives such as the "Great Society Program" and Affirmative Action. Since the Civil Rights Era, many Blacks have joined the ranks of the middle class, while a few (non-athletes) have even become "wealthy". But, while some have eased into the status of the middle class, most Blacks still suffer from higher unemployment, lower wages, and inaccessibility to needed capital and/or credit. According to the U.S. Bureau of the Census, over 56% of Black families earn less than \$25,000 per year compared to white families' 29 percent. That is, the median income for Black families in 1992 was only \$21,161 compared to that of white families which averaged at \$38,909 (Bureau of Census, 1992).

Due to desegregation, Black consumers now had the option to choose where to live and with whom to do business. For many, that choice, due to economic or psychological reasons, has taken them outside of the traditional Black neighborhoods. Many Black-owned businesses, including banks, have suffered as a result of diminished demand as Blacks from every social class opt to do business with non-Blacks. Since desegregation, dollar turnaround in Black communities has become the lowest of any other ethnic group. The challenge, particularly to those BOBs which choose to exclusively target the Black community is to compete to attract and maintain relationships with those Black consumers who represent good credits.

While more Blacks may opt to do business with mainstream banks, the Federal Reserve Bank of Boston's interpretation of the 1990 Home Mortgage Disclosure Act (HMDA) data concluded that Black and Hispanic mortgage loan applicants were still denied at significantly higher rates than white applicants. It was determined that a large percentage of the higher denial rate for Boston-area minority applicants was attributable to their larger level of debt, higher loan-to-value ratios and weaker credit histories. Despite these differences with white applicants, minority applicants with "the same economic and property characteristics" as white applicants were still subjected to a higher denial rate, (17% vs. 11%) (Munnell et al., 1992).

Banks make money by creating the largest spread between the return on lending and the cost of borrowing, given some predetermined level of risk. It is contrary to the concept of profit maximization for any bank to deny a "good" loan due to the applicant's race, holding all other things equal. While this discrimination does occur, it is not the norm. Banks, on average, are not

going to turn down a perfect application due to race. The higher denial rate for minority applicants seems to occur because of perceived flaws in their applications. It should be noted that the majority of all applications, regardless of race, are imperfect. In fact, less than 20% of all loan applicants are flawless (Munnell et al., 1992). Thus, discretion by the loan officer becomes a decision-making tool in the loan review process. It is at this point that the average minority applicant is denied the loan not because their application is unacceptable but perhaps because of the biases or prejudices of the loan officer.

Widespread discrimination on the part of loan officers is certainly not the only factor distorting the attractiveness of Black applicants. Lenders also use benchmarks established by the federal regulators like Fannie Mae and Freddie Mac for selling into the secondary market for mortgages. Normally, banks can maintain liquidity and reduce their portfolio's credit risk level by either selling whole or parts of individual or bundled loans to the secondary market. These markets are better structured to handle some of the risks faced by banks. But, the markets' standards can make it difficult for banks to accept obligations from those customers that do not "fit" the qualifications. BOBs have frequently find it difficult to make "fair" deals in these markets due to their Black borrowers (Munnell et al., 1992).

Ideally, the secondary mortgage market should act as an "equalizer" for Black customers with flawed applications because residential mortgages have been relatively safe investments for banks due to historically low default risks (Smith, 1993). Since this and other secondary mortgage markets offer another level of safety, it serves to ensure liquidity for both lenders and investors. Therefore, by dealing in the secondary markets, all banks should find it easier to be more flexible in accepting flawed applications. It should be noted that the beneficial features of the secondary market should not be abused by participating in riskier transactions. Instead, the markets would allow the "fair" valuation of a loan which has the same degree of riskiness as the standard profile but appears different due to socio-economic reasons.

Market & Regulatory Environment

In an attempt to stimulate the economy, the Federal Reserve Bank implemented a succession of short-term interest rate cuts. The low interest rate environment of 1991 through 1992 served to rebuild profits and raise new capital for American financial institutions left reeling after the devastating period known as the Savings and Loans crisis. The rates banks had to pay to raise funding were now much lower than those they charged to borrowers. This situation allowed

for the creation of large spreads. In fact, many bankers virtually abandoned the concept of acting as intermediaries. Instead, they boosted their own bottom lines by borrowing from the Federal Reserve's discount window at 3% and then investing those same funds in relatively risk-free long term government securities yielding 6-8 percent. This trend of using a federal "subsidy" to borrow short and lend long had created a new potential threat of excessive interest rate risk within the banking industry. Rising rates or a flattening yield curve would damage profitability in a similar manner as the credit crunch of the 1980s had done (Economist, 1992).

While lower rates allowed banks to take advantage of the federal subsidies, these rates also caused a consumer rush to refinance their mortgages. This call feature of mortgages put banks in a precarious position. With interest rates at a 27 year low, banks were forced to either sell these loans at a loss or pay for expensive hedges to cover their exposures. Most banks tried to offset the losses from refinanced loans by cutting deposit costs. Although deposit rates had declined as low as 4%, most savers maintained their balances in the banks. Deposits have been a relatively stable source of funding for banks, even in this low interest environment. If, however, the economy improved, banks would soon be forced to pay higher rates on deposits and to earn less on their spreads (Economist, 1992).

The bank regulators, still vigilant from the S&L debacle, turned their attention from credit risk to interest rate management. In the early 1990s, under the auspices of the Federal Depository Institution Corporation (FDIC), the FDIC Improvement Act directed the Federal Reserve Board, the Office of the Comptroller of the Currency and the FDIC to revise risk-based capital standards to reflect interest rate risk. The controversial policy used a modified duration to reflect the price elasticity of balance sheet contracts in response to a small rate change. Any bank found to have more than 1% of assets in the form of price-sensitive assets or liabilities was considered to be a "high risk" and thus required to set aside additional capital (Riley, 1992). The act was broad and imprecise, but the intention was clear. The regulators were going to begin enforcing stricter interest rate risk management requirements.

BOBs face the same market and regulatory environment as all other banks. BOBs primarily target Black and other people of color as their main customer base. This is the most significant difference between the BOBs and other banks. The current secondary market and regulatory standards make profitable lending to this customer base more difficult. While the top BOBs fared relatively well through the credit crunch of the S&L crisis period, stricter interest rate risk management regulations may threaten the BOBs' ability to serve their communities.

Boston Bank of Commerce (BBOC) Case

The structure of this chapter is a mini version of the first two sections of this thesis in that it covers 1) an analysis of the Black-owned bank, Boston Bank of Commerce (BBOC), 2) its service area and its credit needs, 3) the regulatory constraints, and 4) BBOC's major mainstream competitors. The purpose is to highlight the differences between BOBs and their competitors and how each type of bank deals with the city's community of color. Beginning in 1990, four mainstream New England banks started to focus their attention on the disenfranchised minority community concentrated in the Boston area. The following case study was conducted in 1993 as a client-based, joint thesis between the author and a John F. Kennedy School of Government masters student (Wilkerson and Williams, 1993). The following is our examination of the role of the Boston Bank of Commerce in contributing to the development of Boston's predominately non-White, inner city neighborhoods of Greater Roxbury, Massachusetts (GRNA) during this period of mounting competition and stiffer regulations.

Boston Bank of Commerce Background

As of year end 1992, Boston Bank of Commerce (BBOC) was ranked as the 13th largest BOB with assets holdings of \$85.6 million. The Boston Bank of Commerce's stated mission is "to be a strong and profitable institution recognized for providing quality services" that foster economic development throughout Greater Boston's communities of color, the Greater Roxbury Neighborhood Area (GRNA). The GRNA is comprised of the neighborhoods of Roxbury, Dorchester, and Mattapan. The Jamaica Plain and South End neighborhoods of Boston are also predominately non-White areas in which BBOC has a significant presence.

Mr. Ronald Homer, Chairman and Chief Executive Officer, states that the Bank must effectively respond to the needs of the targeted area and also provide a leadership role without jeopardizing the bank's credibility as a financial institution. First, the Bank has outlined a multi-faceted approach to meeting the needs of the community including promoting home-ownership, small business development, and commercial revitalization. Second, the Bank views itself as a link between the GRNA community and the broader business community; an advocate that encourages investment in and ensures that benefits accrue to the neighborhoods and their residents.

An analysis of the Bank's market orientation and primary banking activities support its stated mission. BBOC's 1992 customer lending profile consisted of 59.5% to Blacks, 25% to

Whites, 6% to Hispanics and Asians and others accounted for 9.5 percent. A geographic breakdown of BBOC's lending is shown in Table 2 below.

Table 2. Geographic Breakdown of BBOC's Mortgage and Business Loans.

Location	Mortgages		Business Loans	
Roxbury	17	10.70%	23	12.90%
Dorchester	34	21.40%	38	21.40%
Mattapan	22	13.80%	7	3.90%
Jamaica Plain	9	5.70%	6	3.40%
South End	7	4.40%	31	17.40%
Other Boston	7	4.40%	31	17.40%
Boston	96	60.40%	136	76.40%
Elsewhere	63	39.60%	42	23.60%
Total	159	100.00%	178	100.00%

Overall, the Bank's mortgage lending appears to be its most substantial area of operations. BBOC is consistently ahead of most other area banks and mortgage companies in lending within the GRNA. These findings are based on an analysis of residential mortgages made between 1989 and mid-year 1992, drawn from 27 census tracts making up parts of the Uphams Corner section of Dorchester and the northeastern section of Roxbury. Of 137 loans made during that period by BBOC and the four large mainstream banks, BBOC made 47, or 34.31 percent, see Table 3. But, the more restrictive underwriting standards imposed by the secondary market limit BBOC's ability to market its mortgage holdings from the GRNA.

Table 3. Mortgage Lending by BBOC & Its Four Mainstream Competitors, 1989-1992.

Lender	# of Mortgages	% of Total Mortgages
Bank of Boston	28	20.44%
BayBank	6	4.38%
Boston Bank of Commerce	47	34.31%
Fleet Bank	7	5.11%
Shawmut Bank	49	35.77%
Total	137	100.00%

BBOC's primary housing market consists of two to four-unit structures and low- to moderate income borrowers. The criteria for the secondary market has traditionally restricted acceptance of these types of properties and borrower profiles. Part of the problem lies in the difficulty of assessing the stream of rental income generated by the additional housing units. Most of the housing stock in Boston and including the GRNA is made up primarily of two to four unit,

triple-decker structures. Single family dwellings which are easier to value are extremely scarce. Couple the valuation difficulty with the lower income borrowers and the result for BBOC is difficulty in selling its mortgage holdings into the secondary market. In fact, the Bank holds twice as many loans which do not conform with Fannie Mae's current standards than loans that do conform. The Bank's inaccessibility to the secondary market has limited the growth of its non-interest income.

Capitalization and asset structure are both problem areas for BBOC. In 1991, the Bank had an equity to asset leverage ratio of 4.38% which only marginally exceeded the 4% minimum imposed by the FDIC. Based on the newly instituted Basel risk-based capital standards, the Bank will likely experience increased lending flexibility. Though the Bank has been able to increase its asset holdings, further growth is severely constrained by the necessity to generate capital. BBOC's asset structure relative to other Black-owned banks (BOBs) within the same asset class of \$50 to \$300 million contains more loans than the other banks. BBOC held about 70% of assets as loans while the other BOB peers averaged only 51 percent. BBOC also held about half the amount of investment securities as the other banks. BBOC was slow in shifting from loans to investing during this period of change.

GRNA Customer Base

Poor performance in the New England regional real estate market has substantially curtailed much of the growth in housing expected to occur through the year 2000. Therefore, mortgage opportunities are likely to be limited to transfers of ownership (purchase) and/or refinancing. While the need remains, the development of rental housing in one to four family structures is expected to decline through 2000. Multi-family and one to four family condominium conversions, however are projected to increase, continuing a trend toward this type of rental housing. The low median wages throughout the GRNA continue to present significant challenges to home-ownership development.

Boston's minority-owned firms and other inner-city businesses, though few in number, have played a significant role in providing Boston residents and other businesses with jobs, goods, and services. There are approximately 7,250 minority-owned enterprises within the Boston area. Forty-four percent are Black-owned, 20% are Hispanic-owned and Asians and other non-Whites represent 36 percent. Boston's minority-owned businesses are currently concentrated (about 90%) in the service and construction industries. The minority-owned and the other area businesses

provide over 11,000 jobs to local residents, most of whom (about 70%) live within the GRNA. Over 60% of sales from local and minority-owned businesses are from within the Boston area, and 38% are from within their own neighborhoods. These businesses are also strong supporters of each other by purchasing about 60% of their total products from Boston area companies, and 32% from neighborhood area businesses.

The major barriers to growth and expansion for Boston's minority-owned and area businesses are 1) the lack of access to capital, financing and business contracts; 2) the need for technical assistance; and 3) the increase in the level of crime within the area. Over 65% of these enterprises find obtaining financing for their ongoing operations and/or expansion is difficult, even at higher costs, or not available at all.

Competition

BBOC's monopoly on credit services to the GRNA has been decimated by the entrance of area competitors, see Table 4 below. The four largest area banks that have established a presence in the GRNA are: Bank of Boston's First Community Bank, BayBank's BayBank Boston, Shawmut Bank and its affiliate Shawmut Mortgage Company, and Fleet Bank of Massachusetts. All four competitors have a heavy retail orientation. Only Shawmut Bank seems to be a major competitor in the residential mortgage market. For business lending, again Shawmut stands apart from the other competitors by lending primarily in Boston's Chinatown neighborhood. The other three banks rely on their membership in the Massachusetts Minority Enterprise Investment Corporation to participate in small business lending.

A description of each of the mainstream bank into the GRNA and their stated roles in the GRNA are outlined below:

Table 4. Bank Facilities Located Within Boston's Greater Roxbury Neighborhood Area (GRNA)

Bank Name	1989	1993
Boston Bank of Commerce	2	2
BayBank Boston	0	22
Bank of Boston - First Community Bank	0	12
Fleet Bank	0	4
Shawmut Bank	0	15
Total	2	55

Source: Strategic Analysis of the Role of the Boston Bank of Commerce in the Greater Roxbury Neighborhood Area, Masters Thesis, May 1993.

BANK OF BOSTON-FIRST COMMUNITY BANK. In 1989, the Bank of Boston took the initiative to establish the First Community Bank as a comprehensive approach to reaching the low and moderate income inner city markets of Boston. The Bank of Boston is the principal banking subsidiary of Bank of Boston Corporation, a bank holding company with combined assets, as of 1992, of over \$31 billion.

Through its 12 branches and over 100 staff members, First Community Bank (FCB), a division of Bank of Boston, targets retail lending and banking services to several of Boston's inner-city neighborhoods, Providence, Rhode Island, and New Haven, Connecticut. In 1991, FCB had over \$250 million in deposits. FCB's product line includes low cost checking and savings accounts, ATM service, affordable mortgages, property improvement loans, and unsecured personal loans.

According to Ms. Gail Snowden, President of First Community Bank, the division's goal is to both increase the Bank's market share and to "normalize" their community development activities into the other more traditional divisions of the Bank by maintaining profitable operations. Normalization is the process of taking products and services from this special unit of the bank and implementing them throughout the entire bank. To the Bank of Boston, the value of FCB is contingent upon the division performing on par with other profit centers within the Bank. To achieve this, FCB's goal is to generate \$25 million in deposits per branch. As an entire unit of branches, FCB has been profitable since its inception in 1990.

First Community Bank's principal strategy is to dominate the New England urban banking market through the use of an extensive full service retail branch network system. Prior to the creation of FCB, Bank of Boston held 7 branches within Boston's inner city. Through Bank of Boston's acquisition of other banks, FCB has obtained 5 more branches and plans to "grow" 3 more in 1993 for a total of 15 branches.

First Community Bank's primary activity is to provide consumer banking products and services. The Bank has established what it has termed "conventional banking plus," a variety of traditional banking products designed to accommodate low to moderate income consumers. These offerings, First Step Bank products include low fee checking and savings accounts which require no minimum balances.

Though a strong retail bank, FCB does not appear to place heavy emphasis on residential mortgage lending. An analysis of residential mortgage data from the period of 1989 to mid-year 1992 reveals that Bank of Boston via its mortgage company made only 20% of all the loans made

by BBOC and its other competitors. However, in the next five to ten years, it is likely that the Bank will intensify its efforts to capture more of the market share of residential lending. FCB has already taken the first steps to accomplish this by currently offering mortgages for multi-family residences to applicants with joint incomes as low as \$25,000.

With respect to commercial lending, the Bank intends on being involved in large scale commercial projects like the Parcel 18/Ruggles Station development. They plan to continue to pursue these types of projects in consortia with other traditional Boston area banks through MEIC (Minority Enterprise Investment Corporation, a multi-bank community development corporation) or through developed "partnerships" with the City of Boston.

BAYBANK-BAYBANK BOSTON. In 1978, BayBanks, Inc. established BayBank Boston, N.A., to serve the downtown Boston area. By 1990, BayBank Boston (BBB) expanded its retail banking services to target Boston's inner-city neighborhoods. As of year end 1992, BayBanks Inc., a bank holding company, and its subsidiaries had a combined asset value of \$10 billion.

According to Mr. Grady Hedgespeth, regional President of BayBank Boston, BBB's goal is to "fit" the Bank's retail and commercial banking focus to meet the needs of the inner-city neighborhoods through the balancing of "high touch" and "high technology". That is, BBB puts a heavy emphasis on consumer products and lending coupled with an extensive ATM network system. Of BBB's 23 facilities within the GRNA, 19 are ATMs with the remaining 3 as full service branches and 1 loan processing center. In order to complete an extensive "hub and spoke system" within the GRNA, the Bank plans major capital investments. The Bank is opening two branches in the Dudley and Lower Roxbury/South area and a 5,000 s.f. retail banking center in Dorchester's Field Corner which will house lenders, the human resources department, and the office of the Regional President.

BBB's principal strategy is to capture a large share of the fee-income activity in the GRNA through the use of its extensive ATM network system. Each of BBB's ATMs are expected to yield at least 9,000 transactions per month. The branches serves as the foundation of this system by providing consumer and small business products and services. BBB is not a serious small business lender.

Analysis of residential mortgage data reveals that BBB also has not placed a strong emphasis on mortgage lending in the GRNA. BBB made only 4% of all the loans made in the GRNA by BBOC and the other mainstream banks. While the majority of BBB's efforts in the GRNA has been on retail banking, the Bank still intends to be involved in larger scale commercial

lending projects. They plan to pursue these types of projects in consortia with other traditional Boston area banks through MEIC, local business associations, or through a developed partnership with organizations such as the Commonwealth Enterprise Fund.

SHAWMUT BANK & SHAWMUT MORTGAGE COMPANY. Shawmut Bank and its affiliate Shawmut Mortgage Company primarily serve the retail and mortgage lending needs of the Metropolitan Region which is comprised of Boston's inner city neighborhoods, Cambridge, Somerville, and Chelsea. In addition to its corporate headquarters, Shawmut has 47 bank offices in the region with over 2,500 personnel.

Within the GRNA, the Bank has 2 full service branches and 13 ATMs and is planning another full service branch and mortgage production office. While Shawmut is a retail-focused bank, its strategy in the GRNA has been concentrated in mortgage lending. Shawmut Mortgage Company has been the major mortgage lender in these inner city neighborhoods by making about 36% of all the mortgages between 1989 and mid-year 1992.

Shawmut does five times more business in Boston's Chinatown than it does throughout the entire GRNA. Shawmut's loan portfolio for Chinatown alone is \$25 million. The Bank believes that Chinatown's enterprises, especially those associated with the restaurant industry, are proven and stable businesses. The primary need for these firms is capital for expansion. With respect to small business lending, the Bank does not appear to be a major player in the GRNA. While the majority of Shawmut's efforts in the GRNA are in the area of mortgage lending, the Bank still intends to be involved in the area's large scale commercial lending projects like the Parcel 18/Ruggles Station development. Their plan is to continue pursuing these types of projects in consortia with other traditional Boston area banks through MEIC or through organizations like Dudley Street Neighborhood Initiative.

FLEET BANK OF MASSACHUSETTS. In 1991, Fleet Financial Group, a \$45 billion financial service company, acquired the failed Bank of New England. The Group established Fleet Bank of Massachusetts (FBM) as a wholly-owned retail banking subsidiary. The Bank has a network of 145 full service branches, and 39 remote ATMs throughout the state of Massachusetts. Of these facilities, the Bank only has three full service branches and a loan production office located within the GRNA. Based on FBM's size and extensive system of branches, ATMs, products and services, the Bank has the potential of becoming a major player in the GRNA.

According to Mr. Ronald Walker, a vice president in Fleet's CRA department, the division's goal is to make substantial investment in the housing and small business development of

the GRNA. A major aspect of this, he says, is to educate both the Bank and the community to the problems and opportunities within the area of “inner-city banking”. While the Bank has designed a \$111 Million Statewide Initiatives program for affordable housing, economic development, and the delivery of banking services, its impact on the GRNA has been mixed. Though the Bank has a retail banking focus, it continues to have a fairly minimal presence in the GRNA retail banking market. However, it has taken steps to enter previously untapped banking market locations, as evidenced by the opening of its first and only bank branch in Egleston Square, Roxbury.

Fleet Mortgage company is a major statewide residential mortgage lender. However, residential mortgage data from the GRNA during the period of 1989 to mid-year 1992 reveal that the Bank only made 5% of the loans in the GRNA. Fleet’s performance in the GRNA is minimal relative to its size and capacity. With respect to its small business lending, the Bank has stated that it intends to also be a major SBA lender statewide. To that end, Fleet has established a Community Banking Department to handle credits of \$500,000 or less for companies with less than \$5 million in sales. It should be noted that with the exception of the Bank’s participation in MEIC, no further evidence suggests that the Bank intends on expanding significant resources within the GRNA.

Recommendations

The following recommendations were presented to the senior management of the Boston Bank of Commerce to help improve their performance within the GRNA. These recommendations were developed based on 1) an assessment of the housing and economic development needs of the GRNA, 2) the strategies and intended roles of four banks with a presence in the GRNA market, and 3) an organizational assessment of the Boston Bank of Commerce. Many of the opportunities and challenges facing the Boston Bank of Commerce are similar to those faced by the other Black-owned banks throughout the country.

1. Initiate or expand efforts to serve an increasingly diverse market. The demographics of BBOC’s primary service area are changing rapidly. The community’s population is shifting from Black Americans towards Asians, Hispanics, West Indians, and African-immigrants. While Black-Americans continue to be the predominant non-White group within the GRNA, the Bank must expand its efforts to reach these other constituencies. Appealing to a broader market will add diversity to the bank’s portfolio and reduce some of the risks.

2. Review asset management. Boston Bank of Commerce holds 68.4% of its assets in loans. That is, while BBOC is a commercial bank, its asset structure more closely resembles that of a thrift. Unlike the other BOBs studied, this bank lends substantially more within its local community of color, the GRNA. The BBOC's portfolio structure has exposed the firm to a higher degree of credit risk than other banks which lend less.

3. Find the Bank's niche and offer consumer products/service consist with that target market. The BBOC has not placed heavy emphasis on targeting its consumer and retail banking products to the low-to moderate income consumers. Also, the Bank has enormous opportunities in the area of small business lending. Seventy percent of minority-owned businesses, as well as businesses located in the Greater Roxbury area reported that additional funding/capital was need to finance ongoing operations and/or expansion. With the exception of Baybank Boston, other competitors have not opted to provide this type of credit to area businesses.

For the remainder of this thesis, the focus will be on the top ten BOBs and their immediate mainstream competitors (those non-minority banks that are both located within their geographic areas and have asset values between \$100 - \$300 million). The mainstream banks will be referred to as the "peer" group. The purpose of this structure is to isolate the most successful BOBs in order to compare and contrast them with their peer competitors. All figures and rates are based on year end 1992 data unless otherwise noted.

Introduction to Target BOBs & Industry Peers

As of 1992, only 10 of the largest 25 Black-owned financial companies had attained asset values of at least \$100 million. The top 10 are listed below in Table 5. Three of these institutions are savings banks (highlighted below in **bold**) and the remaining seven are commercial banks. The combined asset value of the ten “\$100 million banks” was only \$1.46 billion (Black Enterprise, 1992).

Table 5. The Top 10 Black-Owned Banks, Ranked by Assets, 1992.

Rank	Company	Location	Assets*	Loans*	Loans/Assets	Deposits*	Dep./Liabilities
1	Carver Federal Savings Bank	New York, NY	320,862	246,097	76.70%	252,684	78.75%
2	Independence Fed. Sav. Bank	Chicago, IL	239,223	216,293	90.41%	181,708	75.96%
3	Seaway Nat'l Bank of Chicago	Chicago, IL	202,093	56,570	27.99%	168,076	83.17%
4	Industrial Bank of Washington	Washington D.C.	186,808	71,116	38.07%	173,807	93.04%
5	Family Savings Bank	Los Angeles, CA	140,113	115,270	82.27%	114,806	81.94%
6	Independence Bank of Chicago	Chicago, IL	137,278	41,375	30.14%	121,726	88.67%
7	Citizens Trust Bank	Atlanta, GA	128,152	53,770	41.96%	117,401	91.61%
8	Drexel National Bank	Chicago, IL	127,754	35,210	27.56%	118,482	92.74%
9	First Texas Bank	Dallas, TX	110,314	44,967	40.76%	99,709	90.39%
10	Mechanics & Farmers Bank	Durham, NC	107,154	69,083	64.47%	94,584	88.27%
			1,699,751	949,751	52.03%	1,442,983	86.45%
	Savings Banks Totals		700,198	577,660	83.13%	549,198	78.88%
	Commercial Bank Totals		999,553	372,091	38.71%	893,785	89.70%

* All figures are in thousands.

The BOBs: Performance Measures & Comparisons

The ten largest BOBs have achieved their success through serving their communities' credit needs in extremely different ways. For example, the two largest Black-owned financial institutions are the savings banks, Carver Federal and Independence Federal which together represent 33% of the total asset value of the top 10 BOBs. Along with Family Savings Bank which rounds out the top five with just over \$140 million in assets, these three savings banks offered significantly more loans and held less deposits, as a percent of total assets, than the top Black-owned commercial banks. These savings banks averaged holding 83% of their assets in the form of loans compared to the commercial banks' average of only 39 percent.

To highlight the dramatic difference between the commercial and savings banks, compare the second and third ranked banks, Independence Federal Savings and Seaway National (commercial) bank. Both banks are located in Chicago with the same client base, compete with the same mainstream banks, and fall within the same asset size category. But, Independence loaned

over 90% of its assets to its customers while Seaway offered just 28 percent. Clearly there is no one model for successful banking in communities of color.

Methodology

While these three savings banks represent a significant percentage of the top BOBs, their financial structures are drastically different from those of the commercial banks. In order to maintain uniformity, the remainder of the analysis will focus on the top 7 BOBs and 12 of their mainstream peers which are both located within the same geographic communities and possess \$100-\$300 million in assets. Each Black-owned commercial bank, with the exception of Mechanics & Farmers bank, will be compared with other commercial banks from its own city. Given their comparable asset size and access to the same customer base and environmental constraints, any significant deviations from the peer averages should illuminate differences in the strategies adopted and implemented by the Black bank managers.

The following analysis will focus on the areas of profitability measures, lending and borrowing activities, gap analysis, and exposure to various forms of risks such as liquidity and interest rate risks. It should be noted that all the financial figures represent only a "snapshot" of financial conditions and risk exposures on the day of December 31, 1992. The snapshot reveals the positioning the banks have assumed and how they have performed given the existing interest rate environment. Also, as banks are not required to disclose off-balance transactions in public statements, the author did not have access to the types of derivative products that each of the banks may use. Finally, in 1992, FASB had not yet required banks to mark-to-market the value of investment securities. Therefore, the true value and risks associated with the investment securities probably are not accurately reflected.

Analysis of the Top 7 BOBS and 12 of Their Peers

Chicago. The city of Chicago is home to over 2.7 million people (Polk, 1993). Three of the nation's top Black-owned commercial banks (Drexel, Independence Bank of Chicago, and Seaway National) compete amongst themselves and with other mainstream competitors within this market area. Summary figures of profitability measures and gap analysis for the 3 BOBs and 4 area competitors are provided in the Appendix section. The average of the competitors is labeled "Peer Ave." All three BOBs achieved a higher average return on equity (ROE) (19.12%) than the area peer bank average of 14.29% for 1992. The relatively superior return on assets (ROA)

performance by the BOBs was due to their larger Profit Margin average of 17.09 percent. This ratio reveals the BOBs' are relatively better at controlling expenses or taxes. The BOBs' lower Equity Multiplier indicates the use of less debt financing relative to equity than the peer average. Another measure of profitability is the net interest margin (NIM) which is net interest income to total earning assets. The BOBs' average NIM outperformed their peers by about 50 basis points. This confirms that the BOBs' interest earned on investment securities and, to a lesser extent, interest on loans & leases yielded higher returns than that of the average mainstream bank. This indicates that BOBs are currently earning more from their portfolio structure than that of their mainstream competitors. Their advantage is due to the interest rate environment rather than due to the volume of their earning assets.

The targeted Chicago-area BOBs have achieved this degree of relative profitability over the benchmark average by acting contrary to the common assertion that 'loans are commercial banks' major asset and generate the greatest amount of income'(Koch, 1992). As a percentage of total assets, BOBs invested only about 29% of their assets in loans compared to the peer average of 47 percent. While the BOB loan volume was dramatically lower than that of their peers, the BOBs had 1.4x and 2.8x (times) more US Obligations and Other Bonds & Securities holdings than the peer average, respectively. The difference in the net interest margin between the benchmark and the average BOB is marginal. But, the non-interest income account which includes trading activity fees and the provision account serve to widen the difference between the two averages' bottom line or net income. Fees earned on investment securities were more than double for the BOBs while their provision account for loan & lease losses diminished net income by a rate less than half of that of the mainstream average.

The liquidity risk situation is mixed between the peer and BOB averages. While the BOBs have a marginally smaller total deposit base than that of their mainstream peers, their core deposit level which is comprised of demand deposits, NOW accounts, and money market deposit accounts is greater than that of the peer average. This indicates that BOBs are in a relatively stronger liquidity position due to a lower potential need for attaining new funding. But, the peer average has proportionately more securities maturing within one year than the average for the BOBs. Compared to their peers' average of 75%, BOBs held only 67% of their investment securities as short-term holdings. This reduced level of short-term investment securities and loans threaten liquidity for the BOBs. If there were a need for additional funding, the BOBs would have less liquidity to draw from in a timely manner. The remaining long-term portion of rate sensitive assets

include both investment securities and loan products which are mostly fixed-rate interest payments products with maturities of up to 20 years. And finally, the peer average equity base measure which is total equity divided by total assets is about 100 basis points greater than that of the average of the three BOBs. This means the premium on borrowings for the BOBs would be relatively higher in case of a liquidity problem.

Interest rate risk is usually a primary concern for all banks. Whenever the rates paid on assets and liabilities don't adjust in unison, the mismatch exposes the bank to fluctuations in earnings. Unless properly hedged, an unexpected change in interest rates could significantly impact the banks' interest income and overall profitability. The GAP model focuses on managing net interest income by measuring interest rate risk over different time periods based on an aggregate "snapshot" of balance sheet data. The resulting GAP value serves to infer the direction and amount of change in net interest income due to a one percent interest rate move. The GAP value is the difference between rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) for each time period (Koch, 1992). As interest rates change, the cash flows associated with the rate sensitive or "repriceable" asset and liabilities contracts vary. Examples of repriceable assets and liabilities are investment securities or NOW accounts which mature in one year or less. The repriced assets and liabilities alter the value of the bank's net interest income and net interest margin. Fixed-rate contracts, however, do not change in value during this one year period unless there is a default. And finally, neither non-earning assets nor non-paying liabilities generate income or pay interest.

The three Chicago-area BOBs and their four peers, all have negative gaps. This means that they all have more RSLs than RSAs. If interest rates were to increase, the banks' spreads would tighten and net interest income would decrease as the repriced RSLs' effect on the portfolio grows larger than that of the new RSAs. Alternatively, if rates were to decrease, spreads would increase and net interest income would grow. The peers' average GAP ratio (RSA/RSL) was 76% while that of the BOBs' was 64 percent. This indicates that while all the banks held more RSLs than RSAs, the average peer bank held more RSAs relative to the BOB average bank. The BOB's hold more fixed-rate, longer term contracts. The effect is a NIM that is 1.06 times larger than the benchmark. The better NIM margin was driven by the BOBs' larger holding of fixed rate contracts instead of the more interest-rate sensitive types. The BOBs in Chicago, given their portfolio structure and the interest rate environment were relatively more profitable than this sample of their mainstream competitors.

Summary of Chicago-Area Banks. The average of the three BOBs is more profitable than the sample of four mainstream peers. The BOBs achieved this success through lending less loans and investing more securities than the average competitor. Given the year-end 1992 financial statement structure and the interest rate environment at that time, the BOBs portfolio structure contributed more to net interest income as well as net income. Interestingly, while the BOBs achieved higher profitability, they also incurred relatively less GAP exposure. This is as a result of their holding of a larger quantity of high yielding, fixed-rate contracts during a low rate environment than their competition.

Dallas. First Texas Bank and its competitors vie for market share in and around the city of Dallas. Summary figures of profitability measures and gap analysis for First Texas and five of its area peers are provided in the Appendix section. The average of the five competitors serves as the benchmark. First Texas' superior profitability relative to its peers was driven by a stronger net interest margin. This spread between interest income and interest expense for First Texas was 1.15 times greater than of its peers. As a result of its higher net income, First Texas' profitability measures (ROE, ROA, and Profit Margin) all range from twice to over three times greater than that of the peer average. First Texas' profitability was due to substantial savings relative to the benchmark on the interest expense item of "Interest on Deposits". This indicates that while First Texas' investment securities and loan holdings achieved similar results compared to the benchmark, the most significant influence on net interest margin was the smaller obligation to pay interest on deposits.

As a percent of total assets, First Texas held smaller amounts of both investment securities and loans than its peers. These accounts produced interest income rates which were only marginally different. First Texas' provisions account as a percent of total operating income, however, was about 8 times greater than the peer average. Therefore, the BOB's provision account had a larger negative impact on net income than it did for the other banks, as a whole. The remaining assets, the non-earning assets, cash and other assets which includes bank buildings, represented about 40% of First Texas' assets compared to the peer average of 19 percent. Also, while First Texas' deposit obligations were .98 : 1 compared to the benchmark, the amount of interest paid on deposits was only .70 : 1, which resulted in a substantial savings in interest expense for the BOB.

First Texas held, as a percent of total assets, a slightly smaller total deposit base than that of their mainstream peers. But, liquidity is relatively strong due to the BOB's higher core deposit

level of 66% compared to the benchmark amount of 56 percent. But, the peer average has proportionately more securities maturing within one year than the average for the BOBs. The liquidity gained from holding a larger portion of rate-insensitive deposits is practically eliminated due to the lack of short-term, rate sensitive investment securities. Compared to its peers' average of 61%, First Texas held only 7% of its investment securities as short-term holdings. This reduced level (a little more than a tenth of the peer average) is a serious threat to liquidity for the BOB. First Texas does hold about 12% or 1.57 times more of total assets in the form of cash and cash-like holdings than its average competitor. So, while First Texas' current securities holdings are not in a good position to either take advantage of or protect itself from a sudden shift in the yield curve, the cash can serve as a cushion. It seems First Texas has sacrificed short-term liquidity in favor of locking in higher rates on both investment securities and loans which are mostly fixed-rate interest payment products with maturities of up to 20 years.

First Texas and its five mainstream competitors all have negative gaps. Rate-sensitive liabilities (RSLs) outweigh rate-sensitive assets (RSAs). As the yield curve shifts, the repricing of the RSLs will have a larger impact on net interest margin than that of the RSAs. The peers' average GAP ratio (RSA/RSL) was 87% while that of First Texas was 75 percent. This confirms that First Texas holds 1.37 times more of its assets in the form of fixed-rate and non-earning assets. In the current interest rate environment, First Texas' portfolio structure has resulted in a lower gap and a higher profitability relative to its area peer competitors.

Summary of Dallas-Area Banks. First Texas is more profitable than the sample of five mainstream peers. The BOB achieved this success through not only lending less and investing more in fixed-rate assets, but by also holding interest expense to a significantly lower level than its average competitor. First Texas' portfolio structure was most appropriate to take advantage of the interest rate environment which existed on December 31, 1992. While profitability was strong, liquidity for the BOB remained a substantial threat. First Texas has achieved high returns through the incurrence of higher risks.

Atlanta. In Atlanta, Citizen's Trust Bank, the seventh largest BOB, competes with another area peer bank for their share of the city's market. Summary figures of profitability measures and gap analysis for Citizens and its peer bank are provided in the Appendix section. With the exception of the net interest margin measure, Citizens Trust Bank under-performed its peer competitor on every profitability ratio. This is due to Citizens' low net interest income and high interest and non-interest expenses compared to that of its peer. While the net interest margin as a percent of total

assets for the peer was more than twice as large as that for the BOB, Citizen's non-interest expense and provision were 1.43x and 1.46x (times) larger. The result for Citizens was a net income to total asset ratio of only 1.44% compared to the peer's 10.55 percent.

Like the other targeted BOBs, Citizens holds about twice as much of its assets in the form of investment securities than its mainstream competitors. Also consistent with the other BOBs, Citizens holds a little more than half (of the percentage) of loans than its peer. For example, the peer bank held 67% of assets as loans and 22% as investment securities. These peer assets derived 55% and 15% of total operating income from interest on loans & leases and investment securities, respectively. Citizen's portfolio of loans and investment securities only generated 40% and 26% of fees as a percent of total operating income. But, while the results of this comparison of loan and investment securities revenues reveal only marginal differences, Citizen's profitability performance is deteriorated by both the significantly larger non-interest income and provision accounts.

Citizen's liquidity is relatively strong due to the bank's higher core deposit and cash level of about 60% compared to that of its peer which is about 38 percent. But, the peer bank has three time more of its assets that are maturing within one year than does Citizens. This reduced level of liquid assets poses a serious threat to liquidity for Citizens. So, while Citizens' larger holding of stable deposits does serve as a cushion against a swift adverse shift in the yield curve, the disproportionately large amount of fixed-rate assets reduces Citizens' "good" options. Citizens seems to have sacrificed the safety of a "fatter" liquidity position for the higher short-term returns.

Both Citizens and its peer competitor have negative gaps. Citizen's smaller gap of 54%, is a result of its larger holding of both fixed-rate assets and liabilities and of non-earning assets compared to that of its peer. Because of Citizens' holdings, its net interest income, which does not include the non-earning assets, is still larger than its peer despite the fact that overall, Citizens' is less profitable.

Summary of Atlanta-Area Banks. Citizens is less profitable than its area peer. This is due to its larger non-interest income expense and bigger provision account. Citizens lent less and invested more of its total assets in investment securities than its peer did. Of Citizen's assets, it held 2.7x (times) more, as a percent of total assets, in fixed, long-term products than its peer. The BOB attempted to gain higher returns by locking in higher rates, but was unsuccessful in boasting profitability. Other expenses and provisions "ate away" the bank's profitability leaving Citizens in a weakened liquidity position.

Washington D.C. In 1992, Industrial Bank of Washington outperformed two of its D.C. area mainstream peers. Summary figures of profitability measures and gap analysis for the BOB and 2 competitors are provided in the Appendix Section. Driven by a relatively stronger net income level, Industrial's profitability was higher on every measure than that of its competitors. While the peer bank average achieved 98.88% of their operating income in the form of interest income compared to 88% by Industrial, the BOB was still able to be more profitable. Industrial had significantly less interest expense and provisions, and 10.6 times more in non-interest income than its peers. The primary contributor to the non-interest income account is revenue from trading activities. This indicates that Industrial is currently earning more from its portfolio structure than its mainstream competitors.

Industrial has achieved this degree of relative profitability by lending less and investing more in securities than their mainstream competitors. Industrial's interest from securities is not a larger percent of total assets than interest from loans & leases. Instead, Industrial invested only 38% of assets in loans compared to the peer average of 52 percent. Conversely, Industrial's securities holdings represented 46% of assets, while the benchmark level was only 24 percent. Although the net interest margin between Industrial and its peers is only marginal, Industrial's higher trading activities income and lower provisions drive net income to 1.15 time greater than the competition's.

The price for Industrial's higher profitability is higher risk in the form of a serious liquidity deficit. Industrial holds more total deposits but less core or stable deposits than its peers. Core deposits may serve as a source of additional funding due to their lack of repriceable assets. The core deposit benchmark level was 64%, but Industrial held only 46 percent. The other factors creating liquidity problems for Industrial include a low cash level and a smaller holding of short-term, interest-sensitive securities and loans, RSAs. Twenty eight percent of Industrial's total assets were rate-sensitive. This is only 64% of the amount of RSAs held by the peer average. The December 31, 1992 snapshot of financial condition reveals that Industrial sacrificed liquidity to gain profitability.

As in the other cities, all of the banks have negative gaps. Interestingly, Industrial's gap ratio is 1.40 times larger than its peers, but its net interest margin (NIM) is also bigger. This indicates that Industrial holds more RSAs to RSLs and that its assets, excluding the non-earning accounts contributed more to NIM. Due to Industrial's disproportionately large holdings of fixed-

rate assets and the prevailing yield structure, Industrial was more profitable. But, the BOB was also more vulnerable to changes in the yield curve due to its higher RSA/RSL or gap ratio.

Summary of Washington D.C.-Area Banks. Industrial Bank achieved higher profitability by investing more in fixed-rate investment securities and offering less in loans and deposits than its area competitors. This out-performance was made at the expense of liquidity. But, by year-end 1992, Industrial bank had successfully positioned itself to take advantage of the interest rate environment.

Chapter Two

The analysis from the previous chapter reveals that the 7 top BOBs all follow a pattern of lending less and investing more than their peers. All of the BOBs held large quantities of long-term, higher yield Treasury securities. This finding is interesting in that, with the exception of the city of Chicago, each BOB is located in different cities with varying housing and business credits and competition. The only underlying constant for each of the BOBs is their preponderance of serving the same target customer type, the local community of color. By year-end 1992, the 7 top BOBs had each implemented a strategy of borrowing large quantities of short-term deposit products, of making fewer loans, and of investing more in investments than the average commercial bank.

By taking the aggregate of each city's peer average and BOB average, it can be concluded that, as a whole, the top 7 BOBs are more profitable than their mainstream peers. The aggregate summary figures which include the BOB, Mechanics and Farmers are the Appendix section. The BOBs higher profitability was due to their degree of lower lending and higher investing in longer-term investment securities. While the difference in net interest margin between the BOBs and their peers was usually marginal, the savings in provisions and the boost from trading income and other non-interest income made for larger net income levels for the BOBs. The BOBs' higher net income drove all their superior profitability measures. The following findings, based on the previous analysis, will focus on three types of risk exposures that the banks face: liquidity, credit, and interest rate risk.

Liquidity Risk

The BOBs' higher profitability was accomplished at the expense of liquidity. Liquidity is the ability to either borrow funding or to have access to assets which are either available for sale or near to maturity (Koch, 1992). Each of the BOBs sacrificed short-term liquidity by accumulating larger quantities of longer term, rate-insensitive assets. The BOBs allowed themselves to have less of a "cushion" against sudden interest rate shifts. If rates were to go up, the BOBs would have fewer funds available to reinvest at the higher rates. Conversely, if rates were to decline, the returns on investment securities would decrease while borrowers would refinance loans thus threatening the banks' spread. But, given enough time, the BOBs can convert these securities into cash. The characteristics of these government securities such as 30 year Treasuries are well

known, making the sale of these assets at a predictable price relatively easier than most other assets like a loan. While the “predictable” nature of the BOBs’ investment securities does help to reduce their exposure to liquidity risk, it should be noted that the longer a security’s maturity, the greater is the liquidity, default, and interest rate risks.

Credit Risk

Due to the magnitude of the Savings and Loans debacle, credit risk had been a primary concern to both bank management and regulators. The BOBs had managed to diminish much of their credit risk by investing less in loans and more in government-backed securities than their peers. The banks held investment grade securities rated Baa or higher which are issued by federal, state, and local governments and are usually less risky than loans. The BOBs averaged 42.3% and 38.7% of assets in the form of loans and securities compared to the peer averages of 55.5% and 27.2%, respectively. The relative low or no risk inherent in the government securities pool that banks are allowed to deal in makes that portion of the BOBs’ portfolio (about 40% of their earning assets) safer from credit risk. The overall quality of assets, as it pertains to the likelihood for default, for the BOBs is higher than their peers. The remaining portion of the BOBs’ earning assets are in the forms of loans.

While the author does not have access to the default rate for the various types of loans, it may be assumed that the weighted amount of holdings of each type of loan in the banks’ loan portfolios reflects a tradeoff between risk and return. For example, as shown in the summary figures in the Appendix section, the peer banks invested more of their assets in almost every type of loan than the BOBs. The only significant exception was in commercial/industrial loans. In fact, the BOBs chose to invest 2.39x more in business loans than their peers. Business loans are usually extended to fund working capital needs, expansions or acquisitions, and equipment purchases. The government’s Small Business Administration has a loan program to secure loans in order to encourage more lending. This SBA backing makes these loans more attractive as it reduces the bank’s credit risk exposure. The BOBs’ credit risk exposure from their government securities and their government backed lending afforded the banks a relatively lower level of credit risk compared to their peers.

Interest Rate Risk

By 1992, the regulatory emphasis had shifted from credit to interest rate risk. Momentum was growing to enforce strong rate management standards and to impose high costs on those deemed “excessive”. Interest rate risk is represented by the variability in cash flows as the level of interest rates change. The asset and liability contracts held by the banks mature at different times and therefore vary in their relative degree of interest rate sensitivity. All the banks sampled had negative gaps which indicates that their net interest incomes will increase if rates fall, and decrease if rates rise. The BOBs held fewer earning assets (loans and investment securities) with maturities of one year or less than their mainstream competitors. The BOBs’ level of rate-sensitive liabilities was comparable to that of their peers. The BOBs have used short-term borrowing to fund long-term investing. For the immediate future, changing interest rates will have less of an effect on the BOBs. But, permanent shifts in the yield curve will have a disproportionately larger impact on the BOBs as both asset and liabilities contracts are repriced.

The GAP methodology used, while basic, is sound and is commonly used in the banking industry. The GAP technique is limited in that 1) it is specific to only distinct time intervals, thus overlooking the impact of repricing on the rest of the portfolio, 2) its calculations are based on book values, not market values, and 3) it ignores the time value of money. Another technique, Duration Gap which is a single, comprehensive measure summarizes the total portfolio’s exposure to interest rate variability. Duration models complement the GAP model by overcoming the three limitations stated above. But, duration analysis is also limited due to its need for 1) an extensive and sometimes subjective database, 2) a forecast of appropriate rates to discount future cash flows, and 3) an ability for constant monitoring and restructuring of its duration measures as time passes or rates change, or both (Koch, 1992) Due to the inaccessibility of needed rate information, the author’s definition of the risk profile is limited to the GAP methodology described in Analysis section of Chapter One. But, if bank management is unable to afford or comprehend more complicated models, they should use both of these two techniques to gain a better indication of their bank’s interest rate exposure.

Duration analysis is a means of determining a portfolio’s degree of sensitivity to interest rate variability. It reflects any differential in the timing of asset and liability cash flows (Koch, 1992). More specifically, duration measures the relation between the change in the value of an asset/liability or an entire portfolio due to a change in the discount (interest) rate. The duration of

a bank's portfolio with n assets of both loans and investment securities, each with market values of V_i and durations of D_i is:

$$D = (\sum V_i D_i) / \sum V_i$$

This equation may be used to also calculate the bank's liability and equity durations (Smithson et al., 1995). If a bank's weighted duration of assets is greater than the weighted duration of liabilities then a rise in the interest rate would cause net interest income to fall. The rise in interest rates creates a larger discount rate for the cash flows and thus lower durations. Based on the bank's current structure, the duration gap is positive meaning the weighted durations of assets fall by a larger amount than the liabilities. The opposite would be true if the bank's duration gap is negative. Rising rates would result in an increase in net interest income.

As the author was unable to obtain cash flow and rates for the banks' asset and liabilities contracts, a thorough duration gap analysis is not possible. But, a back-of-the-envelope method can be used to serve as an example. The duration gaps of the average peer and BOB may be derived by applying the same rates that banks paid and received in the maturity gap analysis from the Analysis section of Chapter One. For the 19 banks sampled, the average term for the cash flows from both loans and investment securities was primarily 1 to 5 years. Loans earn higher rates than investment securities. Averaged over a 3 year period, the durations of the assets of the peers and the BOBs are determinable by discounting the weighted values of the loans and securities by the rates given. The duration of the liabilities (deposits) was determined in a similar fashion.

The results of these back-of-the-envelope calculations are consistent with those from the thorough maturity gap analysis. As shown in Table 6 below, the weighted duration of the assets for both groups was greater than their weighted duration of liabilities. This indicates that the value of their assets declines more than the value of the liabilities, in the event of a rise in interest rates. The difference between the durations of the assets and liabilities is the duration gap (DGAP). The BOBs have a lower DGAP. Therefore, the BOBs' current exposure to interest rate risk is smaller relative to their peers.

Table 6. Comparison of the Banks' GAP Measures.

Duration GAP*:	Peers	BOBs		Maturity GAP:	Peers	BOBs
DA	2.17	2.13		Rate Sensitive Assets	48.47%	26.27%
DL	0.94	1.03		Rate Sensitive Liabilities	47.22%	40.18%
DGAP	1.40	1.22		GAP Ratio	81.08%	65.97%
Durations:				Rates:		
Inv. Sec	2.65			Ave. Yld Rate-Var.	8.42%	
Loans	2.6			Ave. Yld Rate-Fixed	9.90%	
Time Deposits	1			Interest Cost-Var.	3.84%	
CDs	1.45			Interest Cost-Fixed	6.00%	

* The Duration Gaps were determined using a back of the envelope technique. The estimated durations of each type of asset and liability contract, shown above, were multiplied by their portfolio weights and then summed.

The BOBs held less of their portfolio in the form of loans and investment securities which reduced the BOBs' asset duration to below their peers. But, because the BOBs held 88% compared to the peer average of 81.5% of their liabilities as deposits, the BOBs' liability duration exceeded that of their mainstream competitors. On average, time deposits represented about 65% of each banks' total deposits. Due to the liquid nature of these products, their duration was fixed at 1 year. The remaining deposits were certificates of deposits which had an average term of 2 years. The difference between the BOBs' asset and liability durations was smaller, resulting in a tighter DGAP than their peers. Since the DGAPs are positive, both the market value of the equity and the net interest income decline with rising interest rates (Koch, 1992).

To immunize their net interest income from rate changes, the BOBs would need to shorten their asset duration by 1.22 years or increase their liability duration by 1.39 years. The needed increase in liability duration was found by solving for x in the following equation:

$$(\text{deposits/TA})(\text{current liability duration} + x) = \text{asset duration}$$

which is equivalent to

$$(.88)(1.03 + x) = 2.13.$$

X is equal to 1.39 years. This is also the same as saying the banks can hedge their exposure to interest rate variability by forcing their gap to zero by increasing their level of RSAs to offset their RSLs (Koch, 1992).

Chapter Three

By 1992, interest rates were at a 27 year low. The Federal Reserve Bank was attempting to stimulate the economy by dropping short-term interest rates. Like many other banks, the BOBs choose to take advantage of the subsidy provided by the government. Instead of extending low interest loans to their service areas, the banks borrowed from both the Federal Reserve and the community in order to invest in securities. The banks borrowed from the Fed.'s discount window at 3% and from depositors (the community) at an average rate of 3.84 percent. The BOBs then used these borrowed funds to invest in relatively risk-free government securities which were yielding 6-8% returns. By the end of 1992, the BOBs had positioned themselves to take full advantage of this risk-free spread situation. But, given their portfolio structure, the banks were in danger of incurring net interest income losses if interest rates were to rise.

Since the early 1990s, community leaders, regulators, and politicians have been pressuring mainstream banks like Fleet and Citibank to comply with the Community Reinvestment Act (CRA) by expending more resources to meet the credit needs of their local communities of color. As most of their customers are people of color, the BOBs have more than satisfied the equal lending standards imposed by the federal government's CRA. But, compared to their mainstream peers, the BOBs offer significantly less of their assets to the community while investing borrowed funds (deposits) outside of the community. *Through the use of derivative products and a restructured portfolio, the BOBs could achieve a satisfactory degree of profitability while serving more of their own communities' credit needs.* The following outlines the process that each of the BOBs could implement to meet the stated objective.

A Strategy for Profitably Extending More Credit

While banks are not in the business of forecasting interest rate movements, the task is becoming increasingly more important. Faced with rates at their lowest level in over twenty five years, it seems reasonable to assume that the rates would begin to increase. As indicated by their gaps, rising rates would have a strong negative impact on the BOBs' profitability. It should be noted though that the gap technique, while widely used by small banks, is a simple measure which provides little insight in to how rates will affect the banks' assets and liabilities. As rates change, both sides of the balance sheet are affected. But, the determination of the actual correlation between the rate change and each of the accounts requires the use of sophisticated simulation

techniques. For example, a 100 basis point increase in rates may result in: 1) a higher reinvestment rate for assets that are available or will soon be available; 2) an increase in defaults as customers with floating rate contracts are unable to afford the higher loan payments; and 3) depositors demand higher, more competitive rates. The complex nature of bank asset/liability management places accurate simulation of interest rate vulnerability out of reach for all but the most sophisticated banks such as Bank America (Knowland, 1995).

To fulfill the dual objective of maintaining profitably while extending more credit to their communities, the BOBs would have to restructure their portfolios. To achieve this, the banks would have to move along the frontier to higher returns by incurring higher risks. Assuming that interest rates are bound to begin increasing during 1993, I suggest that the BOBs offset the additional risk incurred from lending more and paying higher deposit costs by investing a larger portion of their assets in corporate bonds. The use of higher yielding corporate bonds will compensate the BOBs for the risk incurred from lending more to the community.

Shown below in Table 7 are the current and suggested asset allocation structures for the average BOB. The "Suggested BOB Average" is based on a reallocation of 10% of the US Obligations to a 7% increase in loans and a 3% increase in other bonds. The 7% increase in loans would result in a \$10 million increase in the amount of dollars extended by each bank to meet their communities' credit needs. On average, the 7 top Black-owned commercial banks would provide an additional \$70 million to credit deprived communities.

Table 7. BOB Asset Allocation*.

	Current BOB Average		Suggested BOB Average	
	% of Portfolio	\$ value of Portfolio	% of Portfolio	\$ value of Portfolio
Cash	7.38%	\$10,538,123	7.38%	\$10,538,123
US Obligations	29.20%	\$41,695,556	19.20%	\$27,416,256
Other Bonds	9.52%	\$13,593,894	12.52%	\$17,877,684
Loans, net	42.31%	\$60,415,718	49.31%	\$70,411,228

* \$142,793,000 is the average value of the seven top Black-owned commercial banks. All figures are based on this average.

The suggested portfolio is based primarily on the assumption that the banks will be faced with a rising interest rate environment during 1993. The actual reallocation of portfolio proportions by each of the BOBs are best determined by senior bank management who are more familiar with the dynamics of their customer base and their local environment. The figures in the

suggested portfolio represent the results of assumptions made about the average BOB's ability to maintain profitability while lending more as rates rise. The BOBs' funding costs (deposits) will increase thus reducing their profitability. The 1992 "risk-free" spread from investing inexpensive funds from the Fed.'s discount window in long-term Treasuries will also diminish as rates rise. To offset these reduced spreads, the banks could invest more in higher yielding loans and corporate bonds.

Compensation for Additional Risk

The allocation of more resources from Treasuries to loans will introduce more credit and default risks as well as require higher provisions for the banks. Often, the BOBs have difficulty selling their loan portfolios at competitive prices because their client base is perceived as different and therefore, more risky than the industry's standard profiles. Those loans that the BOBs cannot participate (sell) at reasonable secondary market rates, "tie up" the banks' assets, reduce liquidity, and increase their cash flows' vulnerability to financial complexities such as defaults and prepayments.

By distinguishing the difference between their Black customers' perceived and actual default risk, the BOBs can be more accurate in pricing their products and also better at understanding the risk inherent in their portfolios. To compensate for the additional risk from lending more, the BOBs could require that some customers pay a spread of 1.5 to 2 points (instead of the industry norm of .5 to 1 point) over the Treasury curve. It should be noted that this suggested high premium over Treasuries is for only those loan applicants that are evaluated as actually being more risky than the allowed regulatory standard. This follows the principle of higher risks demand higher returns. Conversely, higher credit quality customers should be offered competitive rates. Following in the next section is a brief discussion of techniques used to minimize the banks' exposure to credit risk.

To offset some of the incremental risk from lending while still contributing to profitability, the BOBs could also shift more of their investments from Treasuries to investment grade corporate bonds. The corporate bonds yield higher returns. They are also more risky than the government bonds. The bank regulators have restricted banks to holding only bonds rated by Moody's as Baa or above or by S&P as BBB or better. While the investment grade bonds are rated as high quality credits and are "regarded as having an adequate capacity to pay interest and repay principal", the possibility of default is greater than in the case of Treasuries (Bodie et al., 1993). Use of more

investment grade corporate bonds is the best means to compensate the banks for incurring higher risks from lending to the community.

The use of riskier loans and corporate bonds affords the BOBs higher yields and greater profitability. The risks introduced to the BOB's relatively low risk portfolio can be managed through the use of sound banking practices as well as through the incorporation of derivative tools. The most critical component of their risk management effort is the definition of risk. Unfortunately, as discussed above, most small banks lack the in-house resources necessary to accurately determine their exposure to interest rate and other risks. In these cases, the small bank's best resource is their ability to maintain close relations with their communities and to understand the risks and opportunities that they represent.

Use of bank asset/liability management software programs, such as Sendero, which use simulation models are becoming more popular with the low end of the banking industry (Knowland, 1995). These programs include models which simulate the bank's net interest income under various rate scenarios, shifts in portfolio composition, and fluctuations in prepayment and early withdrawal behavior. Other software features may include a hedge package of off-balance sheet accounts such as swap or futures. At a cost beginning at about \$10,000, these simulation software programs (used in addition to gap) can assess the bank's risks that may exist as a result of a particular business strategy (Halliday, 1995).

The BOBs' Credit Risk Exposure

Due to increased lending and the use of corporate bonds, the BOBs will incur higher exposure to credit risk than in their 1992 portfolio. Unlike interest rate or liquidity risk, there is no financial product that can transfer away a bank's credit risk exposure. There are other means that banks can use to minimize their exposure to defaults. The BOBs have chosen to avoid credit risk by limiting their lending to primarily the government and government-backed borrowers. Other traditional methods include participating individual loans, holding higher provisions, diversifying the loan portfolio, and securitizing the entire loan portfolio.

The best way to minimize risk is to avoid it. The next best alternative is to manage risk by properly assessing it and then to handling appropriately. As discussed earlier, BOBs should capitalize on their understanding of their communities. There seems to be a difference between the commonly perceived risk of lending to Blacks and the actual risk. As revealed by the 1990 Home Mortgage Disclosure Act study, significantly more Blacks and Hispanics with similar economic

and property characteristics as Whites were denied loans. At the same time, the Boston Bank of Commerce case study showed that given the appropriate attention, banking in communities of color can be quite profitable. These examples prove that credit quality Blacks do exist and that they can generate higher returns than the BOBs' investment in Treasuries. While increased lending will surely introduce more credit risk into the BOBs' portfolios, the use of proper risk assessment and management techniques will serve to minimize the banks' degree of exposure.

The BOBs' Interest Rate Exposure

Interest rate risk is a major concern for banks. As indicated by both the maturity and duration gaps, the BOBs' current structures expose them to some net interest income variability. Based on the current BOB average portfolio, the bank's net interest income is \$6.9 million. Suppose the yield curve were to shift up by 1% and one fourth of the BOB's loans and securities had matured and been replaced with new assets at the new higher rate of 10.9 percent, refer to Table 7 (BOB Asset Allocation, above). The interest earned would be:

current rate * (% of "non-maturing" assets x earning assets) + (% of maturing assets x earning assets) or

$$9.9\% * (.75 \times \$115.7 \text{ million}) + 10.9\% * (.25 \times \$115.7 \text{ million}) = \$11.7 \text{ million.}$$

But, the BOBs would also have to pay depositors higher, more competitive rates:

$$5.0\% \times (142.9 \text{ million} \times .88) = \$6.3 \text{ million.}$$

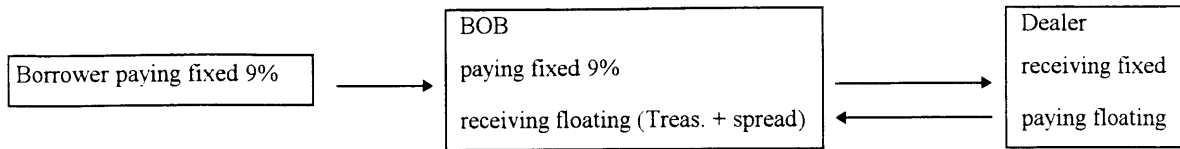
Therefore, a 1% increase in the interest rate has resulted in a new net interest income of only \$5.4 million which is 21% less than before the rate shift.

The banks' cash flows are mismatched due to holding longer term assets and shorter term liabilities. To counter this situation, the banks could simply invest more in shorter term securities or make more loans with shorter maturities. But the spreads on short term securities, in the current falling rate environment, would be smaller. Also, the underwriting costs of doing short term loans would make this option unattractive as well. Rather than adjusting the banks' portfolio structure to manage interest rate risk, a variety of derivative products may be used. These tools could serve to neutralize the BOBs' cash flow mismatches by synthetically shortening the payoffs from their asset portfolio to better match the duration or maturity of their liability structure.

Interest rate futures are contracts between two parties to buy or sell a standardized financial asset at a specified time in the future. As the BOBs need to be hedged from an increase in interest rates, they will assume the role of seller and short futures. Therefore, in the event that rates rise, the net interest income loss due to the banks' mismatched portfolio structure will be offset by the gains from the fallen futures price. To achieve this, the BOBs should sell futures contracts on securities with similar "cash market risk" exposure. Since the average BOB is currently long in primarily 1 to 5 year Treasury bonds, they should short Treasury futures with the same maturities. Treasury bonds currently represent about 30% of the average BOB's total value. Using interest rate futures as a complete hedge will reduce the portfolio's interest rate exposure. But, the total return to the BOB from fully hedging this position would be just the risk-free rate. By shorting the futures contracts against the underlying exposure of rising interest rates, the banks will transfer the riskiness of the asset to the buyer of the futures contract. The complete hedge of the portfolio's Treasury position will leave that portion of the bank assets with no price risk and no risk premium. Instead of price risk, the BOB would now assume basis risk. But, if the hedge is held until the maturity date of the futures contract, the basis risk will reduce to zero (Smithson et al., 1995).

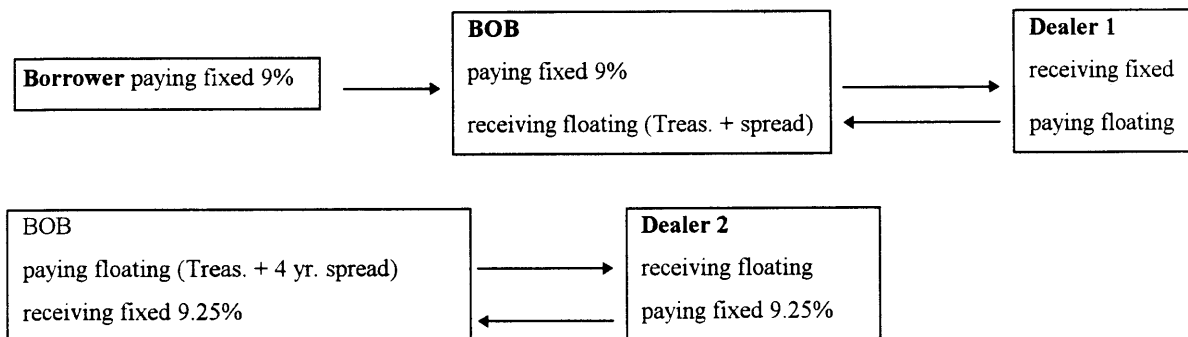
The BOBs can also achieve higher returns than the risk-free rate by using interest rate swaps. Suppose a BOB receives 9.0% fixed cash flow payments from corporate bonds. To ensure that the bank gains the "unlimited" upside potential while limiting the downside risk in an expected rising rate environment, the BOB could swap out the payments it is receiving from fixed to floating. The BOB and a dealer would negotiate the terms such as maturity and the spread over Treasury based on the current Treasury note rate and then settle on a price for the swap. Suppose the BOB is receiving 9% fixed for a 4 year bond. The BOB would want to pay to the dealer the same fixed rate cash flows for 4 years. The BOB wants to receive from the dealer a floating rate of Treasury plus some 4 year spread. If the Treasury rate increases, the floating rate cash flows to the BOB will increase. If the floating rate is greater than the BOB's 9% fixed payment, the bank is making a profit on the swap. If rates decline or stay the same, the BOB's loss is limited to the difference between the dealer's floating payment of Treasury plus the 4 year spread and the 9% fixed rate. See Table 8 below for a diagram of the swap transaction.

Table 8. Swap Transaction to Exchange Fixed Payment for Floating.



To lock in a spread regardless of interest rate movements, the BOB would do the swap transaction described above and then enter into another swap. As the BOB would now be receiving floating from the first dealer, the bank could exchange that floating for a higher fixed rate from a second swap dealer. The higher second rate would be as a result of entering a longer term maturity swap than in the first transaction. The longer the term, the higher the rate. By reversing the form of its payment receipts again, the BOB will neutralize its exposure to interest rate volatility and lock in a higher fixed rate than the original 9 percent. See Table 9 below for a diagram of these swap transactions. Two problems arise though. First, the maturity of the second swap is longer than the actual corporate bond contract. The BOB would have to offset that longer term exposure by entering into another swap or another bond deal. The second issue is the bank would have to be certain that the locked-in spread would be greater than the cost of doing both swaps.

Table 9. Interest Rate Hedge with Locked in Spread Using Swaps.



Highlighted are examples of how BOBs could increase lending while sustaining profitability. Credit risk is going to increase as the banks lend more. To minimize credit exposure the BOBs would have to use the traditional banking methods to avoid or transfer the risk away from the bank. Interest rate swaps can be used in credit quality spread situations to lock-in spreads

from rate movements. But, if the bank's borrower defaults, the bank's principal is not protected by using a swap or any derivative product. Swaps and futures may also be used to hedge the interest rate risk inherent in both sides of the banks' balance sheet. It should be noted that despite all the advantages that derivative products may afford to the BOBs, these tools are of little value if senior bank management is unable to correctly quantify the bank's risk exposure. The first step in any bank's strategy is to understand their own risk position.

Conclusion

Over the past 30 years, the banking industry has undergone dramatic changes. Even more extreme are the circumstances facing Black-owned financial institutions. While the 1960s ushered in a period of opportunities for more Blacks to achieve middle class status, desegregation also brought the flight of Black capital out from their own communities. Black-owned banks (BOBs) now face decreased demand and increased competition. As demonstrated in the Boston Bank of Commerce case, the BOBs were once the credit monopolists of their communities. Now the BOBs are competing against mainstream banks for the minority community's market share. BOBs were once Black people's only hope for financial services. But today, for many, the BOBs serve only as their back-up option if denied credit by mainstream banks (Smith, 1993).

The top BOBs were surprisingly similar. They all chose to lend less and invest more than their peers. In 1992, the BOBs, on average, were more profitable than their peers. They accomplished this by borrowing from both the Federal Reserve's discount window and the community (in the form of deposits) and then invested those funds outside of their own communities. While their net income margins were relatively on par with their peers, the BOBs achieved higher profitability by holding less in provisions and earning more from their trading activities. Also, because of the favorable low rate environment, the BOBs managed to incur less interest rate and credit risk than their peers.

The BOBs must get back to the business of lending if they want to remain profitable. The government's risk-free subsidy that the BOBs have been coasting on will diminish once rates increase. And because the BOBs are so heavily invested in longer term asset contracts and shorter term liabilities, the threat to future net interest income is serious. By investing more in loans and corporate bonds while reducing their gaps to zero through the use of derivatives, the BOBs can maintain their relatively superior profitability performance.

Clearly, the BOB's role within communities of color has significantly changed over the last thirty years. Many would even argue that the BOBs' comparative advantage of having a better understanding of their communities and the risks they represent has been eliminated. As in the Boston Bank of Commerce case, Bank of Boston's community bank has a Black president and a staff comprised of primarily GRNA residents just like the BOB. The effective use of community-oriented staff and services has made the entrance of many mainstream banks into communities of color quite successful. This success is due not only to their community-oriented approach. But, also because these specialized banking divisions are backed by much larger institutions which are better at diversifying their risks and at leveraging their well established reputations than smaller competitors.

The BOBs have already turned their attention to the business community. While the BOBs' total lending rate is significantly less than their peers, the BOBs' do a disproportionately larger amount of commercial loans. Lending to minority-owned businesses backed by the SBA is attractive because it minimizes the bank's credit risk and affords the opportunity for establishing continuing relationships with their customers. The key to the continued success of the BOBs will depend on their ability to adequately serve the credit need of their business communities. Unlike the retail banking or mortgage lending opportunities within communities of color, mainstream banks have chosen to avoid small business lending. As in the Boston Bank of Commerce case, the void in the availability of credit for small business in communities of color leaves that market open to BOBs.

By providing needed funding for working capital, expansion, and acquisition activities for minority-owned businesses, the BOBs can begin to re-establish their positive reputations within their own communities of color. As the BOBs become more involved in the activities of their business clients and suppliers, their exposure within the community will also increase. The BOBs should maximize the benefits of being the "first mover" into this market niche by not only giving these businesses an opportunity to gain needed credit. But, the BOBs should also offer their customer competitive rates on loans and other financial services. Clearly the mainstream banks will pursue small business lending if (or when) they believe that this line of business is profitable. By entering this business lending market first, establishing relationships, and doing deals at competitive rates, the BOBs may finally be able to go on the offensive against both fleeing Black capital and encroaching mainstream competition. Commercial lending is an opportunity for the

BOBs to aggressively alter the communities' perception of the banks without incurring undue risk to the banks' portfolios.

It should be noted that while some BOBs have inferred that they have often been unable to obtain competitive rates on the secondary market for their loans, due to discrimination, the actual problem may be due to the BOBs' small size. According to an officer of the Federal Reserve Bank of Boston, small banks (which are those banks with less than \$500 million in assets) find it more difficult to obtain competitive rates for their loans in the secondary markets due to the banks' low volume (Knowland, 1995). Therefore, the BOBs' challenge of obtaining competitive rates for loans may not be exclusively because of the characteristics of the loan applicants. Instead, the BOBs seem to share the common problem of being too small of a player to get competitive rates in the secondary markets.

Finally, the BOBs have to overcome their current situation of being "out of sight, out of mind" within their market. They should increase their level of lending within their own communities in order to maintain their strong profitability and to re-establish their reputations as committed players in the development of communities of color. Lending more to the local businesses while investing less in Treasury securities (as rates rise) should maintain higher margins for the BOBs. The financial markets also offer the BOBs opportunities to reduce some of the risks inherent to the banks' portfolio through the use of derivative products such as interest rate futures and swaps.

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APPENDIX

Comparison Between Drexel, Independence Bank of Chicago, and Seaway National Bank and four (4) mainstream banks with assets between \$100 to \$300 million located in Chicago, IL
All Figures as of Year End 1992

Population of Chicago: 2,783,726

	Peer Ave. % of TA [^]	BOB Ave. % of TA [^]	<i>Difference</i>	Times (x)
Balance Sheet (^ TA = Total Assets)				
Assets:				
Cash and Dep. From Banks	4.86%	5.93%	1.07%	1.22
US Obligations	30.98%	41.79%	10.80%	1.35
Other Bonds and Securities	6.50%	18.29%	11.80%	2.82
Loans, net	46.79%	28.50%	-18.29%	-0.61
Other Assets	10.87%	5.49%	-5.38%	-0.50
Total Assets	100.00%	100.00%		
Liabilities:				
Deposits	88.95%	80.23%	-8.72%	-0.90
Other Liabilities	3.34%	5.03%	1.69%	1.51
Capital	0.40%	0.71%	0.31%	1.77
Surplus (Add. Paid-in Cap.)	6.08%	2.11%	-3.97%	-0.35
Undivided Profit (R.E.)	1.23%	3.70%	2.47%	3.00
Total Liabilities	100.00%	100.00%		
Income Statement (* OI = Operating Income)				
Interest Income:	% of OI*	% of OI*		
Interest & Fees on L&L	64.56%	32.51%	-32.05%	-0.50
Interest on Balance w/ Dep.	0.40%	0.00%	-0.40%	0.00
Federal Funds Sold	2.58%	2.27%	-0.31%	-0.88
Dividends & Inv. Securities	26.62%	51.72%	25.10%	1.94
Total Interest Income	94.15%	86.74%	-7.42%	-0.92
Interest Expense:				
Interest on Deposits	40.19%	31.53%	-8.65%	-0.78
Federal Funds Purchased	0.32%	0.92%	0.60%	2.92
Total Interest Expense	40.50%	32.45%	-8.05%	-0.80
Other Non-Interest Income	5.85%	13.26%	7.42%	2.27
Other Non-Interest Expense	48.91%	55.46%	6.55%	1.13
Provisions	7.17%	2.86%	-4.31%	-0.40
Net Income	13.09%	16.93%	3.84%	1.29

Chicago-Area Banks Continued

Performance Measures:	Peer Ave.	BOB Ave.	Difference	Times
ROE	14.20%	19.12%	4.91%	1.35
ROA	1.20%	1.35%	0.15%	1.13
Equity Margin (times)	12.61	14.12	1.51	1.12
Profit Margin	14.11%	17.09%	2.97%	1.21
Net Interest Margin	7.21%	7.68%	0.47%	1.07
Equity Multiplier (Total Equity/Total Assets)	8.12%	7.11%	-1.01%	-0.88
Percentage of Total Assets:				
Construction	1.55%	0.47%	-1.08%	-0.30
Farm	0.03%	0.00%	-0.03%	0.00
Comm. Real Estate	3.41%	0.03%	-3.38%	-0.01
Secured by 1st	10.97%	3.96%	-7.01%	-0.36
Secured by Jr	0.83%	0.23%	-0.60%	-0.28
Multifamil Agg	1.69%	2.69%	1.00%	1.59
Nonfarm	14.47%	5.79%	-8.68%	-0.40
Comm/Indust	12.98%	14.37%	1.39%	1.11
Individual	2.74%	7.93%	5.19%	2.89
Other	1.64%	0.52%	-1.11%	-0.32
Total Loans & Leases	50.31%	29.22%	-21.10%	-0.58
Liabilities as a % of TA:				
Money Mkt Accts	5.30%	5.89%	0.59%	1.11
NOW accts	7.28%	8.79%	1.51%	1.21
Total Deposits	88.92%	88.21%	-0.71%	-0.99
Total Demand Deposits	14.78%	20.89%	6.11%	1.41
Total Time & Savings	74.15%	67.32%	-6.82%	-0.91

Chicago-Area Banks Continued

Performance Measures	Peer Ave.	BOB Ave.	Difference	Times
Rate Sensitive Assets	32.75%	24.58%	-8.17%	-0.75
Fixed-rate Assets	50.21%	59.97%	9.76%	1.19
Non-earning Assets	17.04%	15.45%	-1.59%	-0.91
Total	100.00%	100.00%		
Rate Sensitive Liabilities	44.03%	38.24%	-5.79%	-0.87
Fixed-rate Liabilities	0.59%	0.88%	0.29%	1.49
Non-paying Liabilities	48.68%	53.77%	5.09%	1.10
Equity	6.70%	7.11%	0.41%	1.06
Total	100.00%	100.00%		
Rates:				
Ave. Yld Rate-Var.	8.42%			
Ave. Yld Rate-Fixed	9.90%			
Interest Cost-Var.	3.84%			
Interest Cost-Fixed	6.00%			
Net Interest Income	\$12,127	\$10,167	-1,960	-0.84
Net Interest Margin	7.21%	7.68%	0.46%	1.06
GAP*	(\$18,637)	(\$21,304)	-2,668	1.14
GAP Ratio	75.87%	63.97%	-11.89%	-0.84

Comparison Between First Texas Bank and five(5) mainstream banks with assets between \$100 to \$300 million located in Dallas, TX
All Figures as of Year End 1992
Population of Dallas: 1,006,877

Balance Sheet (^ TA = Total Assets)	Peer Ave. % of TA^	BOB Ave. % of TA^	Difference	Times(x)
Assets:				
Cash and Dep.From Banks	7.76%	12.19%	4.43%	1.57
US Obligations	21.20%	19.16%	-2.03%	-0.90
Other Bonds and Securities	3.70%	3.24%	-0.46%	-0.88
Loans, net	56.20%	39.32%	-16.89%	-0.70
Other Assets	11.15%	26.10%	14.95%	2.34
Total Assets	100.00%	100.00%	0.00%	1.00
Liabilities:				
Deposits	92.44%	90.39%	-2.05%	-0.98
Other Liabilities	1.84%	0.84%	-1.00%	-0.46
Capital	1.87%	1.13%	-0.74%	-0.61
Surplus (Add. Paid-in Cap.)	4.04%	4.53%	0.49%	1.12
Undivided Profit (R.E.)	-0.20%	3.10%	3.30%	15.66
Total Liabilities	100.00%	100.00%		
Income Statement (* OI = Operating Income)				
Interest Income:	% of OI*	% of OI*		
Interest & Fees on L&L	67.26%	62.94%	-4.32%	-0.94
Interest on Balance w/ Dep.	0.09%	3.55%	3.46%	40.43
Federal Funds Sold	3.26%	6.71%	3.45%	2.06
Dividends & Inv. Securities	17.95%	20.24%	2.29%	1.13
Total Interest Income	88.55%	93.44%	4.88%	1.06
Interest Expense:				
Interest on Deposits	37.03%	26.01%	-11.02%	0.70
Federal Funds Purchased	0.72%	0.00%	-0.72%	0.00
Total Interest Expense	37.75%	26.38%	-11.38%	0.70
Other Non-Interest Income				
Other Non-Interest Income	11.45%	6.56%	-4.88%	0.57
Other Non-Interest Expense				
Other Non-Interest Expense	68.34%	68.27%	-0.07%	1.00
Provisions	0.92%	7.38%	6.45%	7.98
Net Income				
Net Income	6.02%	18.42%	12.40%	3.06

Dallas-Area Banks Continued

Performance Measures	Peer Ave.	BOB Ave.	Difference	Times(x)
ROE	7.69%	14.33%	6.63%	1.86
ROA	0.43%	1.26%	0.82%	2.90
Equity Margin (times)	18.67	11.40	-7.27	-0.61
Profit Margin	5.90%	18.42%	12.51%	3.12
Net Interest Margin	5.82%	6.68%	0.85%	1.15
Total Equity/Total Assets	5.98%	8.77%	2.78%	1.47
Percentage of Total Assets:				
Construction	3.29%	1.19%	-2.10%	-0.36
Farm	0.12%	0.00%	-0.12%	0.00
Comm. Real Estate	0.02%	0.00%	-0.02%	0.00
Secured by 1st	24.08%	5.04%	-19.03%	-0.21
Secured by Jr	1.74%	0.02%	-1.72%	-0.01
Multifamil Agg	1.73%	0.64%	-1.09%	-0.37
Nonfarm	9.50%	10.62%	1.12%	1.12
Comm/Indust	6.26%	18.86%	12.60%	3.01
Individual	5.47%	3.79%	-1.68%	-0.69
Other	4.49%	0.13%	-4.36%	-0.03
Total Loans & Leases	56.34%	40.29%	-16.05%	-0.72
Liabilities as a % of TA:				
Money Mkt Accts	21.32%	18.48%	-2.84%	-0.87
NOW accts	12.57%	7.81%	-4.76%	-0.62
Total Deposits	91.96%	90.37%	-1.60%	-0.98
Total Demand Deposits	21.67%	39.72%	18.05%	1.83
Total Time & Savings	70.29%	50.65%	-19.64%	-0.72

Dallas-Area Banks Continued

Performance Measures				
Rate Sensitive Assets	Peer Ave.	BOB Ave.	Difference	Times(x)
Fixed-rate Assets	49.01%	30.36%	-18.65%	-0.62
Non-earning Assets	23.79%	32.15%	8.37%	1.35
Total	27.20%	37.49%	10.29%	1.38
	100.00%	100.00%		
Rate Sensitive Liabilities				
Fixed-rate Liabilities	56.56%	40.63%	-15.93%	-0.72
Non-paying Liabilities	0.82%	0.09%	-0.72%	-0.11
Equity	36.14%	50.51%	14.37%	1.40
Total	6.48%	8.77%	2.29%	1.35
	100.00%	100.00%		
Rates:				
Ave. Yld Rate-Var.	8.42%			
Ave. Yld Rate-Fixed	9.90%			
Interest Cost-Var.	3.84%			
Interest Cost-Fixed	6.00%			
Net Interest Income	\$6,482	\$4,604	(\$1,878)	-0.71
Net Interest Margin	5.82%	6.68%	0.85%	1.15
GAP*	(\$14,882)	(\$11,335)	\$3,547	0.76
GAP Ratio	86.39%	74.71%	-11.68%	-0.86

Comparison Between Citizens Trust Bank and a (1) mainstream banks with assets between \$100 to \$300 million located in Atlanta, GA
All Figures as of Year End 1992
Population of Atlanta: 394,017

Balance Sheet (^ TA = Total Assets)	Peer Ave.% of TA^	BOB Ave. % of TA^	Difference	Times (x)
Assets:				
Cash and Dep.From Banks	4.73%	8.12%	3.39%	1.72
US Obligations	20.57%	22.91%	2.34%	1.11
Other Bonds and Securities	1.42%	18.38%	16.96%	12.94
Loans, net	66.68%	41.04%	-25.65%	-0.62
Other Assets	6.59%	9.55%	2.97%	1.45
Total Assets	100.00%	100.00%		
Liabilities:				
Deposits	59.65%	88.27%	28.62%	1.48
Other Liabilities	32.32%	5.38%	-26.94%	-0.17
Capital	1.51%	1.18%	-0.33%	-0.78
Surplus (Add. Paid-in Cap.)	4.14%	4.10%	-0.04%	-0.99
Undivided Profit (R.E.)	2.38%	1.06%	-1.31%	-0.45
Total Liabilities	100.00%	100.00%		
Income Statement (* OI = Operating Income)				
Interest Income:				
Interest & Fees on L&L	54.57%	36.90%	-17.67%	-0.68
Interest on Balance w/ Dep.	0.47%	0.00%	-0.47%	0.00
Federal Funds Sold	2.74%	1.52%	-1.22%	-0.56
Dividends & Inv. Securities	14.74%	26.31%	11.57%	1.79
Total Interest Income	73.08%	64.73%	-8.35%	-0.89
Interest Expense:				
Interest on Deposits	20.84%	21.88%	1.05%	1.05
Federal Funds Purchased	9.28%	0.00%	-9.28%	0.00
Total Interest Expense	30.46%	47.36%	16.91%	1.56
Other Non-Interest Income	26.92%	35.27%	8.35%	1.31
Other Non-Interest Expense	50.81%	72.69%	21.89%	1.43
Provisions	5.63%	8.24%	2.61%	1.46
Net Income	10.55%	1.44%	-9.11%	-0.14

Atlanta-Area Banks Continued

Performance Measures	Peer Ave. % of TA [^]	BOB Ave. % of TA [^]	Difference	Times (x)
ROE	14.71%	2.12%	-12.58%	-0.14
ROA	1.16%	0.13%	-1.02%	-0.12
Equity Margin (times)	12.61	15.76	3.15	1.25
Profit Margin	21.07%	16.86%	-4.21%	-0.80
Net Interest Margin	6.11%	7.32%	1.22%	1.20
Total Equity/Total Assets	7.94%	6.35%	-1.59%	-0.80
Percentage of Total Assets:				
Construction	3.60%	0.49%	-3.11%	-0.14
Farm	0.00%	0.24%	0.24%	0.00
Comm. Real Estate	2.39%	0.00%	-2.39%	0.00
Secured by 1st	11.31%	7.66%	-3.65%	-0.68
Secured by Jr	0.12%	1.55%	1.43%	13.11
Multifamil Agg	0.20%	0.48%	0.28%	2.37
Nonfarm	7.53%	15.09%	7.55%	2.00
Comm/Indust	19.00%	11.96%	-7.04%	-0.63
Individual	10.46%	5.07%	-5.40%	-0.48
Other	12.61%	-0.62%	-13.23%	-0.05
Total Loans & Leases	67.23%	41.92%	-25.31%	-0.62
Liabilities as a % of TA:				
Money Mkt Accts	12.61%	4.26%	-8.35%	-0.34
NOW accts	5.07%	16.89%	11.82%	3.33
Total Deposits	51.26%	90.94%	39.68%	1.77
Total Demand Deposits	16.53%	30.67%	14.14%	1.85
Total Time & Savings	34.73%	60.27%	25.54%	1.74

Atlanta-Area Banks Continued

Performance Measures	Peer Ave. % of TA^	BOB Ave. % of TA^	Difference	Times (x)
Rate Sensitive Assets	68.48%	23.58%	-44.91%	-0.34
Fixed-rate Assets	20.99%	57.34%	36.36%	2.73
Non-earning Assets	10.53%	19.08%	8.55%	1.81
Total	100.00%	100.00%		
Rate Sensitive Liabilities	30.99%	43.43%	12.44%	1.40
Fixed-rate Liabilities	1.31%	1.15%	-0.16%	-0.88
Non-paying Liabilities	60.52%	49.08%	-11.44%	-0.81
Equity	7.18%	6.35%	-0.83%	-0.88
Total	100.00%	100.00%		
Rates:				
Ave. Yld Rate-Var.	8.42%			
Ave. Yld Rate-Fixed	9.90%			
Interest Cost-Var.	3.84%			
Interest Cost-Fixed	6.00%			
Net Interest Income	\$13,105	\$7,515	(\$5,590)	-0.57
Net Interest Margin	6.11%	7.32%	1.22%	1.20
GAP*	(\$21,372)	(\$25,174)	(\$3,802)	1.18
GAP Ratio	85.94%	54.29%	-31.65%	-0.63

Comparison Between Independence Federal Savings Bank & Industrial Bank of Washington and two (2) mainstream banks with assets between \$100 to \$300 million located in Washington DC
All Figures as of Year End 1992

Population of Washington DC: 606,900

Balance Sheet (^ TA = Total Assets)	Peer Ave. % of TA^	BOB Ave. % of TA^	Difference	Times (x)
Assets:				
Cash and Dep.From Banks	6.15%	4.89%	-1.25%	-0.80
US Obligations	20.64%	43.40%	22.77%	2.10
Other Bonds and Securities	3.48%	2.29%	-1.19%	-0.66
Loans, net	52.40%	38.23%	-14.16%	-0.73
Other Assets	17.34%	11.18%	-6.16%	-0.64
Total Assets	100.00%	100.00%		
Liabilities:				
Deposits	85.08%	93.39%	8.31%	1.10
Other Liabilities	7.77%	0.38%	-7.39%	-0.05
Capital	2.92%	0.30%	-2.61%	-0.10
Surplus (Add. Paid-in Cap.)	2.83%	0.64%	-2.19%	-0.23
Undivided Profit (R.E.)	1.40%	5.29%	3.89%	3.78
Total Liabilities	100.00%	100.00%		
Income Statement (* OI = Operating Income)				
Interest Income:				
Interest & Fees on L&L	70.42%	50.67%	-19.75%	-0.72
Interest on Balance w/ Dep.	0.00%	0.64%	0.64%	0.00
Federal Funds Sold	7.28%	3.55%	-3.73%	-0.49
Dividends & Inv. Securities	21.19%	33.27%	12.08%	1.57
Total Interest Income	98.88%	88.13%	-10.75%	0.89
Interest Expense:				
Interest on Deposits	38.97%	34.36%	-4.61%	0.88
Federal Funds Purchased	2.89%	0.00%	-2.89%	0.00
Total Interest Expense*	42.49%	34.36%	-8.13%	0.81
* includes other int. exp				
Other Non-Interest Income	1.12%	11.87%	10.75%	10.64
Other Non-Interest Expense	41.21%	46.61%	5.40%	1.13
Provisions	12.06%	9.38%	-2.68%	0.78
Net Income	6.22%	7.14%	0.92%	1.15

Washington-Area Banks Continued

Performance Measures	Peer Ave. % of TA^	BOB Ave. % of TA^	Difference	Times (x)
ROE	4.64%	9.30%	4.67%	2.01
ROA	0.34%	0.58%	0.24%	1.68
Equity Margin (times)	15.25	16.05	0.80	1.05
Profit Margin	5.54%	7.14%	1.60%	1.29
Net Interest Margin	6.12%	7.77%	1.65%	1.27
Total Equity/Total Assets	6.88%	6.23%	-0.65%	0.91
Percentage of Total Assets:				
Construction	1.72%	0.00%	-1.72%	0.00
Farm	0.00%	0.00%	0.00%	0.00
Comm. Real Estate	1.01%	0.31%	-0.70%	-0.31
Secured by 1st	4.96%	14.41%	9.44%	2.90
Secured by Jr	1.44%	0.79%	-0.65%	-0.55
Multifamil Agg	1.23%	0.93%	-0.30%	-0.76
Nonfarm	16.79%	12.22%	-4.57%	-0.73
Comm/Indust	6.92%	81.47%	74.55%	11.78
Individual	2.77%	1.43%	-1.34%	-0.52
Other	8.41%	0.56%	-7.85%	-0.07
Total Loans & Leases	52.26%	39.04%	-13.21%	-0.75
Liabilities as a % of TA:				
Money Mkt Accts	35.20%	6.78%	-28.42%	0.19
NOW accts	8.40%	14.44%	6.04%	1.72
Total Deposits	84.87%	93.39%	8.52%	1.10
Total Demand Deposits	20.78%	24.81%	4.03%	1.19
Total Time & Savings	64.09%	68.58%	4.49%	1.07

Washington-Area Banks Continued

Performance Measures	Peer Ave. % of TA^	BOB Ave. % of TA^	Difference	Times (x)
Rate Sensitive Assets	43.63%	27.81%	-15.82%	-0.64
Fixed-rate Assets	32.27%	54.89%	22.62%	1.70
Non-earning Assets	24.09%	17.30%	-6.80%	-0.72
Total	100.00%	100.00%		
Rate Sensitive Liabilities	57.31%	35.02%	-22.29%	-0.61
Fixed-rate Liabilities	0.30%	0.05%	-0.24%	-0.18
Non-paying Liabilities	35.52%	58.69%	23.18%	1.65
Equity	6.88%	6.23%	-0.65%	-0.91
Total	100.00%	100.00%		
Rates:				
Ave. Yld Rate-Var.	8.42%			
Ave. Yld Rate-Fixed	9.90%			
Interest Cost-Var.	3.84%			
Interest Cost-Fixed	6.00%			
Net Interest Income	\$10,703	\$11,963	\$1,260	1.12
Net Interest Margin	6.12%	7.77%	1.65%	1.27
GAP*	(\$30,722)	(\$13,412)	\$17,310	0.44
GAP Ratio	76.13%	79.42%	3.29%	1.04