

---

## Community Banks to Reduce Derivatives Investments

Community banks intend to cut back on derivative security investments in 1996, but the accuracy of the industry's predictions is questionable, according to a recent nationwide study.

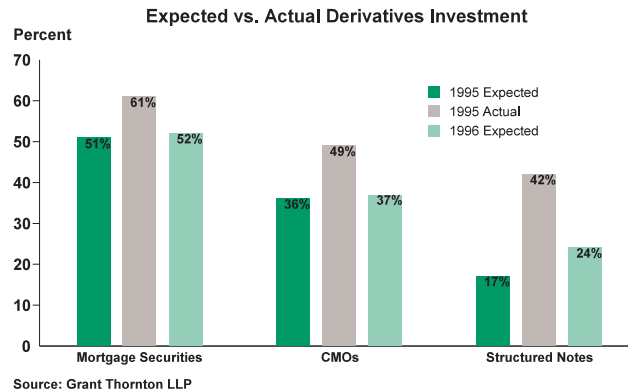
Only 52 percent of community banks, for example, said they expect to invest in mortgage securities, down from 61 percent of institutions that actually invested in the instrument in 1995 (see figure at right). A year earlier, though, the community banks underestimated their mortgage security usage, falling short of the actual 1995 mark by 10 percentage points.

The community banking industry cannot afford miscalculations of such magnitude as it jockeys for position in a more competitive 21st century, concluded Grant Thornton LLP, an accounting and management consulting firm based in Chicago. The findings are part of a new Grant Thornton report on the industry, *Preparing for the New Millennium*.

The company surveyed the chief executive officers of community banks nationwide. Approximately 90 percent of the country's commercial banks qualify as community banks, according to the survey firm. These locally owned and operated depositories (often referred to as independent banks) work from small asset bases of typically \$1 billion or less to originate residential mortgages, commercial notes and industrial loans.

The banks primarily employ three types of derivative instruments issued by Freddie Mac, Fannie Mae and the Federal Home Loan Bank System to strategically diversify their balance sheets and investment portfolios. Besides mortgage securities, the banks also invest in collateralized mortgage obligations (CMOs) and structured notes.

More than one-third of all community banks, 37 percent, predict they are likely to invest in CMOs in 1996. By comparison, 36 percent



expected to hold CMOs in 1995. Nonetheless, 49 percent reported holding multiclass mortgage securities last year, according to the survey.

The industry likewise indicates it will not count heavily this year on structured notes (a type of derivative embedded with an option feature such as a call, put or interest-rate step-up). Only 24 percent believe they will invest in the notes in 1996, up from 1995's predicted usage of 17 percent but far below the 42 percent that did employ the instrument last year.

Grant Thornton attributes the unrealistically low expectations for derivative use to the heightened scrutiny that government regulators are giving to securities holdings. News coverage about derivatives lawsuits in recent years further aggravates the situation, the company said.

The effective management of financial investments and risk is but one step toward ensuring banks' success in the years ahead, survey respondents said. Employing technology, increasing fee income, remaining independent and minimizing regulatory burden ranked at the top of bankers' lists as key to besting the competition.

To obtain a copy of *Preparing for the New Millennium*, call Grant Thornton at (202) 861-4101 or fax a request to (202) 833-9165.