Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION | FOURTH QUARTER 2000

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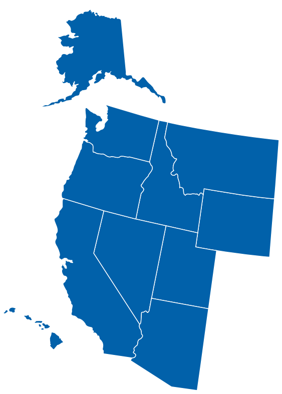

Regional Perspectives

◆ ***The rate of employment growth in the San Francisco Region continued to exceed the nation's as of August 2000*—The construction and services sectors led the Region's job growth, while mining and manufacturing employment declined slightly. In the aggregate, the Region's insured institutions reported healthy conditions as of June 30, 2000. Commercial real estate activity has increased rapidly in five of the Region's metropolitan statistical areas (MSAs) recently. Should demand weaken, there is potential for overbuilding in these areas. Three of these MSAs are highly dependent on historically volatile high-tech manufacturing and services, while two have experienced rapid economic growth driven, in part, by the tourism sector. Community banks in these five MSAs may be particularly vulnerable to an economic downturn, given rapid loan growth and relatively high concentrations of commercial real estate and construction and development loans.** ***See page 3.***

By the San Francisco Region Staff

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion*—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** ***See page 12.***

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REVISION:

The article "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" in the Third Quarter 2000 issue of the ***Regional Outlook*** has been revised to correct a data-related error. The revision affects Chart 4 and Chart 11 of the report. Please see www.fdic.gov/bank/analytical/regional/ro20003q/correction .html for revised versions of Chart 4 and Chart 11, along with an additional explanation of how the revision affects the article.

Regional Perspectives

- **The rate of employment growth in the San Francisco Region continued to exceed the nation's as of mid-2000. The construction and services sectors led the Region's job growth, while mining and manufacturing employment declined slightly.**

- **Insured institutions in the Region reported overall healthy conditions through June 2000. However, commercial real estate loan concentrations and dependence on noncore funding sources are increasing and may contribute to heightened levels of credit and liquidity risks.**

- **Community banks in five of the Region's metropolitan statistical areas considered at risk for overbuilding could be vulnerable in the event of an economic downturn given their high concentrations of commercial real estate and construction and development loans and an increase in new bank formation.**

Region's Economic and Banking Conditions

The San Francisco Region's Employment Growth Rate Continues to Exceed the Nation's

Economic activity expanded strongly in the San Francisco Region during the late summer months. Job growth in the Region continued to outpace that of the nation through midyear 2000. Nonfarm payroll employment expanded 2.8 percent in the Region's 11 states from August 1999 through August 2000 compared with 1.9 percent for the United States. **Arizona, Nevada, Idaho,** and **California** reported the highest levels of job growth, while **Hawaii** and **Oregon** somewhat lagged the nation.

Of the Region's major business sectors, the construction and services sectors experienced the strongest employment growth during this period (up 6.2 percent and 3.9 percent, respectively); the weakest sectors were mining and manufacturing, in which jobs declined (down 0.5 percent and 0.3 percent, respectively). The rise in oil prices has not yet led to an exploration and production employment boom in states where oil and gas output is important, such as **Alaska** and **Wyoming.** Boeing's layoffs have hurt manufacturing employment in **Seattle** and Southern California.

Banking Conditions Are Good, but Show Some Potential for Weakness

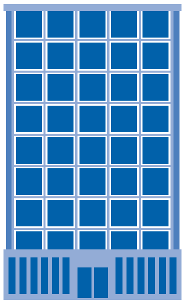
In the aggregate, the Region's 846 insured institutions continue to report healthy ratios for return on assets (1.14 percent), leverage capital (9.4 percent), and delinquent loans to gross loans (1.2 percent).[1] However, loan growth rates and changes in portfolio composition suggest that the Region's banks are heightening their risk profiles. In particular, institutions are relying increasingly on noncore funding sources because brisk loan demand continues to outpace core deposit formation. In addition, as discussed later in this article, traditionally higher-risk, higher-yielding commercial real estate (CRE) loans account for an increasing share of loans at many of the Region's institutions.

Continued high loan growth (18 percent median increase between June 1999 and June 2000) and changes in portfolio composition have implications for overall credit quality. Although the Region's median loan delinquency ratio of 1.2 percent experienced a year-over-year decline and is below the national average of 1.6 percent, loan growth may be masking potential credit risk. Historically, as loan growth rates slow and portfolios mature, loan delinquency and charge-off ratios increase. Already, commercial and industrial (C&I) past-due loan levels are increasing at the Region's large institutions;[2] past-due C&I loans now exceed 2.1 percent of total C&I loans, up from 1.9 percent in June 1999 and 1.6 percent in June 1998.

[1] Delinquent loans include credits that are past due 30 days or more or are not accruing interest because of doubt as to full collectability of principal or interest.

[2] A large institution is defined as an institution with over $1 billion in total assets.

Commercial Real Estate Markets at Risk for Overbuilding—Revisited



CRE development has been brisk in several of the Region's metropolitan statistical areas (MSAs), including the **Las Vegas, Phoenix,** Seattle, **Salt Lake City,** and **Portland** MSAs. As discussed in the ***Regional Outlook,*** third quarter 2000, these five markets are considered at risk for CRE overbuilding because of the rapid increase in recent construction activity.[3] High rates of CRE construction may not be a problem if absorption of space continues. However, lenders should be mindful that continued building could make an area vulnerable if the national or local economy weakens, particularly given the historical lag time of construction cycles' response to changes in demand.

This article explores several trends in these MSAs in more depth, focusing on the following aspects of economic growth and trends in CRE lending that could adversely affect community banks in these MSAs:[4]

- On the basis of real personal income trends, these MSAs appear to be experiencing economic "booms" that could make lenders vulnerable in the event of an ensuing "bust"; similar boom-bust patterns contributed to many bank failures in the 1980s.

- The historically volatile high-tech industry, which depends on capital markets funding, is driving economic growth in three of the five MSAs. Significant tightening in the capital markets could dampen high-tech CRE demand. This, in turn, could affect vacancy and rental rates in these markets and, as a result, CRE loan collateral values.

- Community banks in these five MSAs are actively financing new and existing CRE development, despite the fact that capital markets scaled back CRE investments in 1998 and 1999. Moreover, median CRE-loan-to-total-asset ratios in each of the five MSAs exceed medians reported in other MSAs in the Region and across the nation.[5]

- Unseasoned community banks, which represent a significant proportion of community banks in several of these MSAs, report equally high concentrations of CRE loans to total assets.[6] The ability of these institutions to hold high levels of CRE loan concentrations and maintain asset quality has not been tested during an economic downturn.

As noted in ***Regional Outlook,*** third quarter 2000, these analyses do not "predict an imminent rise in vacancies and losses in the at-risk markets. Instead,… the goal is to raise awareness about substantial growth in real estate development and the corresponding increases in risk exposure to financial institutions."[7]

Are These MSAs Experiencing 1980s-Style "Booms" in Real Income Growth?

Over the past decade, robust economic conditions in some of the Region's large MSAs have spurred higher employment, population, and personal income growth than the national averages. In several of these areas, real . . .estate values are appreciating and real estate construction activity is flourishing. While rapid growth certainly has positive economic implications, an FDIC study of banking problems in the 1980s and early 1990s suggests that such growth is often associated with speculative CRE development. In addition, bank financing of CRE overbuilding may lead to banking problems in later years.[8] Specifically, ***History of the Eighties*** stated that "bank failures were generally associated with regional recessions that had been preceded by rapid

[3] Federal Deposit Insurance Corporation. "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding." *Regional Outlook,* third quarter 2000, pp. 11–18. These 5 MSAs were among 13 identified nationwide. The selection and ranking of MSAs were based primarily on square footage built during 1999 as a percentage of preexisting stock in the office, industrial, retail, multifamily, and hotel property categories.

[4] For purposes of this article, a community bank is defined as a non-credit-card, commercial bank with less than $1 billion in assets, located in an MSA. Industrial loan corporations, special-purpose lenders prevalent in Salt Lake City, are excluded from this group. CRE loans are defined as the sum of multifamily; nonfarm, nonresidential; and construction and development loans. Because of Call Report data limitations, construction and development loans may include amounts used to finance residential building.

[5] For purposes of this article, CRE loans include amounts used to finance commercial-use properties, as well as to construct and develop real estate. Construction and development loans may include amounts used to finance residential real estate construction.

[6] For purposes of this article, unseasoned is defined as an institution that has been chartered less than eight years.

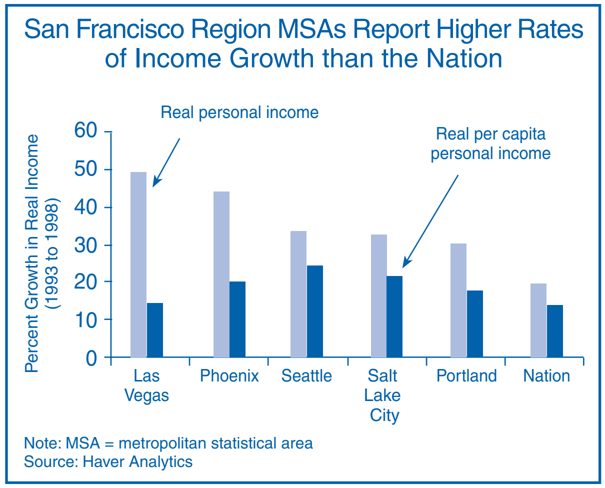
[7] Federal Deposit Insurance Corporation. *Regional Outlook,* pp. 11–18.

[8] Federal Deposit Insurance Corporation. 1997. *History of the Eighties—Lessons for the Future. Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s,* pp. 13–33.

regional expansions—that is, they were associated with 'boom-and-bust' patterns of economic activity."[9] The study found that relatively high growth rates of real personal income across states over a five-year period, followed by subsequent declines (i.e., a state recession)—a "boom-and-bust" pattern—were correlated with an increase in bank failures in later years.[10]

Real personal income growth trends in these five MSAs suggest that they may exhibit characteristics of "boom" markets. From 1993 through 1998, these five MSAs reported real personal income growth that has outpaced the nation's (see Chart 1).[11] During this period, Las Vegas and Phoenix, respectively, experienced the second and third highest real personal income growth rates of the nation's 300 MSAs. Seattle, Salt Lake City, and Portland were among the top 30 MSAs ranked by growth in real personal income.

CHART 1



High-Tech Growth Has Driven Economic Expansion in Three MSAs

Growth in the high-tech sector has contributed significantly to the current expansion and CRE development in several of the Region's MSAs. As discussed in the ***Regional Outlook,*** third quarter 2000, the high-tech sector has fueled job and income growth in the Region. Thirteen areas in the Region were identified in that article as "high-tech MSAs" in which the concentrations of high-tech employment and job growth in this sector exceed the national median. Overlap exists between the Region's high-tech MSAs and areas considered at risk for CRE overbuilding: Phoenix, Portland, and Seattle were identified in both analyses. These MSAs have experienced both rapid rates of high-tech employment growth and significant levels of CRE development during the second half of the 1990s.

Employment in the high-tech sector historically has been more volatile than in most other sectors of the economy. This sector traditionally has been more dependent on the availability of venture capital, which ties high tech more closely to the stock market. Therefore, while job growth in the Region's high-tech MSAs has generally been quite strong in recent years, high-tech employment could moderate or fall should a downturn occur in this sector or the stock market suffer a prolonged decline. Adverse stock market movements could quickly amplify supply-demand imbalances and affect CRE lenders in high-tech MSAs, particularly those with high exposures to CRE loans.

Economic Expansion Has Contributed to Elevated CRE Loan Concentrations and Increased Chartering Activity

Increasingly, community banks have financed CRE growth in the Las Vegas, Phoenix, Seattle, Salt Lake City, and Portland MSAs. As of June 30, 2000, CRE loans typically exceeded one-third of total assets at community banks headquartered in these MSAs (see Chart 2, next page). These CRE loan concentration levels exceeded those observed in other MSAs nationally.[12] Furthermore, in the five highlighted MSAs, median concentration levels of traditionally higher-risk construction and development (C&D) loans were two to three times those reported in other MSAs nationally (see Chart 3, on page 7).

In addition to creating increased C&D and CRE loan demand, robust economic growth has contributed to significant new bank formation over the past eight years. As of second quarter 2000, 24.1 percent of the San Francisco Region's MSA-based community banks were unseasoned (in operation less than eight years). In contrast, over 58 percent of the community banks in these five MSAs are unseasoned (see Table 1, next page). New

[9] Ibid., p. 19.

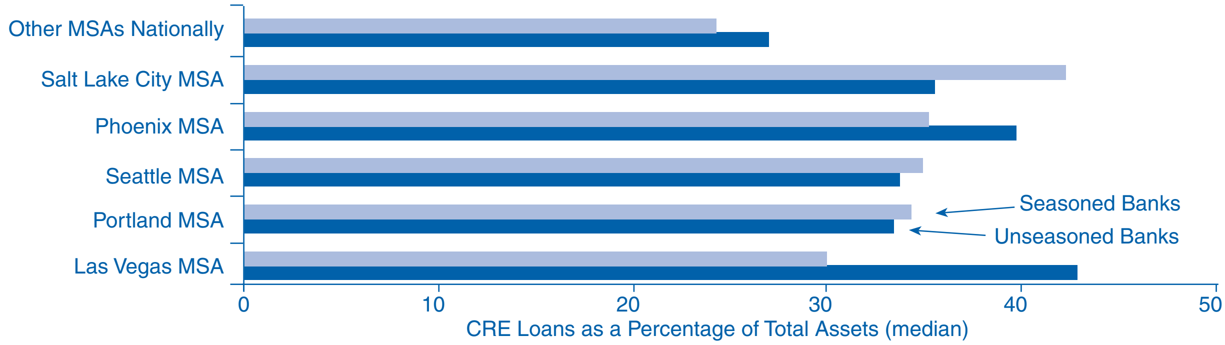
[10] Ibid., pp. 19–21.

[11] The latest data available for MSA personal income are for 1998. The chart covers the period 1993 to 1998.

[12] National comparisons are to median ratios for community banks located in MSAs outside of the five highlighted markets.

CHART 2

Median CRE Concentrations at Community Banks* in the Five MSAs Exceed Medians in the Nation



CRE = commercial real estate; MSA = metropolitan statistical area
* A community bank is defined as a nonspecialty bank located in an MSA with total assets of under $1 billion. Unseasoned banks are those open eight years or less.
The Salt Lake City MSA has only one unseasoned community bank.
Source: Bank Call Reports as of June 30, 2000

chartering activity has been particularly strong in the Las Vegas, Phoenix, Portland, and Seattle MSAs, where unseasoned community banks account for more than half of all community banks within each MSA. Unseasoned community banks in the five MSAs alone represent more than one-third of all unseasoned community banks in the San Francisco Region. In each of the five MSAs, unseasoned banks hold CRE and C&D concentrations significantly higher than those in other MSAs in the Region and across the nation (see Charts 2 and 3).

Community banks within these five MSAs might be particularly vulnerable to an economic downturn because CRE loan concentration levels are high and new bank activity has been brisk. An FDIC study of bank failures during the late 1980s and early 1990s found that high CRE loan concentrations contributed to overall losses and bank failures.[13] The same study also identified disproportionately higher failure rates among newly chartered institutions. Any slowing in the economy could negatively affect banks in the Phoenix, Seattle, and Portland MSAs, where employment growth is

TABLE 1

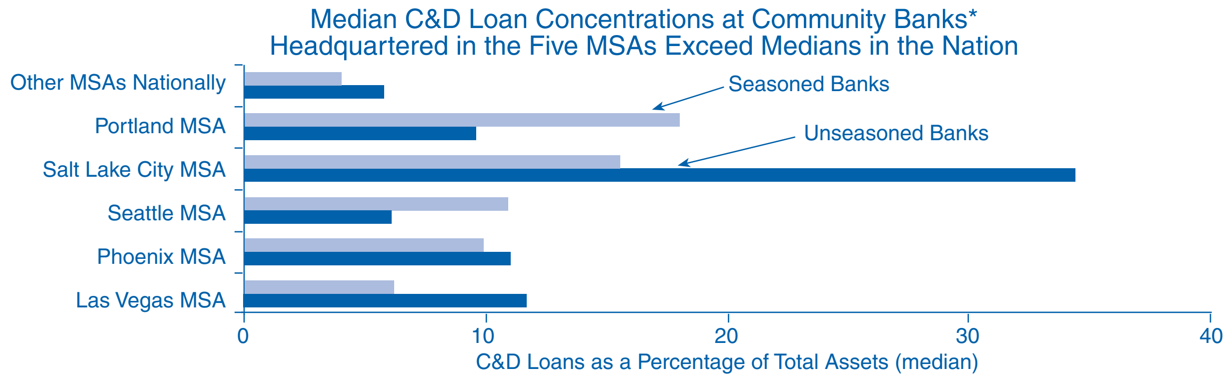
NEW COMMUNITY BANK CHARTERING ACTIVITY HAS BEEN STRONG IN THE REGION'S HIGH-GROWTH MSAS OVER THE PAST EIGHT YEARS

Location of Bank Headquarters	Unseasoned Bank Count	Seasoned Bank Count	Unseasoned Banks to Total Banks
Las Vegas MSA	12	3	80.0%
Phoenix MSA	15	8	65.2%
Portland MSA	9	5	64.3%
Seattle MSA	15	12	55.6%
Salt Lake City MSA	1	9	10.0%
Total of Region's Five High-Growth MSAs	52	37	58.4%
All MSA-Based Banks in the Region	135	425	24.1%

MSA = metropolitan statistical area
Includes only commercial banks with less than $1 billion in total assets. Excludes any new openings for special-purpose entities or those resulting from mergers, acquisitions, or intercompany reorganizations. Unseasoned banks are defined as institutions in operation eight years or less.
Source: Bank Call Reports as of June 30, 2000

[13] Federal Deposit Insurance Corporation. 1997. History of the Eighties—Lessons for the Future, Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s. pp.31–33 and 137–162.

CHART 3



C&D = construction and development; MSA = metropolitan statistical area
* A community bank is defined as a nonspecialty bank located in an MSA, with total assets of under $1 billion. Unseasoned banks are those open eight years or less. The Salt Lake City MSA has only one unseasoned community bank.
Source: Bank Call Reports as of June 30, 2000

tied closely to the high-tech industry. Sustained softening in the gaming sector in the Las Vegas MSA or overbuilding in preparation for the 2002 Winter Olympics in the Salt Lake City MSA could affect community banks' asset quality in these areas.

Rapid Economic Expansion Spurred New Bank Formation and High CRE Concentrations in the Las Vegas MSA

Las Vegas ranked first among the Region's large MSAs in real personal income growth from 1993 through 1998, a result of strong in-migration and rapid job creation. Las Vegas also ranked among the top ten MSAs nationwide for construction activity in four property types: retail, office, industrial, and multifamily. Many banks in the Las Vegas MSA have increased their exposures to CRE loans above the national average since second quarter 1998.

Although economic conditions in the Las Vegas MSA remained strong through second quarter 2000, overall employment growth moderated because fewer new jobs were created in the services sector. The gaming industry continues to be the primary source of growth, and the concentration of jobs and businesses tied to the success of this industry makes the MSA more vulnerable in the event of a national economic downturn or weakening in the tourism industry. In 1999, Las Vegas's visitor volume increased significantly, and several new hotel-casinos opened.[14] However, the ***Las Vegas Convention and Visitors Authority*** stated that a significant decline in new construction was expected in 2000. In addition, the ***University of Nevada Las Vegas Center for Business and Economic Research*** predicted that in 2000, growth in visitor volume might moderate from its high 1999 rate.[15]

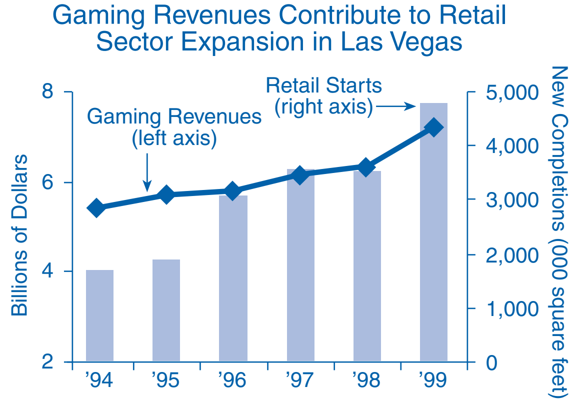
Given the strong reliance of the Las Vegas MSA on the gaming sector, in terms of both employment and revenues, shifts in the sector's health resonate throughout the local economy, particularly in the retail sector (see Chart 4, next page). Through year-end 1999, the retail market experienced high levels of new construction in relation to existing stock. The market appears to have generated sufficient demand for additional space, because vacancy rates have remained low compared with historical rates for the MSA and the nation. However, if visitor volumes moderate, retail absorption rates may decline.

Unlike the retail sector, Las Vegas's office and industrial markets experienced vacancy rates higher than the national average through year-end 1999. In the office market, new space completed and in progress continues to represent a large share of the MSA's existing stock. Although Las Vegas has lower business costs than several other MSAs in the Region, which may be attractive to businesses looking to relocate, its office vacancy rate remains higher than the national average. Similarly, while the vacancy rate in Las Vegas's industrial real

[14] As stated by the Center for Business and Economic Research of the University of Nevada, Las Vegas.

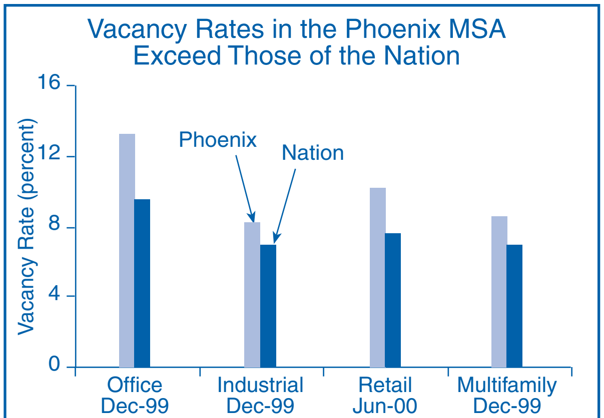
[15] Nearly 12,000 new hotel rooms were completed in the Las Vegas area in 1999. In comparison, only about 4,200 rooms are planned for construction and completion during 2000, according to the ***Las Vegas Convention and Visitors Authority.***

CHART 4



Sources: Las Vegas Convention and Visitors Authority—Clark County, NV, Gaming Revenues; F.W. Dodge—Las Vegas Retail Starts

CHART 5



MSA = metropolitan statistical area
Source: Torto Wheaton

estate market has fallen as a result of steady absorption of new space, it remains above the national average.

Rapid CRE development in the Las Vegas MSA has contributed to high and increasing levels of C&D and CRE loans at community banks. As of June 30, 2000, community banks in the MSA reported a median CRE loan-to-total-asset ratio of 38.6 percent, up from 32.3 percent one year earlier. As shown in Chart 2, this CRE concentration level is well above that in other MSAs nationally. Furthermore, the median ratio of C&D loans to total assets is also relatively high at 11.5 percent, up from 10.8 percent one year ago. Within the Las Vegas MSA, unseasoned banks comprise 80 percent of all community banks and hold nearly twice the C&D exposure of seasoned banks. The risk posed by such high concentrations of C&D loans is particularly evident when measured in relation to Tier 1 capital. Aggregate C&D levels equal or exceed Tier 1 capital in 5 of the MSA's 12 unseasoned community banks. Given the high proportion of unseasoned institutions, the ability of Las Vegas community banks to withstand such high concentrations in an economic downturn is largely untested.

An Increasing Amount of Commercial Space Is Becoming Available in the Phoenix MSA, Financed in Part by Unseasoned Community Banks

Phoenix experienced the second most rapid rise in personal income growth in the Region between 1993 and 1998 and remains vulnerable to CRE overbuilding. It ranks among the top ten MSAs in the nation for new construction and starts in four property types: office, industrial, retail, and multifamily. Furthermore, vacancy rates are higher than the national average in each property type (see Chart 5). Given high levels of construction activity in multiple property types and vacancy rates that are already relatively high, community banks in the MSA appear vulnerable to economic weakening because of increasing exposure to CRE loans.

While several real estate sectors in the Phoenix MSA were identified in the ***Regional Outlook,*** third quarter 2000, to be at risk of overbuilding based on the supply of new space, economic indicators give a mixed view of potential demand. Although slightly slower than in previous years, the employment growth rate in Phoenix through third quarter 2000 was stronger than the national average, particularly in the services, transportation, and public utilities sectors. However, the pace of net in-migration has slowed and may constrain job growth and demand for CRE space going forward.

The Phoenix office market, which has been one of the most active in the country, appears vulnerable to a potential downturn because of the rapid pace of development. The MSA added large amounts of new office space during 1999. Despite strong absorption levels, the vacancy rate at year-end 1999 was 12.4 percent, the highest since 1994.

The industrial, retail, and multifamily sectors also experienced high rates of construction relative to existing stock during 1999. Phoenix is a popular location for semiconductor manufacturing operations and high-tech research and development, but is showing signs of softening. As of midyear 2000, the vacancy rate for the

MSA's industrial properties (8.8 percent) was above the national average (6.7 percent). The retail and multifamily CRE sectors have also been very active, likely in response to the rapid rates of employment growth in the Phoenix MSA.

Real estate markets in the Phoenix MSA warrant monitoring because its community banks are particularly dependent on traditionally higher-risk CRE and C&D lending. As of June 30, 2000, community banks in the Phoenix MSA reported 38.6 percent of all assets invested in CRE credits, versus 24.7 percent nationally. The ratio of CRE loans to total assets is relatively high in both established and unseasoned institutions and has risen steadily over the past two years. Both seasoned and unseasoned community banks also exhibit elevated C&D lending exposures, with median C&D loan-to-total-asset ratios of 9.9 and 10.9 percent, respectively. These concentration levels exceed those typically found in other MSAs across the nation (see Chart 3). As in Las Vegas, the proportion of unseasoned banks in the Phoenix MSA is high, and 8 of 15 newer banks have C&D loan portfolios that exceed Tier 1 capital.

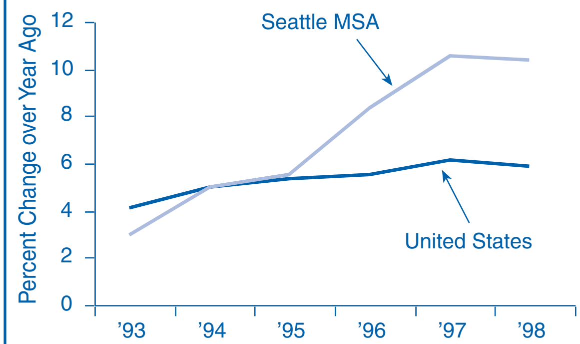
Seattle MSA Economic Growth May Be Slowing, but Community Banks Continue to Increase C&D Loan Exposures

The Seattle MSA has enjoyed strong economic growth and CRE development in recent years, and insured institutions have increased CRE loan exposure. Between 1993 and 1998, real personal income in Seattle increased by 33.7 percent, well above the 19.6 percent national growth rate during the same period. Chart 6 shows that year-over-year income growth in the Seattle MSA has exceeded the nation's since 1994. Median home prices in Seattle have also risen more rapidly than the national average in recent years. Since midyear 1998, community banks in this MSA have significantly increased concentrations in CRE loans. Consequently, these insured institutions may be more vulnerable if the strength of the real estate market dissipates.

Although economic conditions in Seattle remain strong, evidence of a slowdown is beginning to emerge. Growth in the services sector, which accounts for approximately 30 percent of the MSA's employment, dropped to 3.3 percent in August 2000, compared with 4.8 percent the prior year. In addition, the influx of venture capital investment into the Pacific Northwest has declined, and in-migration to the Seattle area has begun to slow. Two years ago, net migration was just below 24,000, but it fell below 8,000 in 1999. These factors could result in slowing absorption across the five CRE property types in the Seattle MSA.

Chart 6

Seattle MSA Personal Income Growth Exceeds the Nation's



MSA = metropolitan statistical area
Source: Bureau of Economic Analysis via Haver Analytics

As of midyear 2000, Seattle's vacancy rates in all five property types—hotel, retail, multifamily, industrial, and office—remained below the national averages. However, the hotel, multifamily, and office sectors continue to add space at rapid rates; each ranked among the top ten nationally for new completions and starts as of year-end 1999. Demand has not kept pace with completions, however. In 1999, the absorption level for the hotel sector dropped to less than half of all completions, and the occupancy rate fell below 70 percent. Multifamily completions and absorptions are also tracking this trend. Although completions in this sector were up 23 percent in 1999, absorptions increased by only 5 percent. The downtown Seattle office market, with its vacancy rate of only 1.2 percent in the second quarter 2000 (the lowest office vacancy rate of any downtown area in the Region), also could weaken if the level of construction activity continues at its fast pace and the rate of absorption slows.

Any CRE supply-demand imbalances could have an adverse effect on Seattle-based community banks, which report high and increasing CRE loan concentrations. The median level of CRE loans to total assets for this group of banks topped 34.3 percent as of midyear 2000, up from 23.9 percent two years earlier. Like overall CRE concentrations, median C&D loan-to-total-asset ratios are relatively high at these institutions. However, median C&D concentrations generally declined between June 1999 and June 2000, falling from 7.7 percent to 6.5 percent. While the MSA's 15 unseasoned community banks have reported declining C&D loan concentrations year-over-year since June 1998, the 12 established community banks have reported increasing C&D loan concentrations. Consequently, the median ratio of C&D loans to total assets (10.9 percent) at established institutions is nearly double the ratio reported by younger institutions (6.5 percent). Regardless, C&D loan concentration levels for Seattle-based community banks exceed the national median (see Chart 3).

Despite Potential Overbuilding in the Office and Hotel Sectors, Insured Institutions in Salt Lake City Report Relatively High CRE Loan Concentrations

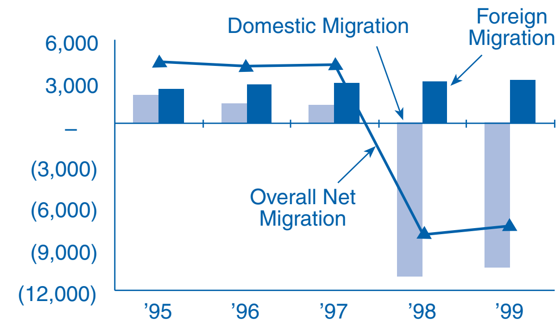
Strong employment growth in recent years and increased building in anticipation of the 2002 Winter Olympics helped Salt Lake City remain among the top ten markets nationwide for new office and hotel construction. In addition, since early 1999, seasoned community banks in this MSA have increased exposures to CRE loans and, as a result, may be more vulnerable should the economy slow.

Economic conditions remain relatively strong, but evidence of a slowdown is emerging. The overall job growth rate in the Salt Lake City MSA slowed to 2.2 percent in second quarter 2000, nearly the same as the national rate. The index of office employment published by ***Torto Wheaton*** indicates that jobs requiring office space, such as those in the services industries and the finance, insurance, and real estate sectors are expected to grow more slowly, suggesting that future demand for new office space could soften. Migration statistics also indicate slowing. During 1998 and 1999, the MSA experienced a net loss of more than 7,000 residents each year (see Chart 7).

Despite the potential for softening, Salt Lake City ranks fourth in the nation for combined 1999 completions and starts in the office sector. ***Torto Wheaton*** expects completion of new office space to continue; 1.5 million square feet are planned for completion in 2000 and 1.1 million square feet for 2001. However, the vacancy rate in this sector is already high—12.5 percent in 1999—after being below 8.1 percent almost every year since 1993. The vacancy rate is likely to continue to rise if demand for office space slows as expected, putting the Salt Lake City MSA at risk of overbuilding.

CHART 7

Salt Lake City MSA Began to Experience Net Out-Migration in 1998



MSA = metropolitan statistical area
Source: Census Bureau via Regional Financial Associates

Extensive hotel construction in preparation for the 2002 Winter Olympics continues to drive down occupancy and room rates. In June 2000, the occupancy rate in Salt Lake City hotels fell to 68.9 percent, down from 72.9 percent a year ago, according to the ***Rocky Mountain Lodging Report.*** Daily room rates also declined during the past year. Together, these factors suggest that supply is exceeding demand in the hotel sector.

Robust economic growth has contributed to high and increasing concentrations of CRE and C&D lending at the area's community banks. Median concentrations of CRE loans to total assets have risen from 31.0 percent in June 1998 to 41.7 percent in June 2000. Concentration levels significantly exceed median exposures in other MSAs in the nation (see Chart 2). Elevated CRE loan concentrations are due largely to these banks' heavy reliance on C&D lending. Construction loans now comprise nearly 20 percent of all assets of Salt Lake City area community banks. Consequently, C&D loan exposures exceed Tier 1 capital levels at 80 percent of the area's community banks.

Portland's High-Tech Sector Is Rebounding, and Banks Are Reporting Increasing CRE and C&D Loan Concentrations

Real personal income in the Portland MSA increased more rapidly than the national average between 1993 and 1998, in part as a result of the creation of higher-paying high-tech jobs. Overall growth in the MSA has spurred development in several CRE sectors. For instance, the total number of hotel rooms expanded by more than 15 percent between 1998 and 1999. During this period, community banks in the Portland MSA reported higher median exposure to C&D loans than the Region and nation.

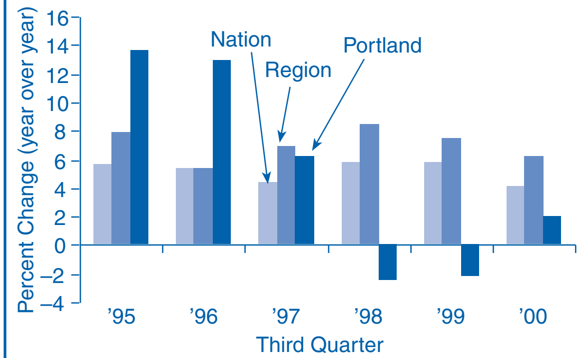
Demand for new CRE development has been driven, in part, by employment growth. Total nonfarm employment in Portland grew 1.7 percent between August 1999 and August 2000. With improved demand from Asia, job gains in some of Portland's electronics manufacturing subsectors have offset declines in other subsectors, such as lumber and wood products manufacturing. Furthermore, Portland's high-tech firms continue to grow faster than their counterparts nationally—three times faster over the past five years, according to the ***Institute for Portland Metropolitan Studies.***[16] Despite the apparent turnaround in high-tech job growth following the Asian crisis, the MSA's construction sector experienced job gains of only 2.0 percent for the year ending August 2000, compared with the Region's 6.2 percent (see Chart 8).

The hotel sector appears to be the most vulnerable CRE property type, as the Portland MSA has experienced higher vacancy rates during the first half of 2000. In addition, the multifamily sector reports a relatively high ratio of new completions and starts to existing stock (over 6 percent), compared to the national average of slightly more than 2 percent. While Portland's multifamily sector vacancy rate remains below the national average, slower net in-migration may decrease absorption rates for this type of space going forward.

On average, community banks in the Portland MSA hold one-third of total assets in CRE loans, up slightly from June 1998. While a 33.4 percent median CRE loan-to-total-asset ratio in this MSA is comparable to other areas in the Region, it exceeds the 24.7 percent concentration for the nation (see Chart 2). Both seasoned and unseasoned institutions are active CRE lenders; however, the area's five established institutions are particularly exposed to C&D credit risk. These community banks hold 17.9 percent of assets in C&D loans, compared with 9.6 percent at unseasoned Portland community banks and 5.8 percent at unseasoned community banks in the rest of the nation (see Chart 3). In the event of market softening, these five lenders could be vulnerable to asset quality slippage.

CHART 8

Portland's Construction Job Growth Lags the Region and Nation



Source: Bureau of Labor Statistics via Haver Analytics

Conclusion

Five of the Region's large MSAs continue to rank among the most active in the nation in terms of increasing supplies of CRE space. Considered in tandem with personal income growth rates and other indicators of economic activity, robust construction activity suggests that these MSAs may be experiencing 1980s-style "booms." High-tech employment growth has spurred development in three of the MSAs; sustained growth in this sector is somewhat dependent on the availability of venture capital, which ties it closely to the stock market. Community banks in all five MSAs have generally increased levels of and concentrations in CRE and C&D loans in response to increased development activity. In addition, the Region's strong economy has contributed to a higher rate of new bank formation in these MSAs. As a result, not only are community banks in these MSAs more highly exposed to traditionally higher-risk CRE and C&D loans, but many of the banks in these MSAs have not been tested during an economic downturn. If not met with equally vigorous demand for new space, sustained construction activity could result in some weakening of asset quality among community banks. In addition, given the significance of high-tech employment in three of the MSAs, CRE asset quality could be vulnerable in the event of a prolonged stock market decline.

San Francisco Region Staff
Stephanie Galloway, Financial Analyst

[16] "The Ecology of the Silicon Forest." November 21, 2000. Regional Connections Project, Portland State University Institute for Portland Metropolitan Studies; http://www.upa.pdx.edu/IMS/.

Emerging Risks in an Aging Economic Expansion

- **The economy and the banking and thrift industries are reporting generally healthy conditions. However, the economic expansion is aging, and it is unlikely that the vigor experienced during the first half of 2000 can be sustained.**

- **Likewise, record banking and thrift industry profits, healthy capital cushions, and good asset quality of recent years may not be sustainable. Declining net interest margins, rising commercial loan losses, tighter liquidity, and riskier asset composition are among the warning signs that industry performance may have peaked for this business cycle.**

- **Specific areas of concern include growing reliance on noncore funding; heightened interest rate risk; increased exposure to market-sensitive revenues; deteriorating credit quality; rising leverage among businesses and households; and signs of imbalance in some residential and commercial real estate markets.**

Although no readily apparent situations or imbalances suggest that a recession or widespread banking problems will develop in the near term, warning signs are present. A highly competitive banking industry shapes the environment in which pressures on insured institutions are unfolding. The presence of a large share of newly chartered banks in some areas appears to be raising the risk profile among all institutions in certain markets. Publicly owned companies remain under intense pressure to grow earnings and increase shareholder value. In addition, local banking environments exist in which a confluence of risks is generating heightened vulnerability for all participants, even during healthy economic times. Complacency in these environments may have negative repercussions for many insured institutions going forward.

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

The performance of the U.S. economy contributes to the opportunities and risks financial institutions face. The current cyclical expansion, now nine and one-half years old, is displaying signs of aging while setting a record for longevity. A consensus forecast calls for moderate real gross domestic product (GDP) growth through 2001, following robust gains in the first half of 2000. Current conditions might be called a "soft landing," in which real GDP growth slows to a sustainable noninflationary rate of 2.5 to 3.5 percent, and unemployment hovers around recent rates.

Although the current macroeconomic environment might appear to be the best of all possible worlds, areas of concern exist. One is that sustained prosperity tends to foster higher levels of risk taking, overconfidence, and complacency. For example, the turmoil in world foreign exchange and financial markets during 1997 and 1998 illustrates how dramatic imbalances can develop and trigger disruptive adjustments even during healthy economic times.

Currently, no specific situation or imbalance seems to threaten the viability of the expansion. However, as detailed below, several likely will contribute to slower economic growth. Situations that warrant monitoring include the following:

- The repercussions from higher energy prices are unfolding. Historically, oil price shocks have weakened several other long-lived economic expansions.

- Short-term interest rates rose over the past year while longer-term rates declined, resulting in a modest inversion of the yield curve. This relationship may inhibit the profitability of some lenders' practice of borrowing short term and lending longer term and also complicate the interest rate risk management process for some insured institutions.

- Continuing low unemployment suggests that demand for additional workers will go unfilled, thus limiting economic growth or triggering bidding wars that increase workers' compensation and, potentially, inflation.

- Stock market sentiment is no longer strongly bullish. A pullback from high valuations and optimism could trigger negative repercussions on consumers' net worth and spending as well as on the level of business investment.

- A large international trade deficit and strong U.S. dollar may be an unsustainable combination over the long run. Meanwhile, repatriated profits of U.S. corporations are being trimmed by the dollar's strength relative to the euro and other currencies.

- Household debt burdens are historically high, with leverage rising the most in recent years among low- and middle-income households. These households' access to credit has increased as lenders competed more fiercely for customers.

- Corporations are more highly leveraged, and potential default risk rose in the past year across a range of industries. Meanwhile, downgrades of publicly traded corporate debt issues are exceeding upgrades by a 2 to 1 ratio.

- In some metropolitan areas, overheated housing markets are developing, in which home prices are rising dramatically and exceeding gains in median incomes.

- Potential signs of excess commercial real estate construction are appearing in several urban areas where banks' construction loan growth also is strong.

Economic indicators of what lies ahead are not clear-cut, and each possible scenario contains a set of potential challenges for insured institutions and regulators. Should economic growth slow considerably, current vulnerabilities, such as highly leveraged borrowers' debt loads and overheated housing markets, could worsen significantly. As evidenced by the rash of bank failures during the 1980s, it doesn't always take a national recession for problems to develop. Alternatively, sustained rapid growth might foster new vulnerabilities and allow current imbalances to intensify or build up. For example, speculative construction could accelerate, stock market volatility could increase, or ballooning trade deficits could generate turmoil in foreign exchange markets.

Signs of Strain Are Also Appearing amid Healthy Banking and Thrift Industries

With the long economic expansion as a backdrop, insured institutions in the aggregate are performing very well. However, the record profits attained in recent years may not be sustainable. The losses posted recently by several large institutions are striking examples of increased appetite for risk resulting in significant financial loss during a period of strong economic growth. While these are isolated instances, they are indicative of the increasingly competitive environment facing the financial services industry.

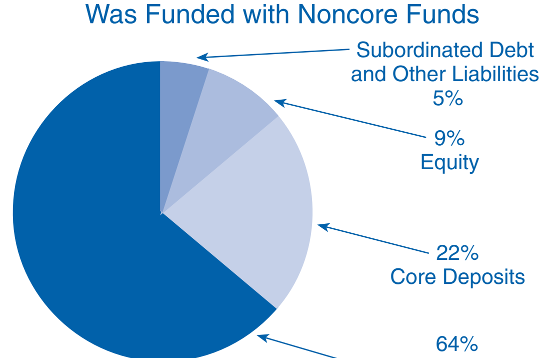
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting that recent increases in interest rates and energy costs not only are affecting businesses but also are taking a toll on some consumers. Other signs suggesting that aggregate risk within the system has risen include the growing reliance on noncore funding to support asset growth, heightened interest rate risk at many institutions, growing concentrations in traditionally higher-risk loan classes, and a shift in institutions' overall asset mix toward higher-risk categories. A brief discussion of these risks follows.

Funding Patterns Heighten Liquidity Concerns

Lackluster core deposit growth is placing pressure on bank earnings and contributing to rising liquidity risk in the banking system. During the past five years, the compounded annual rate of core deposit growth for all insured institutions was just 2.8 percent. Assets over this time grew at a 6.6 percent rate. Accordingly, a significant portion of the industry's growth has been funded by noncore sources (see Chart 1). The higher cost and rate sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

CHART 1

Most of $2 Trillion of Asset Growth since 1995 Was Funded with Noncore Funds



Source: Bank and Thrift Call Reports, June 2000 and June 1995

To compensate for higher funding costs, the industry has pursued growth in higher-yielding asset classes that are traditionally both riskier and less liquid. For example, almost 37 percent of the asset growth in the past five years has come from nonresidential real estate and commercial and industrial loans.

For institutions that fund illiquid assets with wholesale sources, any adverse events that trigger a lack of confidence in the institution may result in higher funding costs, thus placing further pressure on margins. In efforts to obtain funding, an institution also may pledge a greater portion of its best quality assets as collateral, further reducing liquidity. Finally, in instances where funding needs have exceeded available liquidity, the forced sale of illiquid assets to meet funding outflows could result in losses if market conditions are unfavorable. Presumably, the FDIC, as insurer, would suffer greater losses if such an institution failed, because it would be relying on proceeds from the liquidation of less liquid, and potentially lower-quality, assets to satisfy the claims of insured depositors.

Subprime lenders, in particular, tend to rely heavily on noncore funding to pursue aggressive growth strategies. Chart 2 illustrates the extent to which noncore funding exceeds the level of liquid assets for this group. The chart suggests the difficulty these institutions may encounter if forced to convert assets to meet funding outflows. Although subprime lenders may use noncore sources to fund riskier assets to a greater extent than the industry at large, this illustration exemplifies a systemic trend that is raising liquidity risk industrywide and is increasing risk to the insurance funds.

Increasing Levels of Interest Rate Risk Challenge Some Institutions

The refinancing boom of the late 1990s spurred a significant shift into longer-maturity assets for many insured institutions. During this period, a vast majority of mortgage borrowers opted for longer-term, fixed-rate loans, which they obtained at historically low rates. A great deal of the higher-rate or adjustable-rate loans that borrowers refinanced were held in the portfolios of insured institutions, which contributed to a general lengthening of the maturity of assets held at insured institutions.

The trend toward longer-term, fixed-rate assets has been particularly pronounced among mortgage lenders. For example, state-chartered savings banks, which are traditionally mortgage lenders, have experienced a dramatic increase in long-term assets. As of June 30, 2000, almost 45 percent of the median savings bank's earning assets were not scheduled to reprice for five years or longer (see Chart 3).

Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts and savings banks, therefore, have significant exposure to rising rates from low-yielding long-term assets.

CHART 2

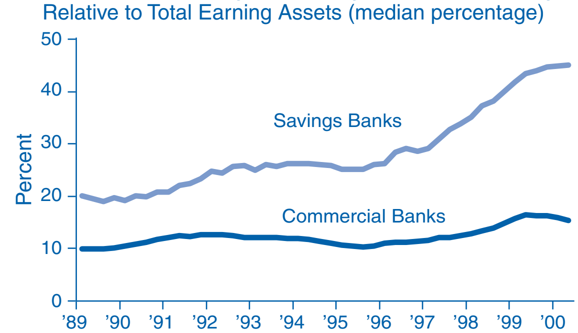
Subprime Lenders' Growing Dependence on Noncore Funding Strains Liquidity

Source: FDIC Division of Supervision and Bank and Thrift Call Reports (data are merger adjusted)

CHART 3

Growing Concentration in Long-Term Assets Elevates Interest Rate Risk

Share of Assets Maturing or Repricing in Five Years or Longer Relative to Total Earning Assets (median percentage)



Source: Bank Call Reports, excluding Thrift Financial Report filers

While most commercial banks do not have as high exposure to rising rates as savings banks, some may have taken on significant risk. The median savings bank has a ratio of long-term assets to earning assets that corresponds to the ratio level for the 93rd percentile of commercial banks. Although the 93rd percentile is in the tail of the commercial bank distribution, almost 600 commercial banks have a concentration in long-term assets that exceeds that of the median savings bank. These institutions may be exposed to significant interest rate risk as well.

While assets have lengthened considerably for many institutions, there has not been a corresponding extension of liabilities. To the contrary, funding pressures are tending to make bank liabilities more rate sensitive. These diverging trends generate concern, especially in a rising interest rate environment. That is, rate increases drive up the cost of funds more rapidly than earning asset yields at institutions with liability-sensitive interest rate risk postures. In a significantly higher interest rate environment, many institutions' current postures likely would cause heavy margin erosion.

Most institutions that have high concentrations in long-term assets also have strong capital and an asset mix that contains lower credit risk than that of many other institutions. Among savings banks, interest rate risk primarily arises from significant concentrations in residential mortgage loans, whereas the typical commercial bank's exposure is more likely to arise from large holdings of long-term securities. However, some institutions with concentrations in long-term assets also may have lower capital levels, a higher-risk asset mix, or poor earnings. Rising rates could weaken these institutions and make it more difficult for them to weather adverse economic or other developments.

Dependence on Market-Sensitive Revenues Increases Earnings Volatility for Some Institutions

During the recent generally favorable conditions in financial markets, the share of revenue earned from business lines susceptible to financial market volatility has increased substantially for some of the industry's largest institutions. Among these revenue sources are fees and gains from asset management, brokerage, investment banking, venture capital, and trading activities. The 19 institutions most active in these lines of business earned over 26 percent of their net operating income from such sources in the second quarter of 2000. Other large institutions also have reported a growing dependence on these volatile sources of revenue.

Turbulence in the financial markets has led to greater earnings volatility for some of these institutions. Stress in the financial markets could weaken the demand for underwriting services or significantly reduce trading revenues or venture capital gains. Furthermore, the same factors that are causing volatility in the financial markets could hamper loan growth and lead to slower revenue growth from core business lines. Should increased earnings volatility from exposure to market-sensitive revenues combine with slower revenue growth from core business lines, some institutions could face significant earnings challenges.

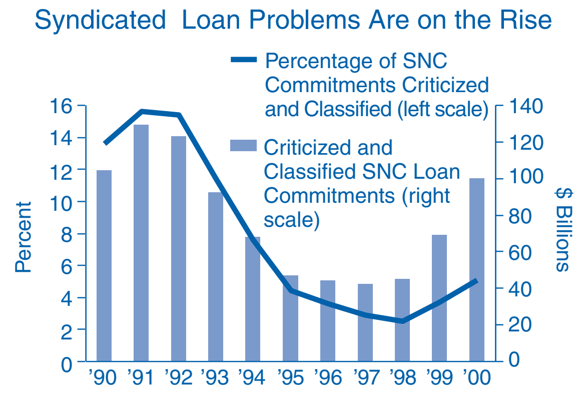
The Rising Level of Problem Business Loans Is Centered in Large Banks

Second quarter 2000 commercial and industrial (C&I) credit quality indicators at banks deteriorated for the eighth consecutive quarter. Noncurrent C&I loans—those on nonaccrual status plus those 90 days or more past-due—rose 13 percent over first quarter 2000 levels to $14.5 billion, or 1.4 percent of total C&I loans. Noncurrent loan levels for the period ending June 2000 were 40 percent higher than the year-earlier level. Net C&I loan loss rates also continue to edge higher but remain well below those experienced by banks in the late 1980s and early 1990s.[1]

Large banks, particularly those active in syndicated lending, are bearing the brunt of deteriorating C&I loan quality. Recent increases in criticized and classified shared national credits (SNCs), which are loans exceeding $20 million that are shared among three or more lending institutions, are illustrated in Chart 4. In the 2000 SNC review, criticized and classified credits increased 44 percent over 1999 levels to 5.1 percent of total SNC commitments. Furthermore, the bulk of the increase was in the more severe *classified* categories, which now comprise 64 percent of total criticized and classified credits, compared with 54 percent at the year-earlier review.

[1]During second quarter 2000, banks posted an annualized net C&I loss rate of 0.67 percent, up from 0.55 percent for second quarter 1999. For comparison purposes, net quarterly annualized C&I loss rates averaged 1.11 percent from fourth quarter 1991 to fourth quarter 1993.

CHART 4



Note: C&I = commercial and industrial; SNC = shared national credit
Source: Shared National Credit Program

C&I loan quality indicators continue to deteriorate despite generally favorable economic conditions. Three factors explain much of this deterioration: certain weak industries, rising corporate debt burdens, and the seasoning of syndicated loans underwritten from 1997 to 1998, when many banks significantly eased business lending standards.

Industry Sector Weaknesses

The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account for the full extent of the increase in noncurrent loans and problem SNC loans. Both of these sectors are within the broader services sector, which experienced a $4.6 billion increase in criticized and classified credits from the 1999 to the 2000 SNC review. However, this increase accounts for only 15 percent of the $30.8 billion increase in criticized and classified SNCs overall.[2] The expected default probabilities evident in market-based information can be used to identify other industry sectors experiencing financial stress. ***KMV LLC*** has developed a model that uses publicly available information to estimate the likelihood of default of individual firms.[3]

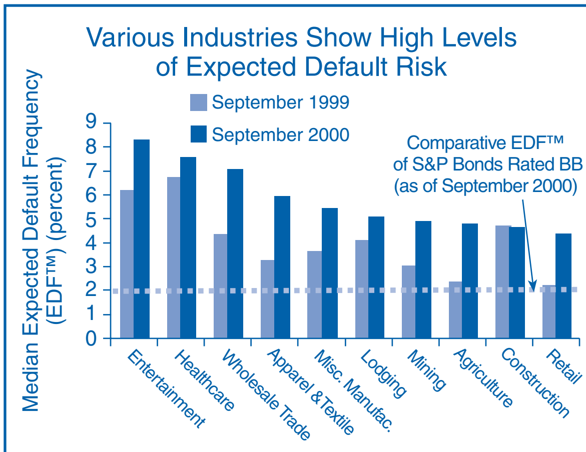
KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

Sectors that include a high proportion of firms with high default probabilities (median one-year default probabilities exceeding 4 percent) are shown in Chart 5. Using entertainment as an example, the bars in the chart show that in September 2000, one-half of publicly held entertainment firms had greater than an 8 percent chance of defaulting on their obligations within one year. In September 1999, this same proportion of entertainment companies had a substantially smaller (6 percent) chance of defaulting within a 12-month period. The median likelihood of default for all the industries shown in the chart far exceeds that of ***Standard & Poor's***-rated, BB-grade (sub-investment-grade) obligors as of September 2000, as indicated by the dotted line in the chart.

Rising Corporate Debt Burdens

U.S. corporate debt burdens, as measured by the debt-to-net-worth ratio for nonfarm, nonfinancial businesses, continue to increase. This ratio reached 83 percent in the second quarter of 2000, up from 72 percent as of year-end 1996. Although debt burdens remain below the 1988–1992 average of almost 87 percent, U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability.

CHART 5



Source: Credit Monitor™ ©2000, KMV LLC, all rights reserved

[2] See the interagency release of SNC results at www.occ.treas.gov/ftp/release/2000-78a.pdf.

[3] KMV Credit Monitor® uses information from a firm's equity prices and financial statements to derive KMV's Expected Default Frequency (EDF™), which is the probability of the firm defaulting within a one-year period. The main determinants of a firm's likelihood of default: the firm's asset value, the volatility of the firm's asset value, and the degree of financial leverage.

Seasoning of 1997–1998 Vintage Loans

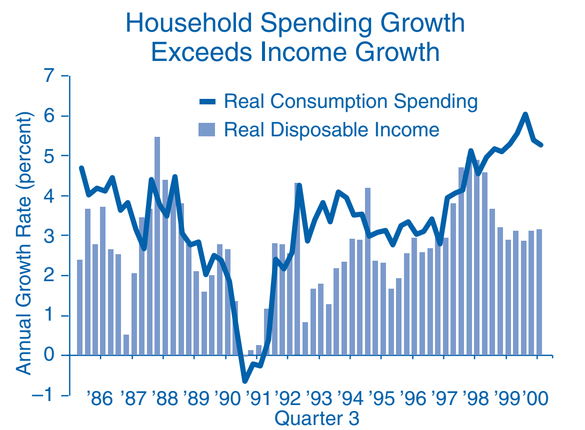
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] Not coincidentally, the period between 1995 and 1998 saw a sharp rise in the proportion of lower-graded, higher-risk credits categorized as leveraged transactions by ***Loan Pricing Corporation.*** Leveraged loan originations—those priced at 150 basis points or more over the London Inter-Bank Offer Rate (LIBOR)—rose from 12 percent of total syndicated loan originations in 1995 to 31 percent in 1999. According to a recent ***Standard and Poor's*** commentary, many banks have acknowledged that 1997 and 1998 vintage credits are beginning to produce higher problem loan levels.[5]

Household Sector's Leverage Is High, and Imbalances Are Appearing

Consumers are enjoying the benefits of the economic expansion, as jobs are plentiful, home ownership remains generally affordable, and credit seems to be readily available for financing motor vehicles and other major purchases. These conditions contributed to record high sales of cars and light trucks during the first nine months of 2000, helping sustain the consumer spending growth shown in Chart 6. One corollary of high vehicle sales, however, is softening prices for used vehicles. Consequently, some lessors—including banks—are realizing lower-than-expected residual values on leased vehicles, which, in turn, are triggering losses in their lease portfolios. This situation illustrates one problem that lenders can encounter even in good economic times.

Spending growth remained robust in recent quarters even as gains in disposable income slowed. The gap between income and spending growth is "financed" as households draw down savings, tap capital gains, refinance mortgages, assume more debt, or undertake some combination of these measures.

CHART 6



Source: Bureau of Economic Analysis via Haver Analytics, Inc.

From 1995 through 1998, and likely since then, the increase in both leverage and debt servicing burdens has been concentrated among low- and middle-income households. Among families holding debt in 1998, debt payments exceeded 40 percent of disposable income for nearly 20 percent in the $10,000 to $24,999 income group and nearly 14 percent in the $25,000 to $49,999 group.[6] One concern is that these debt-laden families may have inadequate financial resources to make payments should adverse conditions or job loss occur. In such instances, lenders could be doubly affected if households draw on their credit card and home equity lines of credit, further compromising their repayment ability, in order to sustain spending in excess of income. The recent rise in credit card losses in banks' card portfolios and rising losses in the portfolios of subprime lending specialists may indicate that strains among some households are spilling over to lenders. ***Moody's Investors Service*** expects credit card losses to rise through 2001, according to a recent analysis of prospects for the U.S. credit card industry.

Overheated residential real estate markets in several metropolitan statistical areas (MSAs) may be another warning of economic imbalances. Dramatic gains in home resale prices in San Francisco stand out (see Chart 7), but this market is not alone in experiencing appreciation considerably higher than income growth. In some markets, where financial-services or information-technology workers are concentrated, bidding wars for properties may reflect the fact that affordability is

[4] See Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices for May and August 2000* and Surveys of Credit Underwriting Practices for 1999 and 2000 from the Office of the Comptroller of the Currency.

[5] "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." July 20, 2000. *Standard and Poor's Commentary*.

[6] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. January 2000. "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin*. Vol. 86, 1–29.

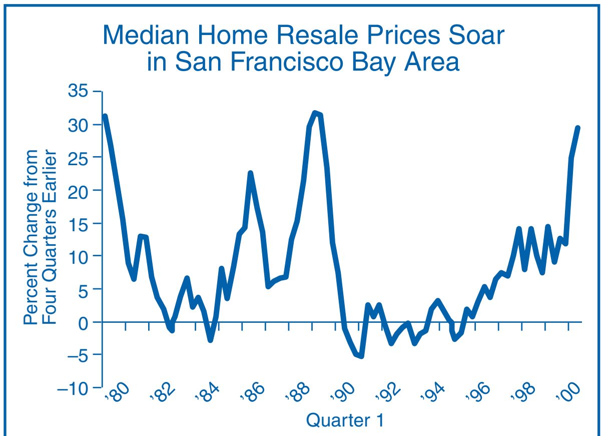
enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real estate lenders arises because pockets of speculative construction under way in some markets may produce units that become increasingly difficult to sell at anticipated asking prices.

Construction and Development Loan Growth Is Accelerating

Commercial real estate (CRE) construction across all property sectors has grown during this expansion, with office construction particularly active. The amount of office space completed in mid-2000 was the largest since 1989 and is projected by ***Torto Wheaton Research*** to continue rising. Not surprisingly, construction and development (C&D) loan volume, growth rates, and concentrations are trending upward rapidly. While total private real estate spending grew about 6.5 percent over the four quarters ending midyear 2000, C&D loans at insured institutions rose by 26 percent. C&D loan growth has remained above 20 percent since 1997, and the aggregate volume of C&D loans is the highest since 1989.

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a

CHART 7



Source: National Association of Realtors via Haver Analytics, Inc.

large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

Nine of the 16 markets highlighted in Table 1 not only have a relatively high percentage of C&D loan exposure but also appear vulnerable to overbuilding in two or more property types.[8] While these markets show no clear signs of emerging economic stress, lenders there clearly may be at greater risk should economic or real estate conditions sour. Other concerns regarding CRE lending arise from a recent ***Office of the Comptroller of the Currency*** survey, which reports heightened credit risk in CRE portfolios and predicts it will increase through 2001. In addition, respondents to a midyear 2000 FDIC survey of examiners reported more frequent comments about excess office and retail space.

Increasing Share of De Novo Institutions Raises the Stakes in Some Markets

A common element among the metropolitan markets listed in Table 1 (next page) is the presence of newer institutions. In 10 of the 16 markets, at least 20 percent of the nonspecialized community institutions are less than three years old. The drive to build market share among these institutions, particularly if they are publicly traded entities, is increasing the competitive pressure on banks and thrifts in these markets. In some instances, the aggregate cost of deposits within the MSAs has risen faster than in the nation as a whole, risk

[7] The term "nonspecialized community bank" refers to institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.

[8] See "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," *Regional Outlook,* third quarter 2000, which identifies markets where new construction is high relative to existing stocks of space.

TABLE 1

High C&D Loan Exposure Appears in Various MSAs		
MSAs with 15 or More Nonspecialized Community Institutions*	Share (%) of Institutions* with C&D Concentrations > or = 100% of Tier 1 Capital	Aggregate C&D Loans Relative to Aggregate Tier 1 Capital (as %) in This MSA*
Atlanta, GA	**65**	**156**
Phoenix–Mesa, AZ	**56**	**131**
Memphis, TN–AR–MS	52	154
Portland–Vancouver, OR–WA	**47**	**146**
Oakland, CA	47	163
Nashville, TN	44	103
Riverside–San Bernardino, CA	42	110
San Diego, CA	41	90
Grand Rapids–Muskegon–Holland, MI	40	81
Seattle–Bellevue–Everett, WA	**39**	**98**
Salt Lake City–Ogden, UT	**38**	**56**
Fort Worth–Arlington, TX	**38**	**110**
Dallas, TX	**36**	**95**
Las Vegas, NV–AZ	**35**	**119**
Lexington, KY	34	80
Denver, CO	**33**	**113**

*Sample includes institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.
Note: Boldface indicates major MSAs identified at risk for excess commercial real estate construction in Regional Outlook, third quarter 2000.
C&D = construction and development, MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports for June 30, 2000

profiles are being elevated, and aggregate leverage ratios are falling, despite the influx of capital from the new institutions. Highly competitive environments have the potential to increase risk taking by negatively affecting underwriting standards and balance sheet composition.

Farm Sector Challenges Continue

Much of the agricultural industry is experiencing stress because of low commodity prices, compounded in some areas by low yields resulting from weather- or disease-related problems. Strong global competition and high worldwide production during the past several years have resulted in large crop inventories, depressed prices, and limited prospects for a price turnaround in the near term. In the aggregate, record levels of government payments have helped the nation's farms maintain a generally stable financial condition but have not eliminated the stress in this sector. In fact, the ***U.S. Department of Agriculture*** projects that at least one in four farm businesses in several regions[9] will not cover net cash expenses in 2000, suggesting that the viability of highly leveraged farmers may be in question.

Fortunately, the aggregate condition of nearly 2,100 insured agricultural banks—institutions with 25 percent or more of loan portfolios in agricultural credits—remains healthy. Generally, agricultural banks continue to report favorable asset quality, earnings, and capital positions. However, they are experiencing somewhat elevated levels of noncurrent loans compared with nonagricultural institutions. Agricultural banks are disproportionately represented among the weakest 25 percent of institutions nationwide in terms of noncurrent

[9] These are USDA's Basin and Range, Mississippi Portal, Fruitful Rim, and Southern Seaboard regions. See www.ers.usda.gov/briefing/farmincome/fore/regional/regional.htm.

loan levels. In addition, rising levels of carryover debt at farm banks may translate into higher losses in the future if commodity prices remain low.

The strains in the farm sector also have implications for nonfarm banks in agricultural areas. In several agriculture-dependent states, such as Montana and the Dakotas, for example, where farmers' earnings are depressed and the economies not well diversified, nonagricultural banks are reporting higher noncurrent levels than insured institutions elsewhere in the nation.

Summary

The long-lived economic expansion has contributed to the banking and thrift industries' record levels of profitability and asset quality. However, as the expansion has matured, both consumer and corporate leverage has risen considerably. Bank liquidity is becoming increasingly strained by lackluster core deposit growth, which has been insufficient to fund strong loan demand. This trend has resulted in a decided shift into higher-risk asset classes to mitigate margin pressures arising from the greater reliance on noncore-funding sources. Furthermore, interest rate risk has risen significantly for many institutions, and after nearly a decade of improving asset quality, the level of problem loans is increasing.

Clearly, high levels of profitability in recent years have been achieved, in part, by an increased appetite for risk. Concern arises because insured institutions' current profitability is being negatively affected by some recent trends, despite the sustained economic expansion. And, while capital levels have remained fairly stable, the amount of risk being leveraged on the industry's capital base is on the rise. Just as a rising tide is said to float all boats, a strong economy can mask potential problems that will become evident should the economic tide turn, particularly in institutions or markets where above-average risk is concentrated. Insured institutions' safety and soundness may be most vulnerable in situations where banks and thrifts are exposed to multiple challenges, whether because of strategic decisions or because of repercussions from economic and banking forces beyond their control.

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