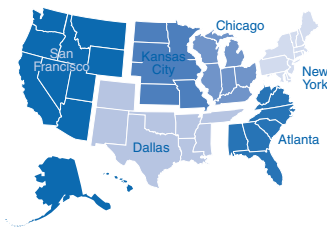

Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION

FOURTH QUARTER 2002

FDIC
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EDITION



DIVISION OF
INSURANCE
AND
RESEARCH

In Focus This Quarter

◆ *Economic Conditions and Emerging Risks in Banking*—In spite of the lingering effects of the recession that began in March 2001, the banking industry as a whole remains well-capitalized and highly profitable. A steep yield curve has boosted net interest income, more than compensating for the rise in provision expenses associated with higher credit losses. Strength in consumer spending and home building mitigated the effects of the recession and continues to support the recovery as the corporate sector undergoes restructuring. The most likely scenario for the economy over the next few quarters is continued slow growth as the recovery gains momentum. If realized, this scenario could afford banks the benefits of an improving credit picture without dramatically altering the current favorable interest rate environment. Despite the overall positive outlook, there are some areas of concern for the banking industry, such as lingering commercial credit problems, portfolio concentrations in formerly fast-growing metro areas, and subprime mortgage and consumer lending. *See page 3.*

By Stephen Gabriel, Thomas Murray, and Lisa Ryu

Regional Perspectives

◆ *Atlanta*—Certain metro areas were ranked according to their vulnerability to weakening in the housing market. Insured institutions' construction and development credit quality could deteriorate in these areas should uncertainty about the housing sector continue. *See page 12.*

◆ *Chicago*—Loan quality concerns linger as credit quality improvement is expected to lag the economic recovery. A return to a flatter yield curve could challenge management of interest rate risk. *See page 16.*

◆ *Dallas*

Midsouth—Lower interest rates benefited net interest margins in second quarter 2002. However, recent narrowing of interest spreads suggests that margins could decline in the near term. *See page 20.*

Southwest—Weak employment growth is contributing to rising office vacancy rates in some metro areas. At the same time, the insured institutions have significantly increased concentrations of commercial real estate loans. *See page 23.*

◆ *Kansas City*—The drought could cause stress for a large number of the Region's insured institutions. The effects of weakening in commercial real estate markets and earnings pressures are also of concern. *See page 28.*

◆ *New York*

Mid-Atlantic—Large bank profitability was mixed, with continued weakness in commercial credit quality. Interest rate risk management may be tested following record mortgage originations and changes in the yield curve. *See page 32.*

New England—Declining employment and earnings in the technology and financial services sectors are dampening regional economic growth. Overall, however, insured institution credit quality remains strong despite weak commercial real estate conditions. *See page 36.*

◆ *San Francisco*—Job growth remained sluggish. Earnings and asset quality have deteriorated somewhat among community banks, and improvement in credit quality may lag the economic recovery. *See page 39.*

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In Focus: Economic Conditions and Emerging Risks in Banking

Introduction

The recession that began in March 2001 appears to have ended in early 2002.¹ Still, significant uncertainty remains about the future path of the U.S. economy. In spite of the lingering effects of the recession, Federal Deposit Insurance Corporation (FDIC)-insured banks and thrifts posted record earnings in the first half of 2002. During this period, banks continued to experience rising credit losses, particularly on commercial loans to corporate borrowers. However, a steep yield curve helped boost net interest income, more than offsetting downward pressure on earnings resulting from credit quality deterioration.

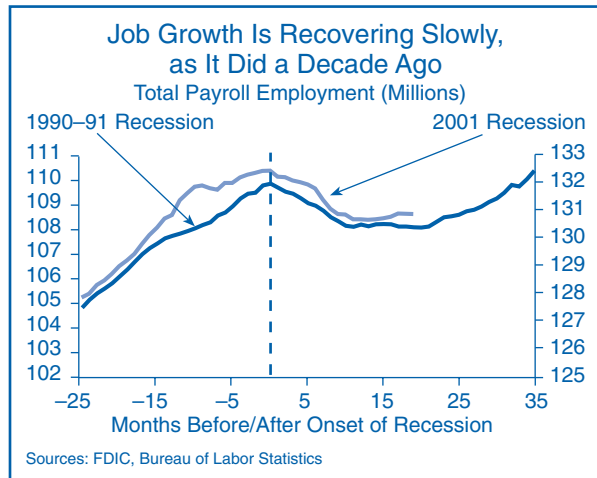
Most economists agree that the U.S. economy is likely to grow at a sub-par rate for the next several quarters. Under this “weak growth” scenario, bank earnings are expected to remain strong on the whole. However, risks for the banking sector remain, including a possibility of further credit quality deterioration in commercial loan portfolios, high credit exposure to previously fast-growing metro areas, and the ongoing problems of subprime consumer and mortgage lenders.

U.S. Economy: Slow Recovery Appears to Take Hold

The U.S. economy appears to be recovering from the mild recession that began in March 2001, but the pace of recovery has been slower than expected. From the peak of payroll employment in March 2001 to the trough in April 2002, the economy lost 1.78 million jobs. Although job growth has been positive in four of the past six months through October 2002, businesses have added only 215,000 jobs, on net, during that period. The weak employment picture thus far suggests that this recovery largely resembles the jobless recovery from the 1990–91 recession, which was also relatively short and mild. It took 34 months to recoup all of the jobs lost during that 9-month recession (see Chart 1).

¹ As of early December, the National Bureau of Economic Research (NBER) has not yet declared the end of recession. The NBER’s dating of a recession often lags the cyclical peaks and troughs by several quarters. See <http://www.nber.org/cycles/recessions.html>

CHART 1



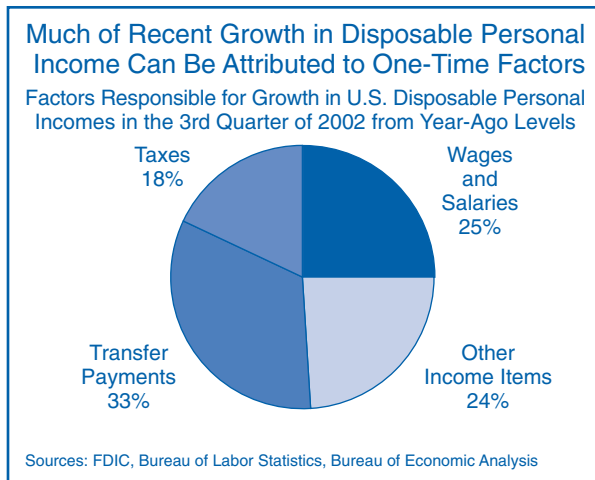
Robust Consumer Spending Has Supported the Economy

Consumer spending and home construction continue to be the twin pillars of economic activity. In spite of the weak employment outlook and dismal stock market performance, the average level of consumer spending during the first nine months of 2002 was 3.3 percent higher than year-ago levels. Some of the main drivers behind this robust growth include healthy growth in disposable personal income, low interest rates, and rising home values.

Real disposable personal income (real DPI) in the second quarter of 2002 was 4.9 percent higher than a year earlier, a growth rate that slowed somewhat to 3.0 percent in the third quarter.² While this robust growth in real DPI has been instrumental in supporting consumer spending, it can be argued that the growth was mostly the result of one-time events, including the 2002 tax cut and the extension of benefits paid to unemployed workers (see Chart 2). A declining tax burden and an increase in transfer payments accounted for 74 percent of the change in disposable personal income (net of the inflation adjustment) between second quarter 2001 and second quarter 2002, and 51 percent in third quarter 2002. Without additional fiscal stimulus, these one-time

² Real DPI takes into account wages and salaries, interest, dividends, rental income, taxes and transfer payments, and measures gains net of the rate of inflation.

CHART 2



effects largely will expire after the end of this year, returning the burden of income growth to the wages and salaries component.

Lower interest rates and inflation have also bolstered consumer purchasing power, allowing consumers' paychecks to stretch further. Auto dealers' zero-percent financing incentives, introduced in the fall of 2001, have boosted car sales to levels just below the record pace of last year. However, there are some signs that consumers' appetite for new automobiles may be waning. Despite continued availability of zero-interest financing programs, total vehicle sales fell from 18.7 million units in August 2002 to 15.4 million units in October 2002 on a seasonally adjusted annual basis.

Historically low mortgage rates continue to bolster the housing sector, which has been a key source of growth for the economy during this downturn. Strong increases in home prices have increased the equity of most U.S. homeowners, and many have converted a portion of their equity to cash through cash-out refinancing.³ *Freddie Mac* estimates that homeowners took about \$59 billion in equity out of their homes during the first nine months of 2002, some of which was used to finance consumer spending and home renovations.⁴ Other households have chosen to lower their monthly mortgage payments by refinancing at the lowest mortgage rates in more than a generation.

³ Cash-out refinancing refers to mortgage refinancing that results in new mortgages that are at least 5 percent higher in amount than the original mortgages.

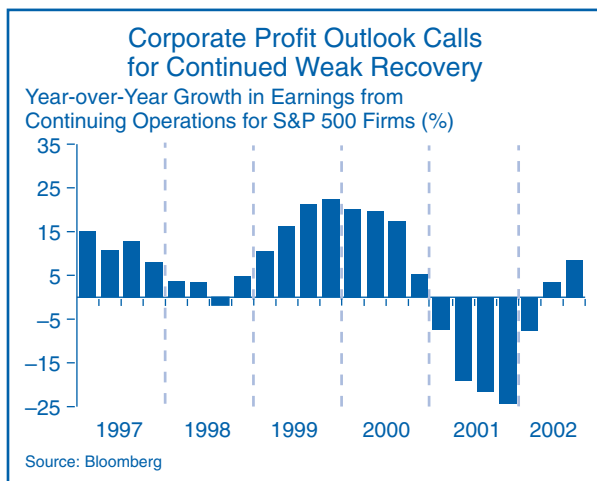
⁴ <http://www.freddie.mac.com/news/archives/rates/2002/3qubp02.html>

By some estimates, residential housing market activity contributed as much as 40 percent of net U.S. economic growth last year and more than 20 percent of GDP growth in the first quarter of this year.⁵ While housing has been a welcome source of support for U.S. economic activity, it should also be recognized that even a slight rise in mortgage rates could sharply curtail refinancing opportunities and slow the rate of appreciation in home values. Because long-term interest rates may rise as economic activity picks up, housing may not play as large a supporting role in the recovery as it did in the recession.

The Corporate Sector Restructures in Response to Declining Profits

The corporate business sector is working slowly through problems associated with high debt loads, industrial overcapacity, impaired earnings, and corporate governance scandals. Corporate profits have been weak for more than a year and a half, weighed down by sluggish pricing power and flagging demand. The business sector has responded quickly by restructuring balance sheets and cutting jobs in an effort to restore profits. However, the recovery in corporate profits has been significantly weaker than expected in early 2002. Year-over-year growth in earnings from continuing operations for S&P 500 firms increased by a modest 3.5 percent in second quarter 2002 from a depressed year-ago level. In third quarter 2002, corporate profits rose 8.5 percent from year-ago levels (see Chart 3).

CHART 3



⁵ Estimates from economy.com. See http://www.homeownershipalliance.com/media/press/pressreleasespressrelease_060502.html

Businesses remain cautious amid a weak earnings environment and depressed equity markets. Accordingly, business investment also remains weak. Nonresidential fixed investment shrank by 5.2 percent in 2001, and economists surveyed by the *Blue Chip Economic Indicators* expect investment spending to contract by another 5.5 percent in 2002 before rising by a modest 4.0 percent next year. By comparison, during the 1992–2000 expansion, annual increases in business fixed investment averaged about 9 percent.

The corporate sector continues to suffer from high levels of defaults, rating downgrades, and bankruptcies, although credit quality problems may have peaked in early 2002. According to *Moody's*, the default rate for U.S. speculative-grade corporate bond issuers fell to 10.4 percent in June 2002 from a peak of 11.5 percent in January 2002. The default rate is expected to fall to 9.2 percent by the end of this year. Telecommunications firms, which were hardest hit by the recession, were responsible for 55 percent of defaults by volume and 37 percent of defaulted issuers in the first half of 2002.

Productivity Growth Has Driven the Economy Forward

Perhaps the most positive signal to come out of the recent economic data is a resurgence in productivity growth. After slowing sharply in the middle of last year, year-over-year growth in output per hour in the nonfarm business sector surged to 4.4, 4.9, and 5.6 percent, respectively, in the first three quarters of 2002. Although the exact causes of productivity trends cannot be traced precisely, many economists believe that technological innovations of the late 1990s continue to spur the gains in labor productivity.⁶ And while these figures are subject to downward revision in the future, for now they provide evidence that businesses may be able to cut their costs at the same time workers benefit from higher wages and lower prices.

Until recently, evidence indicated that most of the gains of productivity growth were accruing to households.

⁶ “The Economic Outlook,” Testimony of Chairman Alan Greenspan Before the Joint Economic Committee, U.S. Congress, November 13, 2002. Also see Stephen D. Oliner and Daniel E. Sichel, “Information Technology and Productivity: Where Are We Now and Where Are We Going?” The Federal Reserve Board *Finance and Economics Discussion Series* 2002-29, May 10, 2002, for more in-depth discussion on factors behind recent labor productivity gains.

The *employment cost index*, a measure of changes in average wage and benefit compensation, increased by about 4.2 percent in both 2000 and 2001, well above both prevailing levels of consumer price inflation and increases in output per hour. The recent experience of the U.S. auto industry also shows how consumers have tended to capture productivity gains—as carmakers cut prices with zero-percent financing deals in late 2001 and auto sales boomed to record levels, the U.S. automotive industry as a whole lost \$9.5 billion for the year.

But there is evidence that businesses are capturing a larger share of the 2002 productivity surge. Much of the recent increase in productivity has resulted not from higher investment spending but from trimming payrolls and using the existing workforce more intensively. During the first three quarters of 2002, productivity gains outstripped the increase in the average employment cost index, which grew by 3.9 percent from the same quarter a year earlier. What this means is that productivity growth increasingly is accruing to the corporate bottom line and may be an inducement to higher investment spending in future quarters.

Where Is the Economy Headed from Here?

The strength of the current economic recovery may well hinge on the speed of recovery in business investment and the sustainability of consumer spending going forward. The outlook for business investment remains cautious given the relatively modest rebound in corporate earnings and the continuing financial market slump. As the corporate sector tries to shore up its bottom line, employment growth is unlikely to accelerate sharply. Unless the housing sector continues to benefit from historically low mortgage rates and rising home values (a somewhat optimistic scenario), consumer spending may moderate from recent robust levels of growth. At present, it is the apparent rebound in productivity growth that gives analysts hope that the corporate sector can continue to cut costs even as households register wage gains that boost disposable incomes. However, even if this recovery scenario unfolds as hoped, economic activity and total employment are expected to grow at sub-par rates at least until mid-2003.

A return to recession (often referred to as the “double-dip” scenario) remains a distinct, though unlikely, possibility. One reason for concern is that an economy growing below its potential is highly vulnerable to shocks that impair confidence and disrupt spending

plans. The current environment is rife with potential economic shocks: war with Iraq, a spike in oil prices, international trade frictions, the threat of terrorist attacks, and the emergence of new corporate governance scandals. It is likely that the uncertainties posed by factors such as these already are having a chilling effect on spending and hiring plans. If so, then the successful resolution of these tensions (for example, the conflict with Iraq) could reduce uncertainty and boost economic activity. However, the potential for a shock-induced double-dip recession remains of significant concern to the banking industry, in particular because of the deflationary pressures in the global economy and the dangers that deflation could pose for lenders (see Inset Box).

Banks Have Posted Record Earnings Despite the Recession

In spite of the recent recession and the slow pace of the apparent recovery, commercial banks posted record earnings of \$45.3 billion in the first half of 2002. Earnings were up 16.6 percent from a year earlier. Despite rising loan losses, particularly among large banks that lend to large corporate borrowers, bank earnings have been bolstered by strong gains in net interest income from strong deposit inflows and a steep yield curve (see Table 1).

How Real Is the Threat of Deflation in the United States?⁷

The minutes of the September 24, 2002, *Federal Open Market Committee* provide a glimpse into the policy debate about a likelihood of further price disinflation and its effect on the economy.⁸ As the U.S. economy recovers at a slower-than-expected pace with the inflation rate remaining below 2 percent, policymakers and economists have discussed the possibility of a deflationary scenario developing in the next few quarters. Of particular concern, from a policy point of view, is that the short-term interest rate is near an all-time low, leaving little room for policymakers to maneuver the short-term interest rate in order to boost domestic demand if a deflationary scenario develops. With a half-percentage-point reduction

⁷ As the rate of inflation has declined in recent years, deflation has been more frequently discussed as a threat to the U.S. economy. See Paul Bishop, "How Will the Expansion End?" *San Francisco Regional Outlook*, second quarter 1998.

⁸ Federal Reserve Board, Minutes of the Federal Open Market Committee, September 24, 2002. www.federalreserve.gov/fomc/minutes/20020924.htm. Disinflation refers to the still positive but falling rate of inflation, while deflation refers to a drop in the level of aggregate prices.

continued on the next page

TABLE 1

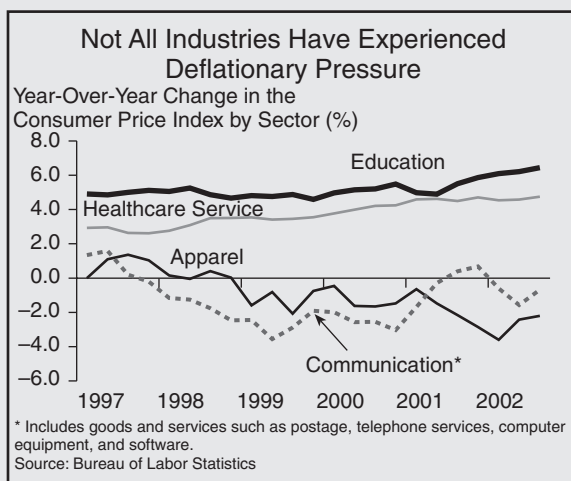
NET INTEREST INCOME BOLSTERED EARNINGS DURING THE FIRST HALF OF 2002, WHILE PROVISION FOR LOAN LOSSES ROSE FURTHER		
ALL FDIC INSURED COMMERCIAL BANKS (\$ IN MILLIONS)	FIRST 6 MONTHS 2001	FIRST 6 MONTHS 2002
NET INTEREST INCOME	\$104,820.0	\$117,627.3
LESS: PROVISION FOR LOAN AND LEASE LOSSES	16,782.6	22,461.6
PLUS: TOTAL NON-INTEREST INCOME	79,028.7	84,165.8
LESS: TOTAL NON-INTEREST EXPENSE	110,026.7	113,397.6
PLUS: GAIN ON SALE OF SECURITIES HELD TO MATURITY	2.3	-0.6
PLUS: GAIN ON SALE OF SECURITIES AVAILABLE FOR SALE	2,028.3	1,715.3
TOTAL INCOME PRE-TAX, PRE-EXTRAORDINARY ITEMS	59,070.0	67,648.6
LESS: INCOME TAX	19,889.4	22,417.2
TOTAL INCOME PRE-EXTRAORDINARY ITEMS	39,180.6	45,231.4
PLUS: EXTRAORDINARY ITEMS NET OF TAXES	-349.8	37.8
NET INCOME	\$38,830.8	\$45,269.2

SOURCES: BANK CALL REPORTS, RESEARCH INFORMATION SYSTEM

in the target rate on November 6, 2002, the federal funds rate now stands at 1.25 percent, the lowest rate since the late 1950s.

Whether the current disinflationary trend is a precursor to outright deflation remains to be seen. Some argue that the recent trend in aggregate prices is driven primarily by a few sectors and should not be viewed as an economy-wide trend. Indeed, prices for services such as medical care and education continue to rise at a robust rate even as the overall inflation rate falls. Deflationary pressure is most pronounced in manufacturing sectors where excess capacity and a substantial demand shortfall exist, such as in the telecommunications industry (see Chart 4). The fuel and apparel industries also face significant deflationary pressure, although fuel prices appear to be more dependent on geopolitics than economic conditions going forward.

CHART 4



However, as the U.S. economy continues to sort through the imbalances left over from the late 1990s, the falling inflation rate and historically low interest rates leave it vulnerable to deflationary pressure. The equity price bubble of the late 1990s and its subsequent collapse have created a significant mismatch of supply and demand in many sectors of the economy, which may not be resolved without some downward adjustments in prices.

A recent study by the *Federal Reserve* observes that deflation is very difficult to predict in advance, as evidenced by the recent case of Japan.⁹ The study concludes that the fact that deflation is more costly to the economy than inflation warrants a most aggressive monetary policy response to signs of a disinflationary trend.

Clearly, deflation would have significant adverse effects on the banking industry, depending on its severity and duration. Past episodes of asset and goods price deflation often coincided with banking crises, particularly when the banking sector was already in a weakened financial position. Given the current income and balance sheet strength of the U.S. banking industry, short and mild deflation is likely to have a limited adverse impact. However, prolonged deflation would present more serious challenges to the industry by eroding the collateral value of assets and increasing the real debt burden of borrowers. Deflation could also lead to a decline in nominal income for households and businesses, reducing their ability to repay outstanding debts. In combination, these developments likely would lead to significant credit quality deterioration, while an increase in real interest rates would weaken loan demand.

Despite these dangers, there are good reasons to think that serious deflation is unlikely to occur in the United States. One reason is a well-capitalized banking sector with relatively low levels of nonperforming loans. Another is the fact that policymakers appear to be alert to the dangers of deflation and determined to take steps to prevent it from taking hold. Finally, it appears that modern financial instruments and risk management tools contribute to the financial flexibility of households and businesses, reducing the potential for a widespread liquidity crisis. One example is the use of credit derivatives by commercial lenders to off-load credit risk. Another is the benefits of loan prepayment options that allow households and businesses to reduce their interest expenses by refinancing at lower interest rates. Together, these factors limit the possibility of a prolonged deflation that could seriously harm the banking industry.

⁹ Alan Ahearne, et al., "Preventing Deflation: Lessons from Japan's Experience in the 1990s," Board of Governors of the Federal Reserve System *International Finance Discussion Papers* 729, June 2002.

In the first half of 2002, commercial banks saw their net interest income increase by \$12.8 billion over year-ago levels. This increase was more than twice the growth in loan loss provisions, which rose by \$5.6 billion. The disparity between growth in net interest income and loss provisions largely explains why credit quality deterioration associated with the recession has had little effect on overall earnings. If the economy continues on a path of slow recovery, most banks are expected to maintain relatively strong financial positions.

The Number of Troubled Institutions Is Rising, but Remains Below Levels of the Early 1990s

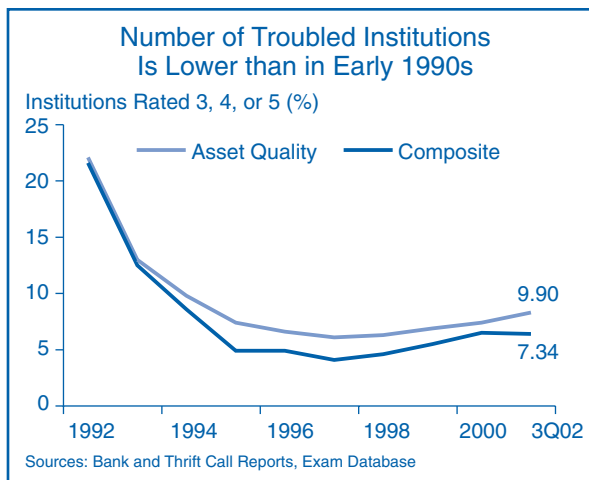
Supervisory ratings again deteriorated slightly during the first half of the year but remain far stronger on the whole than they were a decade ago. While the number and assets of *troubled institutions* remain low compared with the early 1990s, a significant upward trend is evident (see Chart 5).¹⁰ Approximately 7.3 percent of institutions were rated *composite* 3, 4, or 5 at September 2002, representing 3.4 percent of the industry's total assets. Nearly 10 percent of institutions had *asset quality ratings* of 3, 4, or 5 at September 2002, representing 9.7 percent of the industry's assets. Although the number of 3-rated institutions has remained relatively stable since year-end 2000, the number of 4- and 5-rated institutions has increased from 99 at December 2000, to 128 at December 2001, to 148 at September 2002.

Classified assets at large banks are growing faster than those at community banks.¹¹ As a percentage of Tier 1 capital plus reserves, large banks' classified assets increased to 26.9 percent in the second quarter of 2002 from 17.4 percent two years ago. At community banks this ratio increased to 14.6 percent in the second quar-

¹⁰ Supervisory ratings are assigned to banks according to the CAMELS rating system at the end of examinations based on performance in five areas: Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. Bank supervisors assign a 1 to 5 rating for each of these components and a composite rating for the bank. (The composite CAMELS rating does not represent an arithmetic average of assigned component rating, and the weight attributed to any component in determining a bank's overall composite rating depends on the degree of supervisory concern associated with the particular component.) Banks with ratings of 1 or 2 are considered to present few, if any, supervisory concerns, while banks with ratings of 3, 4, or 5 present moderate to extreme degrees of supervisory concern. For this analysis, banks with composite CAMELS ratings of 3, 4, or 5 are referred to as "troubled" institutions.

¹¹ Community banks are defined as banks with total assets less than \$1 billion, while large banks are defined as those with total assets greater than \$1 billion.

CHART 5



ter of 2002 from 12.7 percent at second quarter 2000. One factor driving this trend is the loan mix at large banks compared to the loan portfolio composition of community banks. Commercial and industrial (C&I) loans are typically a higher percentage of total loans at large banks than at community banks. As of June 30, 2002, banks with over \$1 billion in assets held C&I loans equal to 21 percent of total loans, compared with just 15 percent for community banks.

Market Indicators of Large Bank Performance Have Weakened

In spite of rising losses in large banks' commercial loan portfolios, the market perception of large banks appears to be mixed. Recent stock market declines have driven the median market-to-book ratio for the 25 largest U.S. banking companies down to 2.0 by September 2002 from a peak of 3.1 in March 1999. Still, the current ratio is significantly above the median ratio of less than 1.0 recorded in December 1990, during the last recession. The Philadelphia Bank Sector Index (24 large banking companies) dropped 14 percent during the year ending September 2002, although the index still managed to outperform the S&P 500 index.

The Banking Industry Faces Three Challenges in the Year Ahead

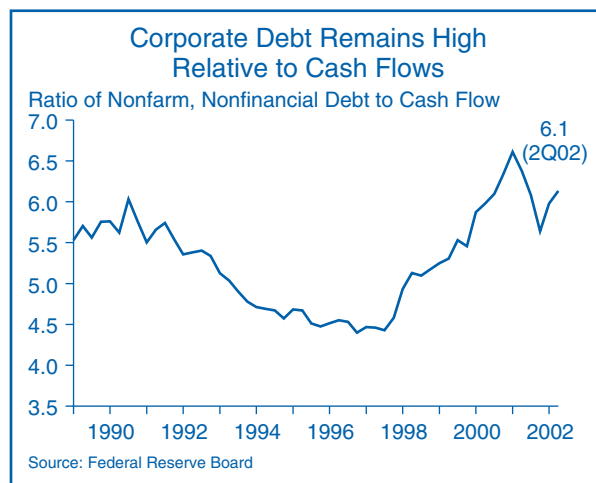
Although banking industry performance overall has remained strong in the wake of the recession, certain areas of heightened concern remain. Three areas that might pose problems are continued weakness in com-

mercial credit quality, credit concentrations in formerly fast-growing metro areas, and subprime mortgage and consumer lending.

Commercial Credit Quality. Excess capacity and weak pricing power continue to plague most of the business sector. Capacity utilization in U.S. manufacturing, mining, and utilities industries fell from 82.8 percent in June 2000 to 74.4 percent in December 2001, and remained just above 75 percent as of October 2002. For the beleaguered high-tech sector, the capacity utilization rate remains about 63 percent, with the communication equipment sector reporting a capacity rate of less than 50 percent.¹² In spite of attempts to cut debt loads, the level of corporate debt remains high relative to internally generated cash flow. The ratio of debt to cash flow for nonfarm, nonfinancial businesses fell from a historical high of 6.24 in 2001 to 6.13 as of June 2002; however, it remains significantly above the historical average of 4.9 percent between 1970 and 2001 (see Chart 6).

The weak economy and the problems of the technology and telecommunications sectors have pushed the percentage of criticized shared national credits (SNCs) to a ten-year high in 2002. Total criticized SNCs increased in 2002 to \$236.1 billion (or 12.6 percent of total commitments), from \$193 billion (9.4 percent) in 2001.¹³

CHART 6



¹² The high-tech sector includes computers, communications equipment, and semiconductors.

¹³ Criticized credits include loans classified as “substandard,” “doubtful,” or “loss,” plus those rated as “special mention.” For more information, see the interagency press release on the 2002 Shared National Credit review at: <http://www.fdic.gov/news/news/press/2002/pr10402.html>

Some 8.4 percent of SNCs (\$157.1 billion in commitments) were classified as substandard, doubtful, or loss in the 2002 review. The level of classified credits grew by 34 percent from the year before—a deceleration from the 86 percent rate of increase noted in the previous report. The troubled telecommunications and cable industries accounted for 18.7 percent of all criticized SNCs and about 40 percent of SNC losses in the 2002 review. In 2001, the telecommunications and cable industries represented 9.5 percent of all criticized SNCs.

Declining business demand continues to take its toll on office and industrial commercial real estate (CRE) markets. The nation’s major office and industrial markets have experienced falling rental rates, rising vacancies, and negative net absorption. The national office vacancy rate climbed to 16.1 percent at the end of September 2002, as declining rental rates and increasing vacancies continued to characterize all major markets. At the same time, the national industrial vacancy rate reached 10.9 percent, exceeding the previous record of 10.8 percent set in 1992.¹⁴

Although the outlook for CRE markets is rather pessimistic, banks have not yet seen a serious deterioration in CRE loan portfolios. Possible reasons for the apparent resilience of bank CRE portfolios in this cycle include stronger underwriting practices, continued scrutiny by federal bank regulators, increased participation by nonbank lenders, and the resulting scrutiny by market analysts. Still, stresses in CRE markets are starting to show up, with sporadic reports of office properties selling below replacement costs. Sales of properties at prices less than replacement costs were rampant in the late 1980s and early 1990s, resulting in severe loan losses to banks and thrifts and an interruption in commercial development that lasted for several years.¹⁵

Credit Concentrations in Formerly Fast-Growing Metro Areas. Growth in economic activity during the 1991–2001 expansion was not uniform across the nation. It tended to be most pronounced in certain metropolitan areas that specialized in high-tech or fast-growing service industries. These areas, in turn, tended

¹⁴ Torto Wheaton Research, *Office and Industrial Outlook*, Fall 2002. For perspective, the industrial property vacancy level of 10.9 percent as of September 30, 2002, translates to 1.2 billion square feet of vacant space, up by 50 million square feet from the previous quarter.

¹⁵ Dean Starkman, “Another Victim of the Bubble: Office Building Prices Decline,” *Wall Street Journal*, October 29, 2002.

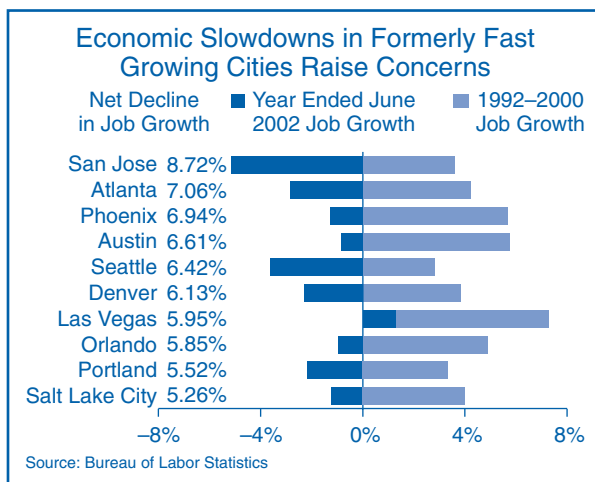
to be concentrated in the sunbelt and western states.¹⁶ During the expansion, community banks operating in some of these areas accumulated large volumes of commercial and CRE loans relative to equity capital. While these high loan volumes are easy to understand in light of the need to finance high levels of economic activity, they also created concentrations of credit risk. Banks operating with a concentration in high-risk loans (commercial, construction, CRE, and multifamily) are particularly vulnerable to unexpected economic trends in their metro areas.¹⁷

Since the onset of recession in March 2001, a number of these previously fast-growing metropolitan areas have experienced a marked deceleration or outright decline in job growth (Chart 7). An update of a methodology previously used to identify cities with both a concentration of higher-risk loans and significant slowdown in job growth results in a list of 13 cities where credit concentrations are a particular concern: Atlanta, Denver, Grand Rapids,

Las Vegas, Orlando, Phoenix, Portland, Salt Lake City, San Francisco/Oakland, San Jose, Sarasota, Seattle, and Tampa.¹⁸ The purpose of this exercise is not to pass judgement on specific institutions or loan types, but rather to point to conditions that warrant extra attention to risk management practices on the part of lenders.

Subprime Mortgage and Consumer Lending. Developed largely since the 1990–91 recession, subprime lending (defined as a program of lending to borrowers with limited or impaired credit histories) has been the subject of significant regulatory and market concern during the past few years. Although subprime lenders routinely incur much higher credit losses than prime lenders, they also tend to earn commensurately high returns. Since the onset of recession in March 2001, however, subprime lenders have seen loss rates rise sharply—in many cases well above levels predicted by internal credit models. These unanticipated losses have narrowed the difference in earnings between subprime and prime credit card lenders and are forcing subprime lenders to recalibrate their models.

CHART 7



The FDIC currently identifies approximately 125 institutions with subprime loans equal to at least 25 percent of Tier 1 equity capital. Among credit card specialists in this group, net charge-offs in the second quarter of 2002 were 8.4 percent of average outstanding balances, compared with 2.8 percent for credit card specialists that were not also identified as subprime lenders. Subprime credit card specialists reported a 4.2 percent return on assets in the second quarter, compared with a 3.3 percent return on assets for non-subprime credit card specialists.

Another source of concern is the continued prevalence of subprime lenders among failed and problem institutions. From the beginning of 1997 through the second quarter of 2002, 31 FDIC-insured institutions with \$6.8 billion in assets failed. Of these, 31 percent (holding 64 percent of failed bank assets) had been identified as subprime lenders. Some 88 percent of estimated losses to the insurance funds resulted from the failure of subprime institutions. Subprime institutions continue to be over-represented among troubled institutions. The institutions identified as subprime lenders make up only 1.4 percent of all FDIC-insured institutions. However, subprime lenders account for 8.2 percent of all troubled institutions.

¹⁶ See “Back to the Future: How This Downturn Compares to Past Recessions,” *Regional Outlook*, second quarter 2002, <http://www.fdic.gov/bank/analytical/regional/ro20022q/na/Infocus.html>

¹⁷ A similar methodology was used in “Back to the Future,” *Regional Outlook*, second quarter 2002, article to identify ten metro areas where credit concentrations were of particular concern.

¹⁸ Eight of the 13 cities in this list were considered “markets at risk” for CRE overbuilding in “Ranking Metropolitan Area’s Risk For Commercial Real Estate Overbuilding,” *Regional Outlook*, third quarter 2000 (see <http://www.fdic.gov/bank/analytical/regional/ro20003q/na/index.html>).

Conclusion

The recession that began in March 2001 is probably over and, on balance, it has had only limited adverse effects on the overall financial condition of FDIC-insured institutions. Credit losses have risen substantially at large banks that lend heavily to large commercial borrowers, but strong deposit growth and wider net interest margins have helped produce record bank earnings. Strong consumer spending and residential real estate activity have supported the economic recovery to this point, although a continuation of these positive trends is by no means certain.

As the corporate sector restructures, the U.S. economy appears to be undergoing a modest recovery similar to the upturn that followed the 1990–91 recession. During this process, risks will predominate on the downside due to the unusually large number of economic and geopo-

litical uncertainties. These factors, which may be inhibiting economic activity at present, could at some point grow more serious and even threaten to push the economy back into recession.

Specific areas of concern for FDIC-insured institutions include (1) continuing credit losses at large banks on loans to large, corporate borrowers, (2) concentrations of credit risk among smaller institutions headquartered in formerly fast-growing metro areas, and (3) subprime lenders, which continue to figure prominently among failed and troubled institutions.

Stephen Gabriel, Senior Financial Economist

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Atlanta Regional Perspectives

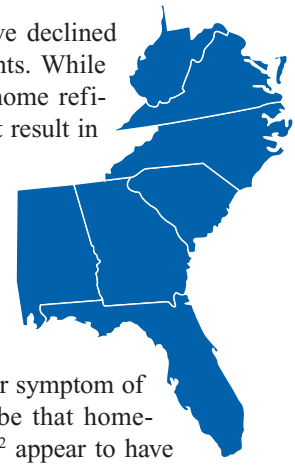
Weak Economic Growth May Affect the Atlanta Region Housing Market

The severity of the recent economic downturn, although keenly felt in several metropolitan area labor markets, has been mostly offset by strength in the Atlanta Region housing markets. Home prices have continued to appreciate and low mortgage rates have helped support home sales; however, this critical component of the Region's economy may be showing some signs of weakening. This article attempts to identify markets that may be most vulnerable to this weakening and assess the implications for the Region's banking economy.

Low Interest Rates May Not Be Spurring Home Sales in the Atlanta Region as in the Past

Traditionally, declines in mortgage rates have fostered increases in home sales, as more first-time homebuyers can afford homes, while existing homeowners may trade up in the market. However, during 2002, this relationship may not have been as strong as expected in the Atlanta Region. According to Freddie Mac, by late September interest rates on 30-year fixed-rate mortgages in the Southeast¹ had fallen below the 6 percent threshold for the first time in more than two decades. Since March of

this year, mortgage rates have declined by more than 100 basis points. While prompting record levels of home refinancings, this decline did not result in a surge in home sales (see Chart 1). In fact, anecdotal evidence in a number of the Region's markets indicates that demand for higher-end homes has weakened and prices for these homes have come under pressure. Another symptom of the declining demand may be that home-ownership rates in the South² appear to have peaked or even declined slightly during the year ending second quarter 2002. Housing markets may have reached a point at which lower interest rates do not result in a corresponding increase in sales.

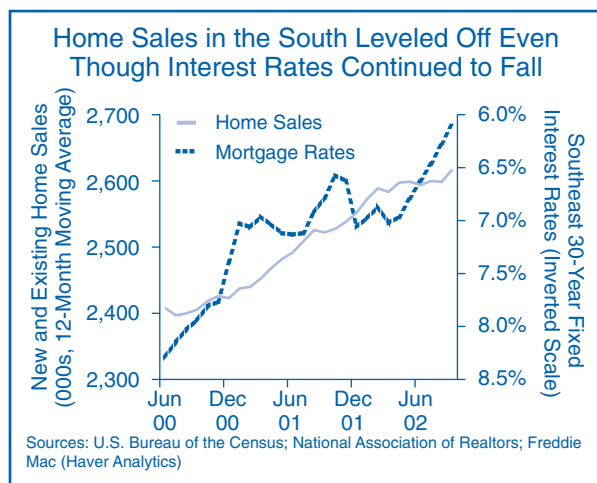


How We Measured Vulnerability in Housing Markets

The importance of the housing sector to the Atlanta Region economy makes it essential to identify metropolitan area banking markets that are vulnerable to the effects of weaker housing demand. We constructed a housing market risk ranking measure that considers three factors: economic conditions, home price-income growth divergence, and banking industry exposure.

Economic Conditions. Although any economic downturn can pose challenges to the banking industry, areas that have experienced a sea change in the level of growth may be particularly vulnerable. A period of rapid expansion followed by an unexpectedly sharp decline in the level of growth may prove exceptionally disruptive as the local economy struggles to readjust to the new business environment. The **Atlanta** metro area has experienced dramatic and rapid changes. During the 1990s, Atlanta's rate of job growth ranked among the nation's highest. In contrast, during the year ending

CHART 1



¹ Freddie Mac defines the Southeast as North Carolina, South Carolina, Tennessee, Kentucky, Georgia, Alabama, Florida, and Mississippi.

² U.S. Census Bureau definition includes the following states: Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

August 2002, the metropolitan area experienced the largest percentage of job losses in the Atlanta Region. To capture this effect, we compared the difference between 1992 to 2000 annual job growth and the percentage change in employment during the year ending August 2002 across all Atlanta Region metropolitan areas.

Home Price-Income Growth Divergence. Although home prices in the Atlanta Region have continued to appreciate during the recent recession, disparities between home price and income growth over the longer term may contribute to the emergence of home price “bubbles.” Such disparities have occurred in several metropolitan markets, particularly in **Florida**, during the past few years. This component attempts to quantify this imbalance by comparing growth in personal income and home prices between 1998 and 2001.

Banking Industry Exposure. The third component of the risk ranking attempts to gauge the local banking industry’s level of participation in a metropolitan area’s homebuilding sector. For purposes of our analysis, we considered commercial banks with assets less than \$1 billion.³ We also limited our examination to markets with at least seven locally headquartered community banks, which restricted our universe to 25 metropolitan areas in the Atlanta Region. To measure the degree to which the local banking industry was involved in homebuilding, we compared the level and trend in construction and development (C&D) lending exposure. Although C&D lending includes residential and commercial construction loans, most community bank involvement has been in residential development.⁴

The risk ranking measurement was equally weighted between the economic (economic conditions and home price-income growth divergence) and banking (level and trend in C&D exposure) components.

³ Large banks (assets greater than \$1 billion) were not considered in this analysis, as these institutions likely lend in several markets, and it is difficult to measure exposure to economic conditions in a particular metropolitan area.

⁴ While Call Report data do not allow us to discern lending between residential construction and construction for other purposes in the Atlanta Region, the limited asset size of these institutions generally precludes their involvement in large office, industrial, and retail projects. Discussions with bank examiners and bankers also generally confirm that most of the C&D lending at community banks is for residential projects.

Analysis of the Results of the Housing Market Risk Ranking Measurement

The risk calculation⁵ resulted in a ranking of the 25 metropolitan areas by economic and banking exposure, as shown in Table 1. Owing to the comparatively severe effects of the recent recession and the high and rising level of C&D exposure, Atlanta ranked first. Anecdotal evidence presented in a recent *Atlanta Journal-Constitution* article⁶ appears to confirm the vulnerability of the Atlanta area’s housing market. The effects of the metropolitan area’s economic weakness also may be emerging in the form of rising foreclosure rates. The relatively high level of banking exposure in the Atlanta area may be exacerbated by the fact that it is home to nearly 90 community banks, almost equal to the sum of the next seven highest-risk ranked metropolitan areas. Despite the effects of the recession on the local economy and the large banking exposure, home price appreciation and income growth in the Atlanta area have diverged only slightly since 1998, a fact that may help support price levels in the housing market.

⁵ To capture major economic changes that may have occurred in each of the 25 markets, we looked at annual job growth for the periods 1992 to 2000 and August 2001 to August 2002. Subtracting the two measures for each market, we obtained a basis point difference. Markets with the greatest difference (negative) were ranked higher in terms of divergence of economic growth. For example, Atlanta ranked first with job growth for 1992–2000 at 4.4 percent annually and for August 2002 (year-ago percentage change) at minus 2.9 percent—a difference of minus 727 basis points.

We measured the divergence in growth between home prices and personal income by comparing the growth in these two measures between 1998 and 2001. Markets with the greatest basis point difference were ranked higher in terms of divergence in home price and income growth. For example, Norfolk ranked first, with home price growth of 11.1 percent versus 7.3 percent in personal income growth—a difference of 378 basis points.

We measured the level of involvement in homebuilding by ranking median C&D exposure (loan-to-asset ratios). Atlanta ranked first, with a median exposure of 16.76 percent. The trend in this exposure during the recent recession may be as critical to gauging risk and was designated as the fourth component in our risk ranking. We ranked the change in median C&D exposure between second quarter 2002 and second quarter 2001. Fort Myers ranked first, with an increase in median C&D exposure of 451 basis points.

We weighted the measures equally and summed the rankings for each metropolitan area. The metropolitan area with the lowest sum was ranked first in terms of overall market risk. Atlanta ranked first, with the lowest sum. Atlanta ranked 1 in economic growth divergence, 13 in home price-income growth divergence, 1 in level of C&D exposure, and 4 in trend of C&D exposure, for a sum of 19.

⁶ Michael Kanell, “Housing Market Shows Signs of Slowing,” *Atlanta Journal-Constitution*, October 17, 2002.

TABLE 1

ATLANTA RANKS FIRST IN THE HOUSING MARKET RISK MEASURE	
RANK	METROPOLITAN AREA
1	ATLANTA
2	SARASOTA
3	FORT MYERS
4	WEST PALM BEACH
5	FORT LAUDERDALE
6	ORLANDO
7	ROANOKE
8	JACKSONVILLE
9	DAYTONA BEACH
10	TAMPA
11	MOBILE
12	GREENVILLE
13	SAVANNAH
14	RALEIGH
15	MACON
16	NORFOLK
17	CHARLOTTE
18	BIRMINGHAM
19	CHATTANOOGA
20	WASHINGTON
21	GREENSBORO
22	MIAMI
23	FORT WALTON BEACH
24	RICHMOND
25	NAPLES

NOTE: RISK RANKINGS BASED ON FOUR FACTORS: CHANGE IN RATE OF ECONOMIC GROWTH, DIVERGENCE BETWEEN HOME PRICE AND INCOME GROWTH, AND CONSTRUCTION AND DEVELOPMENT LENDING LEVELS AND TRENDS.

The results of the ranking show the predominance of Florida’s metropolitan areas, which account for eight of the top ten metro areas. Although job losses in the state’s metropolitan areas during the year ending August 2002 generally were modest compared to those experienced in many other areas of the Atlanta Region, these losses often represented a substantial departure from performance during the 1990s expansion. Consequently, Florida’s markets ranked high in terms of the change in economic conditions. The **Sarasota, Tampa, Fort Lauderdale, and Jacksonville** economies also ranked high in terms of the level of disparity between home price appreciation and income growth. At the

same time, insured institutions headquartered in each of these metropolitan areas have reported rising levels of C&D loan exposure, especially in **Fort Myers**, where the median C&D exposure in second quarter 2002 was 11.32 percent, up more than 400 basis points from the previous year. Institutions headquartered in **Orlando** and **Jacksonville** reported increases in excess of 200 basis points during the same period.

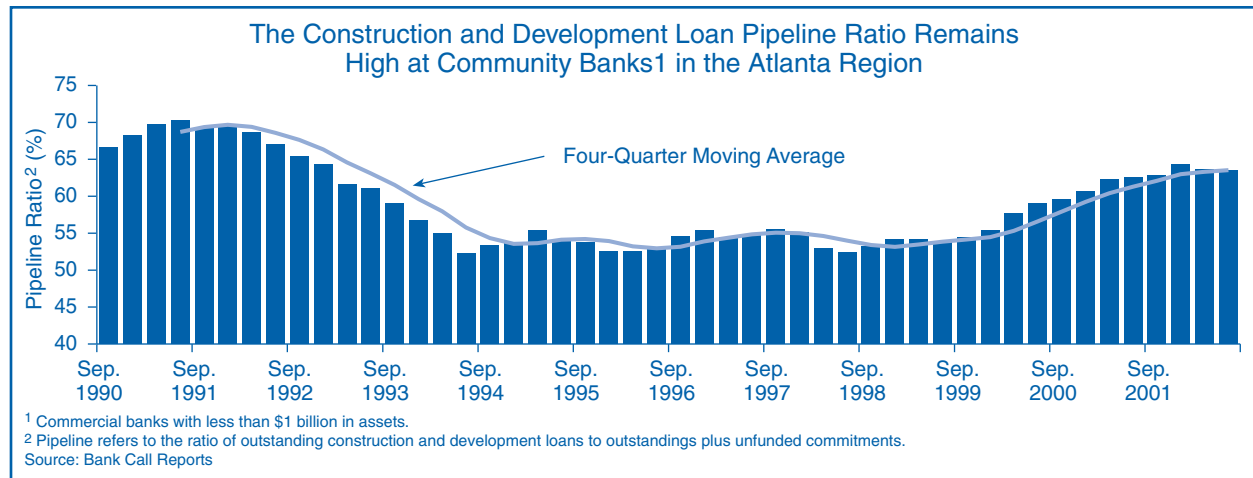
In contrast to other Florida metropolitan areas, **Naples** ranked last among the 25 areas studied. Although the median C&D loan exposure among community banks in this metro area was 7.88 percent, up 90 basis points from the previous year, the area has not experienced a comparatively sharp change in the economic environment, and growth in personal income has outpaced home price appreciation. **Miami** also ranked at the lower end of the spectrum. However, given the substantial change in economic performance during the recession compared to the 1990s, in addition to other factors, such as weak growth in Latin America, the metropolitan area continues to be vulnerable to any weakening in the housing market.

Metropolitan areas outside Florida tended to rank lower for different reasons. **Raleigh**, for example, ranked 14th, largely due to the fact that incomes have kept pace with home price appreciation. However, the metropolitan area witnessed a substantial adverse change in economic conditions, while C&D exposure remained high and continued to rise. Elsewhere in North Carolina, the **Greensboro** banking market continued to report rising levels of C&D exposure, despite declining employment levels. The **Charlotte** and **Greensboro** metro areas have experienced home price pressures in higher-end markets.

Recent C&D Loan Performance among Atlanta Region Community Banks Remains Reasonably Strong

Although the results of the housing market risk ranking highlighted market vulnerabilities, C&D loan credit quality has shown limited deterioration. Community banks in the 25 metropolitan areas covered by this analysis reported 1.18 percent of all C&D loans as noncurrent in second quarter 2002, up 33 basis points from one year earlier. The greatest increases occurred in **Miami** and **Fort Walton Beach**. However, credit quality deterioration may have been masked by bor-

CHART 2



rowers drawing on credit lines, as could be suggested by the rising share of outstanding C&D loans to C&D loans plus unfunded commitments⁷ (see Chart 2). In addition, credit quality tends to lag the economic cycle, and, depending on the direction of housing markets, C&D loan quality may remain a concern in the coming quarters. Recent increases in residential foreclosure rates across the Atlanta Region may indicate

how housing markets will perform in the near term. Should uncertainty about the economy and the Region's housing markets continue, lenders should monitor C&D loan performance for any signs of further deterioration.

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⁷ Often referred to as the "pipeline ratio."

Chicago Regional Perspectives

Improving economic conditions in the Region¹ suggest that economic recovery has been under way for the past year. Nevertheless, the nascent recovery has yet to return the Region's economy to prerecession levels of employment or manufacturing activity. While the condition of the Region's banks and thrifts is substantially stronger than immediately after the recession of the early 1990s, significant challenges remain. Although loan quality represents the greatest immediate risk, management of interest rate risk could be particularly challenging during the coming year.

Loan Quality Concerns Linger while High-Risk Loan Exposures Grow

As asset quality improvement may lag the economic recovery, asset quality among the Region's insured institutions remains a significant concern. The aggregate past-due² loan ratio for community banks³ has yet to show meaningful improvement. The past-due ratio for community banks stood at 2.34 percent on June 30, 2002, only 15 basis points below the recent peak on December 31, 2001. This meager improvement has occurred among loans that are moderately past due. Noncurrent loans, a designation that encompasses loans 90 days past due or in nonaccrual status, have held at 1.06 percent of loans for the past two quarters, well above the 0.74 percent level experienced immediately before the recession. Should noncurrent loan rates rise further, profitability may be affected adversely, as the allowance for loan and lease losses (ALLL) may need to be bolstered.⁴

Whether the slight improvement in total delinquencies observed in 2002 marks the beginning of a sustainable improvement in asset quality remains to be seen. Clearly, many commercial and consumer borrowers have refi-

nanced, availing themselves of lower interest rates to reduce debt service requirements. Nevertheless, certain loan segments, such as nonresidential commercial real estate (CRE), may have yet to experience the full effects of last year's recession. Softness in many of the Region's CRE markets may make it difficult for lessors to replace expiring leases on equally favorable terms.⁵



Community banks continued the long-term trend toward increased concentrations in traditionally higher-risk loan segments, such as CRE lending, during the past two years. The greatest potential for credit quality issues going forward likely resides in the construction and development⁶ (C&D) and commercial and industrial (C&I) portfolios. C&D lending historically has been susceptible to relatively high charge-off rates. Within C&D, net charge-offs are already high relative to other loan types. Exposure to this business line, currently 6 percent of total loans, is roughly twice what it was in the early 1990s and has grown continuously, despite the weak macroeconomic environment of the past two years. The proportion of C&I loans has held steady throughout the past decade, but this portfolio segment recently has experienced a marked increase in delinquencies. The C&I loan portfolio had the highest noncurrent loan percentage of all loan types as of June 30, 2002, reaching its highest level in the past two years (see Chart 1).

Looking ahead, if the fragile recovery continues to gain strength, credit quality concerns are likely to subside. However, renewed macroeconomic weakness may pressure many insured institutions that have increased exposure in traditionally higher-risk loan segments, such as CRE and C&I lending.

¹ Beginning in the first quarter 2003 edition of the *Regional Outlook*, the Chicago Region will include the state of Kentucky.

² Past-due includes loans at least 30 days delinquent or in nonaccrual status.

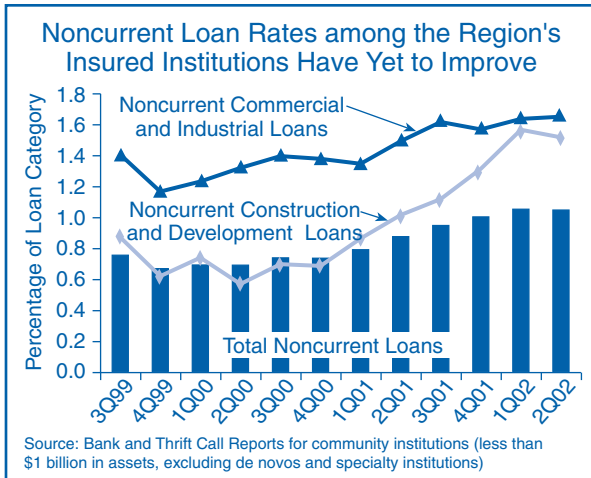
³ Insured institutions with less than \$1 billion in assets, excluding institutions less than three years old and specialty institutions, such as credit card banks or institutions with very low loan levels.

⁴ Although the ratio of ALLL to total loan levels has increased steadily during the past two years, ALLL coverage of nonperforming loans is down sharply, from 156 percent two years ago to 112 percent as of June 30, 2002. During the same time period, Tier 1 leverage capital rose from 9.20 percent to 9.40 percent of average assets.

⁵ Office vacancy rates increased in all but one of the Region's seven major CRE markets in second quarter 2002, with rates ranging from 13.3 percent in Chicago to 22.0 percent in Columbus, Ohio. The vacancy rate in each market is significantly above the year-ago level.

⁶ Call Reports do not distinguish between safer pre-sold owner-occupied residential construction loans and speculative residential real estate or commercial construction loans.

CHART 1



Interest Rate Risk and Persistent Net Interest Margin Compression Challenge the Region's Insured Institutions

The Region's community institutions have faced declining net interest margins (NIMs) for the past decade, evidence of structural changes within the banking industry and an increasingly competitive environment. An increasingly competitive banking environment has resulted in pricing pressure on both sides of banks' balance sheets. Growth in noncore funding,⁷ generally more expensive than core funds, has contributed to some of the long-term NIM compression. However, what makes the deteriorating NIM trend noteworthy is that it has occurred as community banks were using strategies that generally would be expected to improve NIMs. For instance, loan-to-asset levels have increased, and the portion of securities portfolios invested in lower-yielding Treasuries and Agencies has declined. Within loan portfolios, the share of CRE loans has risen markedly, which should boost loan yields. Furthermore, capital levels are high relative to ten years ago, reducing the need for interest-bearing liabilities.

These strategies have not improved NIMs, as would normally be expected, because the Region's community institutions have been faced with balance sheet and margin disruptions resulting from the significant steepening of the yield curve during 2001. Although steep yield curves are generally considered beneficial to NIMs, the rapid transition from a relatively flat to a steep yield curve proved detrimental to many institutions that would be

⁷ Noncore funding consists of large time deposits, brokered deposits, foreign office deposits, and other borrowings.

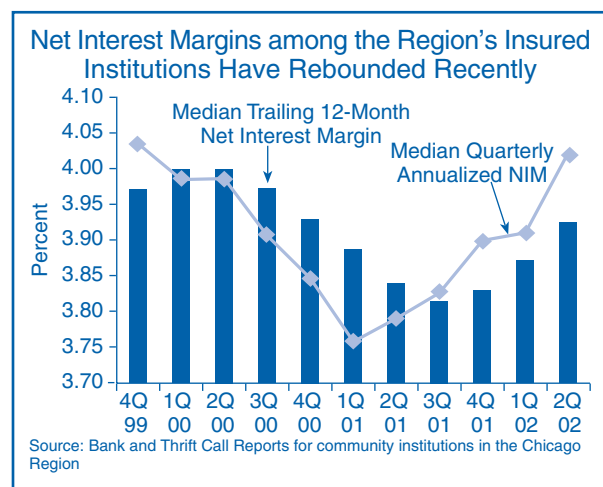
expected to benefit from a gradual decline in short-term rates. Initially, asset yields responded to falling rates more quickly than institutions could adjust funding costs, which exacerbated the competition-related NIM pressure.

Recent margin improvements (see Chart 2), however, show that the disruptions associated with balance sheet restructurings have abated, and insured institutions are starting to benefit from the significant spread between long- and short-term rates. Across the Region, median NIMs were dipping even before the first interest rate cuts occurred in 2001. The trailing 12-month median NIM peaked June 30, 2000, and bottomed on December 31, 2001. An analysis of the median quarterly annualized NIMs shows that the initial disruption was substantial, as prepayment options in loan and securities portfolios were exercised. Quarterly annualized NIMs, which give a more timely view of margin trends, essentially have reached early 2000 levels, even though full-year margins have turned upward only recently. Barring another rapid yield curve shift, trailing 12-month NIMs are expected to continue improving in the near term.

Shifting Balance Sheets and a Return to a Flatter Yield Curve May Challenge Management of Interest Rate Risk for Some Institutions

More recently, growth in loan-to-asset levels has contributed to the recent improvement in margins among insured institutions in the Chicago Region compared with institutions elsewhere in the nation. As loans are generally higher yielding than securities, margins have benefited. Furthermore, CRE lending, typically one of the higher-yielding loan segments, has risen relative to total loans.

CHART 2



Regional Perspectives

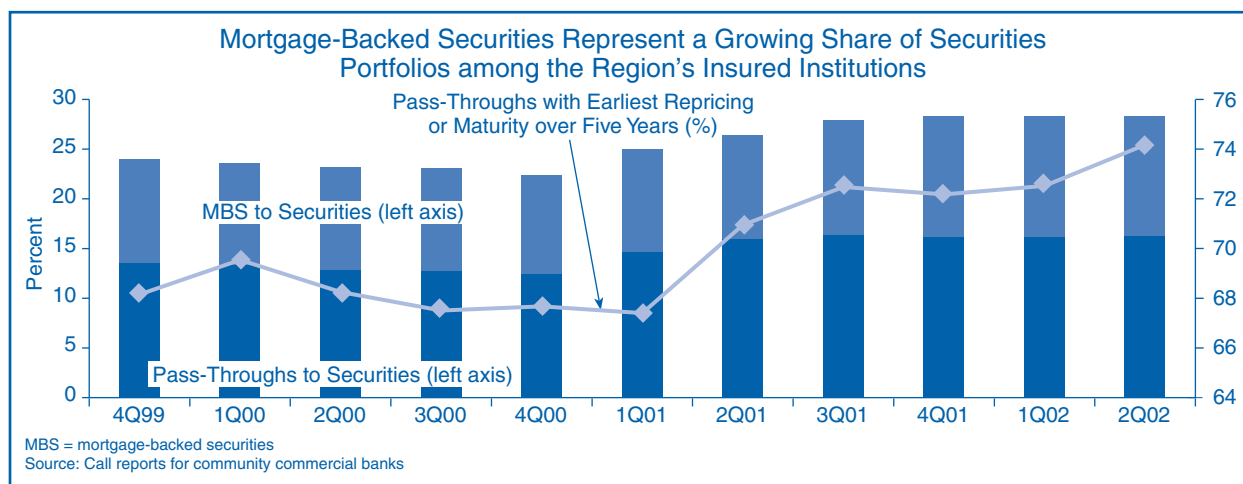
Conversely, community commercial banks⁸ have pulled back on residential real estate lending, despite significant mortgage origination volumes occurring nationally, perhaps an indication of increased preference in the Region for higher-yielding credits. Next year, any sharp decline in mortgage origination refinancing activity⁹ likely will increase competition for home mortgage lending, further pressuring pricing. As institutions try to manage the expected decline in volume, management also will contend with an increased preference for adjustable rate mortgages (ARMs).¹⁰ Even though 30-year fixed-rate mortgage rates are at 30-year lows, the spread between 30-year fixed-rate mortgages and one-year ARMs is at a ten-year high.¹¹ For many institutions, higher shares of ARMs will alleviate some interest rate risk challenges, but such a strategy comes at the cost of lower initial loan yields.

In addition, a migration toward higher-yielding instruments has occurred in securities portfolios. The widening spread between the current yield on fixed-rate

mortgages and comparable maturity U.S. Treasury securities has made mortgage-related investments appear more attractive.¹² Higher shares of pass-throughs and mortgage-backed securities have contributed to increased option risk in securities portfolios (see Chart 3). Furthermore, the percentage of pass-through securities effectively repricing after five years has been rising. Option risk resulting from these positions can manifest itself in two ways: mortgage-backed securities may lengthen in duration because of the deceleration of prepayments (i.e., increased extension risk) in a rising rate environment, or principal prepayments may occur (i.e., increased reinvestment risk) in a falling rate environment.

Overall, the composition of liabilities has not changed appreciably over the past two years. The vast majority of time deposits continue to mature or reprice within one year, although the percentage has been falling. Although repricing data on other borrowings are not available from Call Reports, maturity information shows that

CHART 3



⁸ Data for community commercial banks, which excludes thrifts, are used for the balance of this article, as thrifts do not report asset repricing and maturity information to the same level of detail as commercial banks.

⁹ The *Mortgage Bankers Association* forecasts that refinancings will represent 29 percent of mortgage originations in 2003, down from 49 percent forecast for 2002. Total mortgage originations are forecast to decline from \$2.0 trillion to \$1.4 trillion during the same period.

¹⁰ The share of ARMs originated nationally has risen in recent quarters (up from 12 percent in fourth quarter 2001 to 20 percent in second quarter 2002).

¹¹ According to the *Federal Home Loan Mortgage Corporation*, the spread was 1.90 percentage points during third quarter 2002, compared with 1.02 and 1.14 in 2000 and 2001, respectively.

¹² As of August 31, 2002, the spread between 30-year fixed-rate mortgages and 7-year constant maturity Treasury notes was 2.41 percentage points, compared with 2.10 and 1.87 percentage points on average for 2000 and 2001, respectively.

such borrowings are extending. Brokered deposits maturing in one year (now 50 percent) are falling as well. Lengthening of liability maturities, if properly matched with lengthening asset maturities, may reduce interest rate risk at some banks.

Further Margin Improvement Will Likely Be Muted; Effective Interest Rate Risk Management Is Essential

Further gains in margins may come if the yield curve maintains its steep upward slope, as time deposits would continue to reprice at low short-term rates. However, additional improvement is likely to be modest. Although the strength of the economic recovery remains uncertain, further significant short-term interest rate cuts may be unlikely. Nevertheless, if a reduction in short-term rates were to occur, any short-term benefit would likely be muted, as many deposit products are already at an effective rate floor. Furthermore, increased optionality in securities portfolios could contribute to more prepayments and banks reinvesting at lower market rates.

If the recovery strengthens, higher short-term rates may result. Recent margin improvements among the Region's insured institutions may be short-lived if institutions fail to prepare for a return to a flatter yield curve. Many banks may now be unduly exposed to rising short-term rates if they have been invested in longer-term assets at the same time depositors have avoided longer-term deposit instruments. Should the yield curve flatten, these institutions could again experience NIM compression.

NIM performance during the past two years illustrates how significant yield curve changes can affect the Region's institutions. The past two years also have provided an opportunity for asset and liability managers to evaluate the performance of interest rate risk monitoring systems, especially the validity of assumptions regarding borrower and depositor behavior. Although forecasting factors that will affect NIMs is complex, management must strive to develop interest rate risk systems that identify interest rate scenarios that may have the most detrimental effect on margins.

Mike Anas, Senior Financial Analyst

Dallas Regional Perspectives

Midsouth Bank and Thrift Earnings Outlook¹

A Weak Manufacturing Sector Continues to Have Adverse Effects on the Midsouth Economy

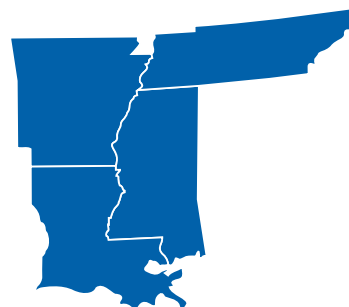
Economic conditions in the Midsouth remained sluggish, with employment levels virtually unchanged during the second and third quarters of 2002. A key contributing factor is the lingering weakness in the area's important but beleaguered manufacturing sector.² This sector lost 128,000 jobs during the 27 months ending September 2002. However, net job losses for the area were only 55,000, thanks to significant employment gains in the service sector. The rate of job losses in the manufacturing sector has slowed somewhat, indicating that the economy may be improving.³ However, weak employment conditions persisted in other sectors, including transportation, public utilities, and retail.

Credit Quality and Earnings Improved during the First Half of 2002, Despite Economic Weakness

Credit quality appears to have improved for most Midsouth insured institutions during second quarter 2002, but challenges continue in certain areas. Reported past-due loan levels declined among 55 percent of insured institutions in the Midsouth,⁴ suggesting an improvement. However, institutions in areas where employment is highly concentrated in the manufacturing sector continue to report past-due loan ratios above the median for

the Midsouth.⁵ Furthermore, 17 percent of the area's insured institutions reported relatively high past-due loan ratios of 5 percent or more in

the second quarter, almost twice the median for this area. (Refer to *Memphis Regional Outlook*, first quarter 2002, for a detailed discussion of the effects of employment concentrations in the manufacturing sector on insured institution credit quality.)



Banks and thrifts headquartered in the Midsouth reported sharply higher returns on assets (ROAs)⁶ in the first half of 2002, largely as a result of higher net interest margins (NIMs) compared with a year earlier (see Table 1). The improvement in earnings performance was widespread, with more than two-thirds of insured institutions reporting an increase in earnings in the first six months of 2002 compared with a year ago.

TABLE 1

INSURED INSTITUTIONS HEADQUARTERED IN THE MIDSOUTH REPORTED STRONG EARNINGS IN THE FIRST HALF OF 2002		
MEDIAN RATIO	2001	2002
ROA (%):		
1ST QUARTER	1.04	1.10
2ND QUARTER	1.04	1.18
NIM (%):		
1ST QUARTER	4.02	4.13
2ND QUARTER	4.02	4.33

NOTES: ROA—RETURN ON ASSETS; NIM—NET INTEREST MARGIN (EXCLUDES DE NOVOS)
SOURCE: BANK & THRIFT CALL REPORTS

¹ As used in this article, Midsouth refers to Arkansas, Kentucky, Louisiana, Mississippi, and Tennessee. Beginning with first quarter 2003, analyses of Kentucky banking and economic conditions will appear in *Chicago Regional Perspectives*.

² The manufacturing sector represents 16 percent of total employment in the Midsouth, compared with 13 percent for the nation.

³ Evidence of recovery in the manufacturing sector is provided by two measures, one national and the other regional:

- The Institute for Supply Management's Purchasing Managers Index climbed from 48.1 at year-end 2001 to 56.2 by June 30, 2002. An index reading above 50 suggests expansion, while a reading below 50 suggests contraction. However, by September 2002, the index had fallen to 49.5.
- The average weekly hours worked by manufacturing sector employees rose sharply in the first half of 2002. Such an increase typically precedes an increase in employment in the sector (discussed in more detail in *Memphis Regional Outlook*, third quarter 2002).

⁴ Median past-due loans were 2.60 percent of total loans in second quarter 2002, down from 2.82 percent the previous quarter.

⁵ The median past-due loan ratio was 2.71 in second quarter 2002 among insured institutions headquartered in areas dependent on the manufacturing sector (areas with manufacturing employment at least 16 percent of total employment). The past-due ratio was 2.10 for banks in other areas.

⁶ The 14 basis point increase in second quarter 2002 ROA compared with a year ago is the largest increase in the past ten years.

Regional Perspectives

The favorable movement in interest rates during 2001 and early 2002 strongly influenced NIMs. The yield curve steepened considerably from year-end 2000 through first quarter 2002 as short-term rates fell more rapidly than long-term rates (shown by the widening spread between three-month London Interbank Offer Rate (LIBOR) and five-year Treasury rates in Chart 1.)⁷ Historically, bank and thrift NIMs have tracked, with a slight lag, changes in the shape of the yield curve (see Chart 2).

The Interest Rate Environment Has Become Somewhat Less Favorable in Recent Quarters

Future NIM performance will be influenced by the direction of interest rates as well as the movement of interest rate spreads. The narrowing of spreads between spring and fall 2002 suggests that the improvement in NIMs could possibly end in the fourth quarter, assuming NIMs continue to track changes in the shape of the yield curve. Any benefits to NIMs of additional downward movement in rates likely would be muted, as interest rates on many deposit products are already at an effective rate floor.

CHART 1

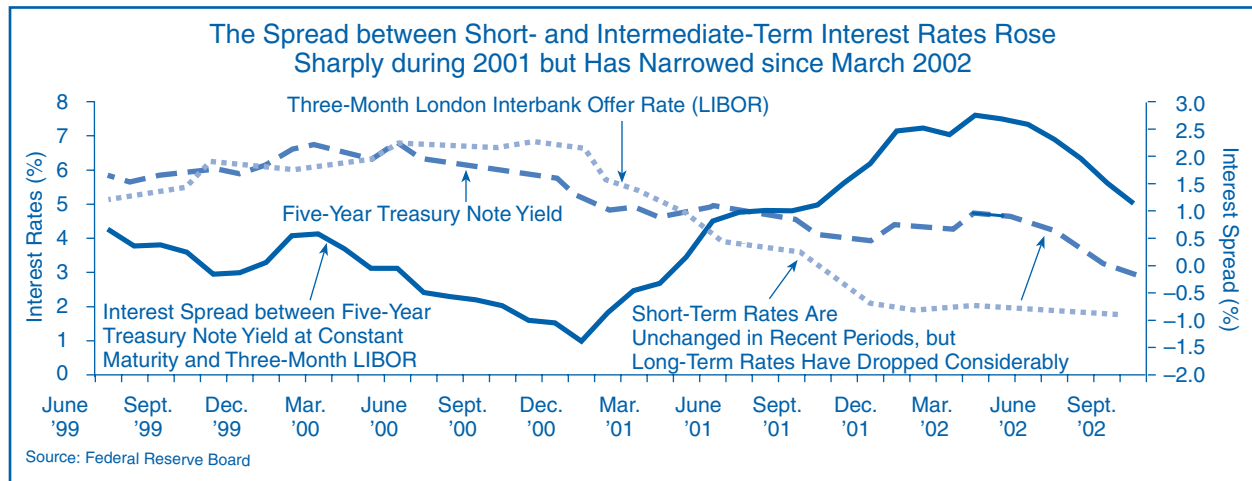
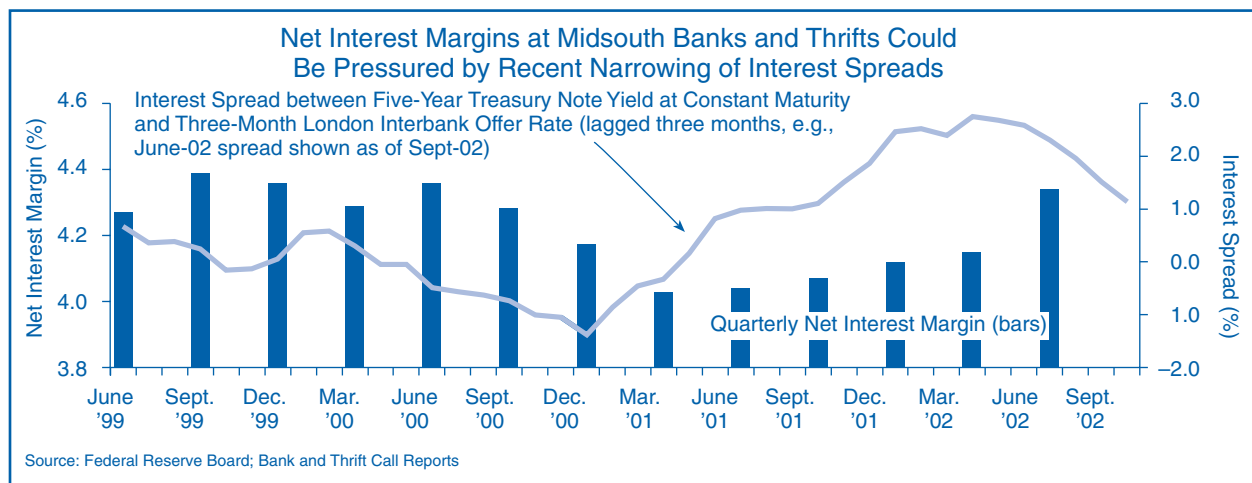


CHART 2



⁷ Yield curve steepness peaked in March 2002 at 275 basis points. By late October, the spread had declined to 125 basis points. The ten-year average monthly spread is 77 basis points. Comparisons of short-term and long-term or intermediate-term interest rates other than three-month LIBOR and five-year Treasury would yield similar results.

The potential pressure on NIMs among Midsouth banks and thrifts results not from mismatches between asset and funding maturity/repricing,⁸ but rather from the effects of a nonparallel shift in rates on asset yields and funding costs. Since March 2002, intermediate- and long-term rates, which influence the pricing of many asset classes, have fallen considerably, while short-term interest rates, which affect deposit pricing, remained largely unchanged (see Chart 1). As a result, the decline in yields as assets reprice downward is likely to proceed more rapidly than the reduction in funding costs.

This recent shift in the yield curve likely will influence assets and liabilities, with perhaps the greatest effect on mortgage-related assets. The recent decline in longer-term rates led to a dramatic increase in home mortgage refinancing, affecting securities portfolios and lending activities of many insured institutions in the Midsouth.

- **Securities Portfolios:** As discussed in *Memphis Regional Outlook*, third quarter 2002, investment decisions during 2001 at most established community banks and thrifts⁹ favored mortgage-backed securities (MBS) and mortgage derivative securities (MDS).¹⁰ The increased volume of mortgage refinancings contributed to acceleration in prepayments during the second half of 2002. Many of these investments are being called, and banks and thrifts must reinvest the proceeds in a lower interest rate environment. As a result, earnings could be affected adversely.
- **Mortgage Lending:** Direct mortgage lending also has been affected, particularly by the tremendous volume of existing loans being refinanced at lower

⁸ Many institutions have significantly extended reinvestment horizons or purchased instruments with complex embedded options in an effort to improve the yields of securities portfolios, a strategy that likely will increase the vulnerability of earnings performance to rising interest rates. This increased market sensitivity in investments is discussed in *Memphis Regional Perspectives*, third quarter 2002.

⁹ Established community banks and thrifts have less than \$1 billion in total assets and have been in operation for more than three years.

¹⁰ From December 31, 2000, to June 30, 2002, MBS plus MDS increased from 4.0 percent of total assets at established community banks to 6.3 percent. As a percentage of total securities, these securities rose from 16.8 percent to 26.5 percent during the period. Large banks (those with over \$1 billion in assets) also increased holdings of MBS and MDS but by relatively smaller amounts (from 9.9 to 10.6 percent of assets and from 48.0 to 56.9 percent of securities).

rates.¹¹ Bank and thrift earnings have benefited from the considerable fee income generated by the high volume of mortgage originations. However, insured institutions that provide mortgage servicing on loans sold to the secondary market may suffer adverse earnings effects because of impairment write-downs. Those write-downs likely will be more pronounced during the second half of 2002 as large volumes of refinancing applications submitted in the late summer are processed.

Future Earnings Performance Also Could Be Affected by Continued High Provision Expenses

ROAs increased dramatically in the first half of 2002 despite increased provision expenses. Although banks and thrifts reported declining loan delinquencies, loan charge-off rates remained above levels reported a year ago.¹² Although the recent drop in delinquencies may lead to expectations of declining loan losses, vulnerabilities in the national economy, described in Economic Conditions and Emerging Risks in Banking, suggests that credit losses could increase in the near term.

Most banks and thrifts in the Midsouth have appropriately increased their allowance for loan and lease losses (ALLL) to compensate for heightened credit risk stemming from uncertain economic conditions. Two broad measures of ALLL adequacy among insured institutions showed considerable improvement during the year ended June 2002:

- The ratio of ALLL to total loans climbed from 1.25 percent to 1.31 percent.
- ALLL coverage of total nonperforming loans rose from 142 percent to 154 percent. Nonetheless, ALLL coverage remains below the national median of 167 percent.

Despite these ALLL trends, increased provisions may be needed should credit losses climb in the second half of

¹¹ Three-quarters of insured institutions headquartered in the Midsouth have significant holdings (at least 25 percent of total loans) of mortgages on one- to four-family residences. Call report data do not provide information on the volume of those loans that are or were originally for purchase of a home rather than being acquired to bolster collateral.

¹² The median past-due and nonaccrual loan ratio peaked at 3.05 percent on December 31, 2001, before falling to 2.6 percent as of June 30, 2002. Loan charge-offs during the first six months of 2002 represented 8 basis points of average loans, compared with a 7 basis point loan loss rate reported during the first half of 2001.

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2002. Factors that should be considered in determining allowance adequacy were discussed in *Memphis Regional Outlook*, second quarter 2002.

Challenges Lie Ahead

The potential for a less favorable interest rate environment exists and, coupled with sluggish economic

growth and ongoing asset weakness, suggests that banks and thrifts in the Midsouth may not be able to sustain recent strong earnings performance. The effectiveness of interest rate risk monitoring systems will become extremely important as managers seek to make informed asset and liability management decisions.

Memphis Staff

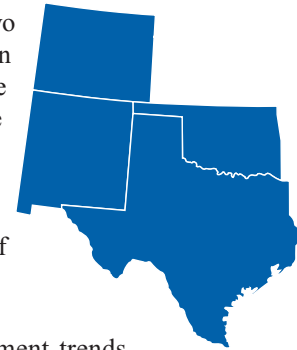
Southwest Perspectives

The Southwest Continues to Experience the Aftermath of the Recession

The economies of **Colorado, New Mexico, Oklahoma, and Texas** have performed differently from one another since the recession began in March 2001. As of July 2002, nonfarm employment in Colorado and Texas remained below peak levels (see Chart 1), in large part due to continuing stress in the states' key high-tech sector. Colorado's nonfarm employment ranks second to last in the nation, with a negative growth rate of 2.6 percent. The Texas economy lost the greatest number of jobs in the nation (143,000) since the economy entered recession. By contrast, during the 1990s, Colorado and Texas ranked among the nation's top six states in nonfarm employment growth.

Employment growth rates in New Mexico and Oklahoma remain positive. However, total nonfarm employment is only modestly higher than when the recession began. The effects of the national recession on the

economies of these two states have been muted, in large part thanks to the continuing strength of the government sector and the fact that high-tech manufacturing represents a smaller share of their employment.

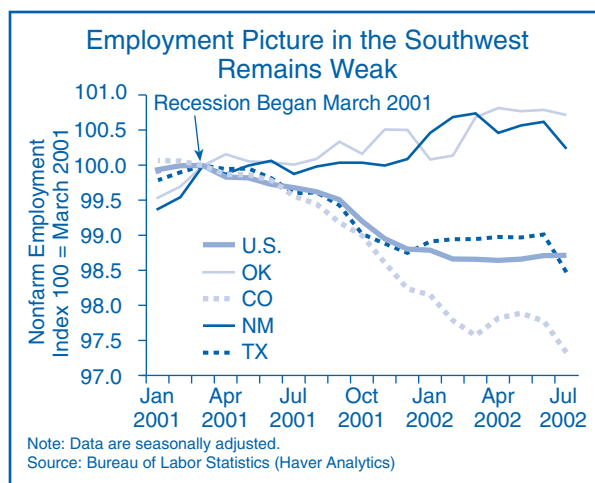


Despite positive employment trends in Oklahoma and New Mexico, the Southwest may lag the nation in employment growth because of ongoing problems in the Region's high-tech and energy sectors.

The Energy Sector Remains Troubled Despite Higher Oil Prices

Oil prices have trended upward this year, increasing more than 50 percent (based on monthly averages) between January and September 2002.¹ Price increases have been attributed to turmoil in the Middle East—the Israeli-Palestinian conflict and the possibility of U.S. military action against Iraq. Concern about potential oil supply disruptions that could be caused by the events in the Middle East add what one industry consultant terms a “fear premium” estimated at \$3 to \$5 per barrel of oil.² Additionally, the Organization of Petroleum Exporting Countries (OPEC) has reduced output by 3.5 million barrels a day since January 2002,³ causing U.S. oil and gas inventories to decline to the lowest level in more

CHART 1



¹ Based on West Texas Intermediate crude oil prices provided by the *Wall Street Journal* and Haver Analytics. September's figure through September 23, 2002 was supplied by www.economagic.com

² Daniel Yergin, head of Cambridge Energy Research Associates, “Don't Mention the O-Word,” *The Economist*, September 12, 2002.

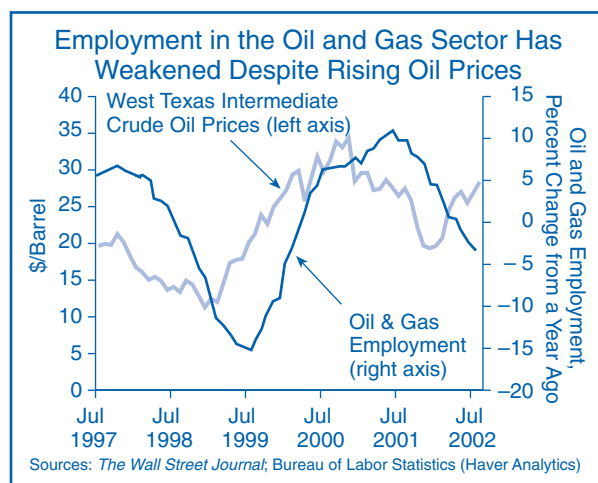
³ Neela Banerjee, “OPEC Feels Pressure to Produce More Oil,” *New York Times*, September 16, 2002.

than 20 years. This decline in inventories has also contributed to upward pressure on energy prices.

Despite higher oil prices, however, the Region's oil and gas industry has not performed well. Even as prices have increased, year-over-year employment growth has weakened since mid-year 2001 (see Chart 2). This weakness can be explained, at least in part, by the lag effect between oil prices and production and employment. Consequently, the decline in industry employment in 2002 reflects the 30 percent decline in oil prices from August to December 2001.

Furthermore, a weak global economy, the effects of September 11, and a mild U.S. winter drove down demand for refined fuels and squeezed profit margins. For example, Exxon Mobil Corporation and Royal Dutch/Shell, two bellwether companies, reported sharply lower second quarter earnings at a time when the industry generally performs well, during the seasonal switch from heating oil to gasoline production. Equally important, the industry continues to consolidate, reducing costs through layoffs, selling existing operations, and shuttering inefficient plants, all developments that adversely affect employment levels. Moreover, many oil and gas firms are using the revenues from higher oil prices to pay down debt, meet stringent environmental regulations, and repair frayed balance sheets. Although these trends will help restore the industry's profitability in the long run, production and employment will be dampened in the interim.

CHART 2



Finally, the Southwest economy is unlikely to benefit from rising oil prices to the same extent as in previous years. Although all states in the Region rank high in oil and natural gas production,⁴ the transformation from natural resource-based economies in the 1980s to information technology and services-oriented economies in the 1990s has led to greater industrial diversification, tying the Region more closely to the U.S. business cycle. Sustained oil prices above \$30 a barrel would hamper U.S. and global economic growth (perhaps contributing to a double-dip recession) and could result in higher inflation rates,⁵ possibly eroding confidence among consumers, businesses, and investors. Higher oil prices affect consumers in the form of higher gasoline prices, resulting in a decline in disposable personal income and a scaling back of consumer spending. Moreover, oil and natural gas are major cost inputs in many industries (e.g. manufacturing, transportation, and utilities), and higher prices would hurt business investment and exports.

Problems in the High-Tech Sector Continue to Dampen the Region's Economy

The high-tech boom of the 1990s helps explain why the U.S. and Southwest economies performed well during the past decade. The economies of Colorado and Texas—states with high concentrations of telecommunications equipment manufacturers and services providers, semiconductor and personal computer firms, and software developers—grew faster than the U.S. economy,⁶ in part as a result of the strong demand for high-tech products. Moreover, states with highly developed technology sectors have shown a strong positive correlation with per capita income growth.⁷

However, when the high-tech boom of the 1990s gave way to the high-tech bust in early 2000,⁸ many previously

⁴ Independent Petroleum Association of America, <http://www.ipaa.org/info/econreports/stateinformation.asp>

⁵ To see how rising energy prices have affected the U.S. economy, refer to "Energy Price Impacts on the U.S. Economy," http://www.eia.doe.gov/oiaf/economy/energy_price.html

⁶ Between 1990 and 2000, Colorado and Texas nonfarm employment (seasonally adjusted) grew at annualized rates of 3.8 percent and 2.9 percent, respectively, compared with 1.8 percent for the nation.

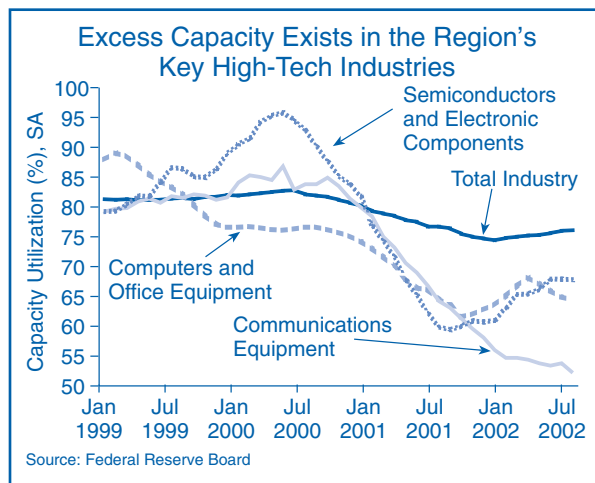
⁷ The Progressive Policy Institute, "The 2002 State New Economy Index," <http://www.neweconomyindex.org/states/2002/summary.html>

⁸ March 2000 is generally believed to be the start of the high-tech bust. The NASDAQ peaked at 5048.62 (closing) on March 10, 2000; five weeks later (April 14, 2000) the NASDAQ closed at 3321.29, having lost one-third of its value. Source: <http://bigcharts.marketwatch.com/historical/default.asp>

Regional Perspectives

fast-growing areas fell into recession, characterized by declines in employment growth rates. Moreover, the high-tech sector probably will emerge last from the recession, because excess supply and weak demand have resulted in over capacity that will take time to correct. Capacity utilization rates for certain high-tech industries are far below industry trends (see Chart 3). Industries with low utilization levels generally are characterized by declining production and weak demand. Poor equity market performance that constrains business investment, limited pricing power, and shifting business and consumer preferences also are contributing to the malaise of the high-tech sector.

CHART 3

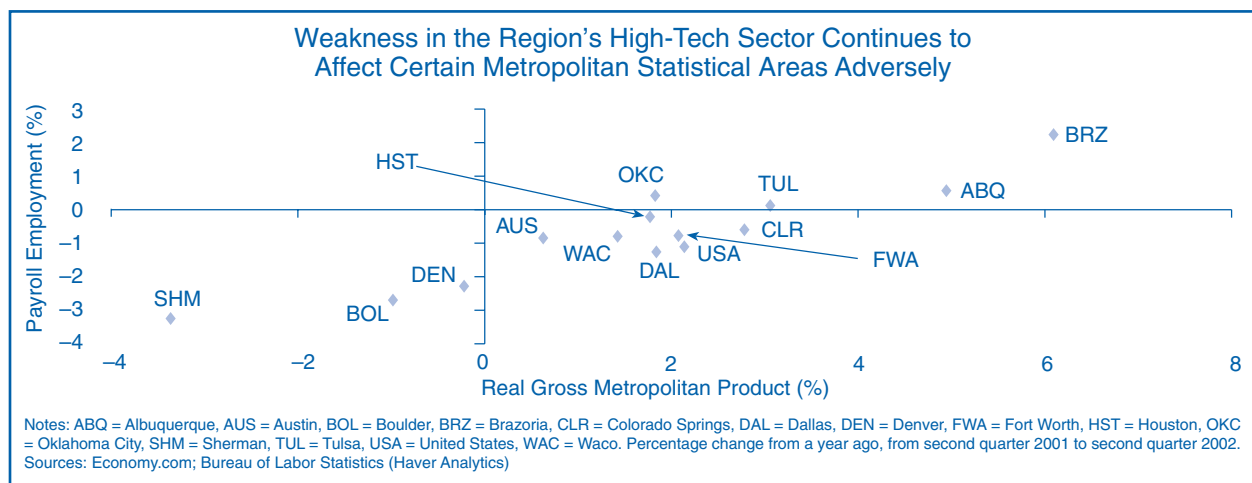


The importance of the high-tech sector to the Southwest's economy and the likelihood that this sector will stay weak for some time suggest that economic growth in the Southwest will remain below levels of the mid- to late 1990s, particularly in Colorado and Texas. Many of the Southwest's high-tech metropolitan areas have already shown evidence of these trends.⁹ Previously robust metropolitan economies, such as **Austin, Boulder, Colorado Springs, Dallas, Denver, Fort Worth, Houston, Sherman, and Waco**, have experienced declining payroll employment growth, falling output growth, or both (see Chart 4).

Weakness in Office Employment Has Contributed to a Rapid Rise in Vacancy Rates in Several Southwest Office Markets

Office vacancy rates continue to climb nationwide, up 630 basis points from 9.8 to 16.1 in the three-year period ending September 30, 2002, the largest increase in more than a decade. Vacancy rates in four Dallas Region metropolitan statistical areas (MSAs)—Dallas, Austin, **Oklahoma City**, and Denver—rank among the highest in the country as a result of declines in office employment in these MSAs.¹⁰ The Dallas MSA ranks highest in the nation, with a vacancy rate of 25.8 percent. Austin ranks second (25.7 percent), Oklahoma City ranks fourth (21.7 percent), and Denver ranks tenth (20.0 percent).

CHART 4



⁹ Metropolitan areas selected had high-tech output as a share of total metropolitan output greater than 10 percent based on analysis done by DRI-WEFA for the U.S. Conference of Mayors, http://usmayors.org/citiesdrivetheeconomy/chart3_tech.pdf

¹⁰ Based on the 55 metro markets tracked by Torto Wheaton Research.

Vacancy rate trends in each metro market have differed significantly, and rates also have diverged across metro area submarkets.

The Austin and Denver MSAs have experienced rapid increases in vacancy rates, coinciding with the downturn in the high-tech and telecommunications sectors following a period during which the rates tracked at or below the national average. However, the vacancy rate in Austin has risen almost fivefold in three years, the most dramatic increase in the country. Furthermore, the Austin suburban market reported an office vacancy rate of 27.2 percent as of September 30, 2002, the highest in the nation, with about 10 percent attributable to sublease space.¹¹ Sublease space often occurs when companies acquire space in anticipation of future growth. If that growth fails to materialize, as typified by the recent downturn in the high-tech sector, the excess space is returned to the market as sublease space.

In contrast, office vacancy rates in the Dallas and Oklahoma City MSAs have remained significantly above the national average for the past decade, and pricing for this continued high level of office vacancies appears to have been factored into the market. However, vacancy rates in the Dallas MSA suburban markets have increased 10 percentage points during the past three years, creating downward pressure on rent rates and property cash flows.

Implications for the Region's Insured Institutions

As office vacancy rates have risen, insured institutions in the Southwest have expanded construction and commercial real estate (CRE) portfolios to record levels. As of June 30, 2002, 23 percent of the Region's banks and thrifts reported CRE concentrations in excess of 300 percent of Tier 1 capital, the highest level in the past 15 years. Certain groups of insured institutions have expanded these portfolios to a greater extent (see Table 1). As might be expected, metro banks report higher CRE concentrations than rural banks, and larger institutions tend to have higher concentrations than smaller institutions.

More than half the banks and thrifts headquartered in the Dallas and Houston MSAs report relatively high CRE concentrations. Given the current high office vacancy rate in the Dallas MSA, this situation is especially problematic.

Despite the fact that the Southwest's insured institutions have increased concentrations in these traditionally higher-risk loans at the same time commercial real estate markets have weakened, banks and thrifts in the Southwest continue to perform well. The aggregate return on assets for the six months ending June 30, 2002, was 1.46 percent, up 23 basis points from a year earlier, and the highest level since June 1996.

TABLE 1

INSURED INSTITUTIONS INCREASE CRE EXPOSURE AS OFFICE MARKETS WEAKEN		
PERCENT OF INSURED INSTITUTIONS WITH COMMERCIAL REAL ESTATE LOANS GREATER THAN 300 PERCENT OF TIER 1 CAPITAL	6/30/02 (%)	6/30/99 (%)
NATION	24	15
SOUTHWEST	23	15
AUSTIN MSA	32	18
DALLAS MSA	52	32
DENVER MSA	34	28
HOUSTON MSA	56	37
OKLAHOMA CITY MSA	33	24
METRO—SOUTHWEST	40	25
RURAL—SOUTHWEST	9	5
MORE THAN \$100M—SOUTHWEST	36	27
LESS THAN \$100M—SOUTHWEST	14	9

NOTE: MSA = METROPOLITAN STATISTICAL AREA
SOURCE: BANK AND THRIFT CALL REPORTS

¹¹ Torto Wheaton Research.

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In addition, falling short-term interest rates combined with an upward-sloping yield curve have improved net interest margins among the Region's insured institutions as interest expense has fallen below 2 percent, the lowest level in a decade.¹² Capital levels remain strong, as evidenced by a core capital ratio of 8.36 percent, the highest level in the past ten years. Although aggregate

¹² The combined interest expense for the Southwest's insured institutions for the six months ending June 30, 2002, was 1.82 percent of average assets.

past-due and charge-off ratios are slightly higher than those reported for the past several years, they remain relatively low by historical standards.

However, a note of caution is needed. Deterioration in credit quality often lags the business cycle. As a result, should the economic recovery take hold, weakness in certain segments of the loan portfolio, especially those with exposure to stressed industries, may yet emerge.

Dallas Staff

Kansas City Regional Perspectives

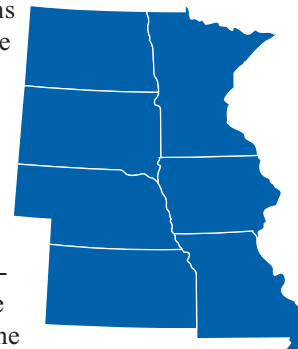
Many issues of concern to the nation’s insured institutions also are of concern to institutions in the Kansas City Region. The Region’s community banks are experiencing the effects of weakening in commercial real estate (CRE) markets and earnings pressures because of challenges to asset liability management, although to a lesser degree than institutions across the country (see text box). Overall, however, the drought could cause the greatest stress for a large number of the Region’s community banks. Although the drought is affecting areas across the country, its severity in the Kansas City Region, together with the Region’s disproportionately high number of farm banks, magnifies its potential adverse effects.

Drought Is Stressing the Western Part of the Kansas City Region

In mid-September, the *National Oceanic and Atmospheric Administration* reported that the average temperature for the contiguous United States from June through August was 73.9° F—the third hottest summer since record-keeping began in 1895, surpassed only by the summers of 1934 and 1936. Moderate to extreme drought¹ now covers 45 percent of the United States. Much of the Great Plains and western United States was severely affected by drought in the spring,

and drought conditions worsened during the summer.

Poor crop conditions nationwide have translated into forecasts for significantly lower production of corn, soybeans, and wheat (see Table 1). In August, the



U. S. Department of Agriculture (USDA)

revised its monthly forecast for corn production downward 9.2 percent to 8.9 billion bushels nationwide, the smallest crop since 1995. The USDA also revised the forecast for the soybean harvest down 8.1 percent to 2.6 billion bushels, the smallest crop since 1996.

Western portions of the Kansas City Region, including much of **Kansas, Nebraska, North Dakota, and South Dakota**, are experiencing the worst drought since 1988. Forecast yields of corn, soybeans, and spring wheat and actual yields of winter wheat already harvested are substantially below 2001 levels.

Nebraska has been more severely stressed by the drought than the other states in the Region, as measured by the value of lost crop production. Some farmers in

TABLE 1

USDA FORECASTS DECLINING CROP PRODUCTION DUE TO DROUGHT				
CROP	CORN	SOYBEANS	SPRING WHEAT*	WINTER WHEAT
KANSAS	-30	-32	—	-20
NEBRASKA	-21	-24	—	-22
SOUTH DAKOTA	-8	-7	-15	62
NORTH DAKOTA	-28	18	-47	—

NOTE: TABLE COMPARES 2002 FORECAST PRODUCTION TO 2001.
 *ACTUAL PRODUCTION IN 2002.
 SOURCE: USDA CROP PRODUCTION REPORTS, 2002.

¹ The Drought Monitor, a joint project of the National Oceanic and Atmospheric Administration and the United States Department of Agriculture, defines “Moderate Drought” as occurring in areas with “Some damage to crops and pastures and some water shortages developing or imminent,” and “Severe Drought” as occurring in areas with “Crop or pasture losses likely; water shortages common; water restrictions imposed.” It defines “Extreme Drought” as occurring in areas with “Major crop or pasture losses; widespread water shortages or restrictions.”

Kansas City Region Insured Institutions Face Additional Challenges

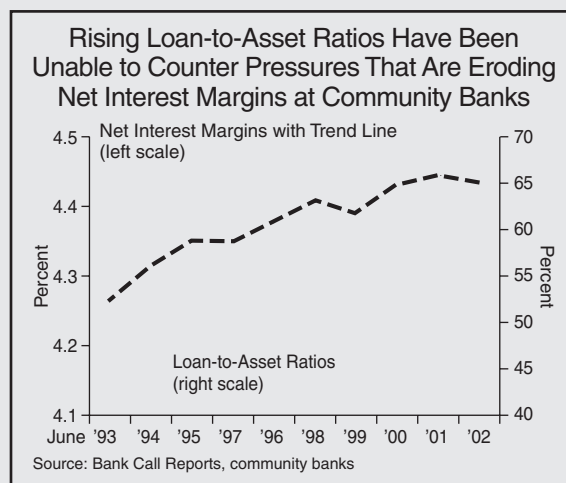
Insured Institutions Continue to Increase CRE Exposure Despite Weakening Office Markets

Many of the Region's metropolitan markets have experienced rapid increases in commercial office vacancy rates since 2000 as high completion rates outpaced low or even negative net absorption because of slowing employment growth. *Torto Wheaton Research* reports second-quarter 2002 office vacancy rates of 17.9, 16.9, and 14.5 percent, respectively, for the Region's three largest markets, **Minneapolis-St. Paul, St. Louis, and Kansas City**. Vacancy rates were below 10 percent in Kansas City and St. Louis and below 11 percent in Minneapolis-St. Paul at year-end 2000. While office markets began softening in 2000, insured financial institutions in these markets continued to increase capital exposure to CRE lending. The median CRE loan-to-Tier 1 capital ratio for established institutions (over eight years) increased from 209 percent at June 2000 to 228 percent at June 2002; newly chartered institutions nearly doubled the median ratio, from 97 percent to 180 percent. Despite these increasing concentrations during a time of market weakening, no material CRE credit deterioration has been reported; however, that could change if market weakness continues.

Pressure on Community Bank NIMs Continues

Competitive pressures on both sides of the balance sheet continue to affect community bank net interest margins (NIMs). NIMs have changed significantly during the past several years (see Chart 1). Shifts in monetary policy, combined with asset-sensitive balance sheets, contributed to a widening of NIMs in 2000 and a narrowing in 2001. NIMs currently are up from year-ago levels, as interest rate shocks ended in late 2001, and the Region's banks are benefiting from a steep yield curve. Despite this volatility, long-term trends suggest that NIMs overall are narrowing. Moreover, slackening loan demand suggests that NIMs could continue to be pressured going forward.

CHART 1



the western panhandle of Nebraska are experiencing the worst conditions since the Dust Bowl of the 1930s; many farmers in the Panhandle will produce no crop at all. The nonirrigated portions of Nebraska's corn and soybean crops have suffered most, with corn production projected to be 30 percent less than last year. The *University of Nebraska* estimates the cost of the drought at \$1.4 billion, or 2.5 percent of Nebraska's gross state product. Many observers believe the actual impact will be considerably greater when the full extent of the damage becomes evident by year end. Map 1 shows the severity and duration of recent drought among the Region's counties.

Cattle producers are also feeling the effects of the drought (see Table 2). Kansas and Nebraska rank second and third, respectively, among the nation's cattle-producing states, and the Region's four states together represent

20 percent of the nation's herd. As Table 2 indicates, the drought has severely reduced the supply and quality of grazing pastureland as well as supplies of hay.

Farmers and ranchers were forced to feed hay to their livestock over the summer because of the poor quality of pastureland, a practice that usually does not occur until autumn or winter. Declining supplies of hay and increased demand are pushing up prices, forcing livestock operators to seek alternatives, such as harvesting roadside ditches and cutting drought-stressed crops prematurely for silage. Moreover, because they were forced to use hay stocks this summer, many livestock operators are pessimistic about finding enough forage to last the winter months.

In addition, some cow-calf operators in drought-affected areas are being forced to sell young cattle at severely

TABLE 2

USDA DATA SHOW EFFECTS OF DROUGHT ON REGION'S GRAZING CONDITIONS						
PASTURE/RANGE CONDITIONS	VERY POOR (%)	POOR (%)	FAIR (%)	GOOD (%)	EXCELLENT (%)	NUMBER OF CATTLE (IN 000s)
KANSAS	41	30	20	8	1	6,600
NEBRASKA	58	28	10	4	0	6,400
SOUTH DAKOTA	34	27	23	15	1	3,950
NORTH DAKOTA	30	27	27	15	1	1,970

SOURCES: "USDA WEEKLY WEATHER AND CROP BULLETIN," SEPTEMBER 17, 2002. "USDA CATTLE" REPORT, FEBRUARY 2002.

discounted prices to cattlemen in states with more plentiful forage supplies. For example, reports from a major livestock auction in **Fort Pierre**, South Dakota indicate that more than six times the usual volume of cattle are being sold in its weekly auctions, primarily to buyers from states where drought is not a problem.

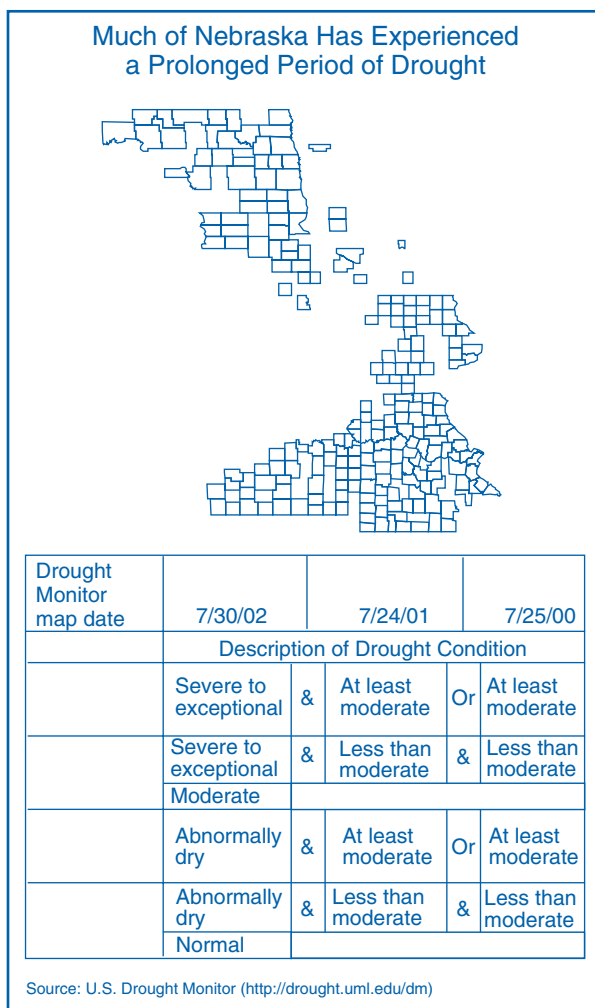
The economic distress caused by the drought has aggravated an already weak cattle market. Prices have been falling for the past year and a half. The prices of fed steers peaked above \$79 per hundredweight in first quarter 2001, but have declined to below \$66, the lowest price in the last two and half years.

Farm Banks Could Be Affected Adversely by the Drought

The drought could have a negative effect on many farm banks as well.² The effects of the drought likely will not be evident until early 2003. However, the drought follows a period of stressed agricultural conditions in many states, particularly Nebraska, Kansas, and South Dakota, where crop prices have been at historically low levels for the past four years. While federal government financial assistance bolstered the farm sector, the prolonged period of low commodity prices has left many rural farm banks holding considerable levels of carryover debt.³ Should the drought continue and levels of carryover debt increase, farm bank credit quality could weaken.

Regional analysis by the FDIC indicates that farm banks in areas that have experienced prolonged drought conditions⁴ (dark-shaded counties in Map 1) are reporting

MAP 1

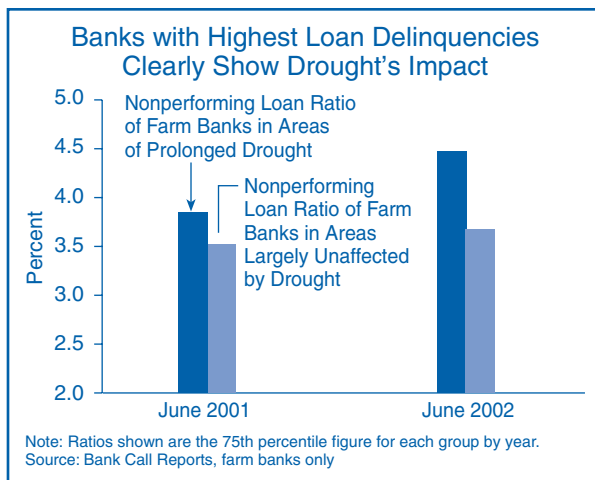


² An FDIC-insured bank is considered a farm bank if total agricultural production loans and loans secured by farm land equal at least 25 percent of total loans.

³ Carryover debt occurs when a farm operator is unable to repay monies borrowed to cover the current growing season's operating costs.

⁴ For analytical purposes, the FDIC considered a county to be in persistent drought condition if it was in a severe to exceptional drought condition in July 2002 and in at least a moderate drought condition in July 2001 or July 2000.

CHART 2



greater weakening in asset quality than farm banks in areas that are largely unaffected by drought (nonshaded counties in Map 1). For example, delinquency rates are increasing more rapidly in areas that have experienced prolonged drought. The median nonperforming loan ratio of banks in areas of prolonged drought increased from 2.24 percent in June 2001 to 2.46 percent in June 2002, while the median ratio for banks in areas largely unaffected by drought declined from 2.22 percent to 2.04 percent. This disparity is even more pronounced among the worst performers in each group (see Chart 2). Examinations of insured institutions also note weakening credit quality among farm banks in areas of prolonged drought. Adversely classified assets as a share of capital are approximately 50 percent higher among farm banks headquartered in areas that have experienced prolonged drought conditions than in institutions in largely unaffected areas.⁵

Although asset quality appears to be slipping, farm banks' capital protection is near an historic high. The median leverage capital ratio of 9.9 percent as of June 30, 2002, represents a slight 30 basis point decline over a two-year period. Moreover, the ratios of loan loss reserves to total loans and loan loss reserves to noncurrent loans remain high, at 1.65 percent and 122.73 percent, respectively. In fact, even after the recent period of prolonged drought, farm banks are better capitalized now than they were immediately before the last major drought in 1988. The median leverage capital ratio for the Region's farm banks as of December 31, 1987, was 8.7 percent.

Conclusion

Farm incomes in the most drought-stricken areas are expected to be much lower than in previous years. The 2002 farm bill enacted earlier this year does not provide relief for production losses, nor does it address the needs of livestock operators. Insured financial institutions and state lawmakers are lobbying for federal drought relief funds. Although there is uncertainty at this time about the specific provisions of any aid package, many observers expect that, should Congress pass a relief bill, funds would be made available for livestock and crop producers.

Richard Cofer, Senior Financial Analyst

Jeffrey W. Walser, Regional Economist

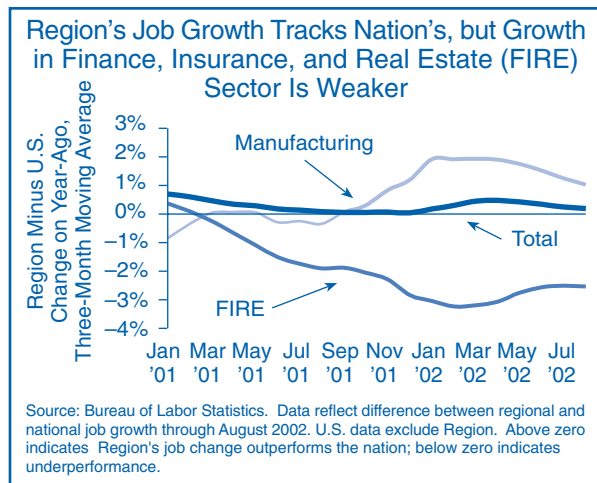
⁵ Data are based on the examination ratio of adversely classified assets as a share of capital for examinations completed during the one-year period ending in September 2002.

New York Regional Perspectives
Mid-Atlantic Perspectives¹

Mid-Atlantic's Job Growth Approximates the Nation's, but Economic Uncertainty Clouds Outlook

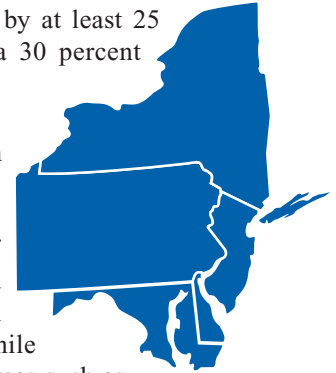
Since January 2001, the Mid-Atlantic's employment trends have approximated the nation's. However, employment growth among the Mid-Atlantic's key industry drivers—financial services and manufacturing—has varied widely compared with national trends (see Chart 1).²

CHART 1



Job growth in the Mid-Atlantic's finance, insurance, and real estate (FIRE) sector has trailed the nation's since March 2001 and has been negative since December 2001. Job losses are centered in **New York City** (the New York City metropolitan area has sustained among the nation's highest rates of job loss in this sector) and **New Jersey**, and outweigh job growth in this sector elsewhere in the Mid-Atlantic. The FIRE sector fuels other key industries in the Mid-Atlantic, such as publishing and business services. Additionally, employees in this sector tend to be highly compensated, and as a result, layoffs and salary cuts have a significant downstream effect on the Mid-Atlantic's economy. According to recent reports, Wall Street bonuses, often a significant component of total

compensation, could decline by at least 25 percent in 2002, following a 30 percent decline in 2001.³



Overall, the rate of job loss in the Mid-Atlantic's manufacturing sector has been less severe than the nation's. The pace of job recovery in **Buffalo** and western **Pennsylvania** has been stronger than the nation, while manufacturing job losses in areas such as **Binghamton** and **Rochester**, New York, **Johnstown** and **Allentown**, Pennsylvania, and **Newark**, New Jersey, have exceeded national trends. Because of their relatively strong concentration in high-tech manufacturing, Binghamton and Newark have been particularly hard hit by the downturn in telecommunications and technology-related industries.

While the Mid-Atlantic's labor markets have yet to gather momentum, several economic indicators suggest that economic recovery is under way. The **Bank of Tokyo-Mitsubishi/UBS Warburg U.S. Regional Retail Sales Survey for the Northeast**, which tracks the level of retail sales for several of the Mid-Atlantic's states, indicated that sales increased steadily from May 2002 through September 2002. In addition, a survey by **Manpower Inc.**, which measures executives' hiring plans and employment outlook, shows improvement since first quarter 2002, and the outlook for fourth quarter 2002 is for a net employment gain.⁴ A trend toward renewed growth in nondefense capital goods (excluding aircraft) expenditures on a year-over-year basis also suggests that the nation's business sector may have improved in third quarter 2002, which would bode well for the Mid-Atlantic's manufacturing sector.⁵

Notwithstanding some favorable economic indications for the national and regional economies, vulnerabilities remain; many are associated with the potential for war in the Middle East, a possible disruption in the supply of oil, and increased financial market volatility. The economic

¹ This article covers economic and banking conditions for insured institutions headquartered in Delaware, Maryland, New Jersey, New York, Pennsylvania, Washington, D.C., and Puerto Rico and the U.S. Virgin Islands.

² Employment growth data are year-over-year changes in three-month moving averages. U.S. data exclude the Mid-Atlantic Region as defined herein.

³ Federal Reserve Board, *Beige Book*, October 23, 2002. *Crain's New York Business*, August 19–25, 2002, p. 1.

⁴ Manpower Inc., *Employment Outlook Survey Data for the Northeast, All Industries*, fourth quarter 2002.

⁵ U.S. Department of Commerce, September 2002.

uncertainty that would arise from these developments could lead consumers and businesses to postpone economic decisions, which could weaken regional and national economic prospects.

Mid-Atlantic's Surge in Home Prices Feeds Speculation of a Potential "Housing Bubble"

Fueled by record low mortgage rates and favorable demographics, single-family home prices around many of the Mid-Atlantic's major metropolitan areas have soared over the past two years, often at double-digit rates and far in excess of income growth. Perhaps more significantly, in areas such as **Bergen-Passaic**, New Jersey, **Nassau-Suffolk**, New York, and around the **District of Columbia**, the pace of home price appreciation continued to rise through the first half of 2002, while easing slightly for the nation.

Despite strong home price appreciation, some economists believe that a "housing bubble" may be avoided. While housing prices have increased sharply around some of the Mid-Atlantic's major cities, the increase has been less than during the 1980s, when prices rose at double-digit rates for five to ten years. In addition, supplies of new homes in major metropolitan areas have been constrained by a lack of land, much of which was developed in the 1980s and 1990s. Housing demand in some of the Mid-Atlantic's cities also has been supported by population growth in the 24-to-44 age bracket (those most likely to buy a first home) and increased immigration. As a result, although home prices in some areas may decrease, particularly if mortgage rates rise, prices are unlikely to drop sharply absent substantial declines in employment or income.

Mid-Atlantic's Office Markets Soften but Remain Better than a Decade Ago; Some Areas Warrant Monitoring

Similar to national trends, during the past two years the Mid-Atlantic's office market conditions weakened as a substantial amount of previously occupied space was sublet, which has contributed to higher vacancy levels and pressured office rents. In many of the Mid-Atlantic's major metropolitan areas, sublet space represents approximately 20 to 30 percent of total vacant office space.⁶ Even New York City, which lost 60 percent of downtown

⁶ Torto Wheaton Research, *Office Market Snapshot*, Second Quarter 2002.

Manhattan's Class A office space following September 11, has experienced a significant rise in vacancy rates and a moderate decline in rental rates.⁷

Despite recent increases, vacancy rates in most of the Mid-Atlantic's office markets were below the national average in second quarter 2002, and none of the Mid-Atlantic's office markets have reached the peak vacancy levels experienced during the 1990–1991 recession. The relative lack of construction projects during much of the 1990s may help the Mid-Atlantic weather the current downturn.⁸ Moreover, according to anecdotal reports, office construction starts declined during second quarter 2002 in several of the Mid-Atlantic's larger markets, perhaps demonstrating better market discipline during this real estate cycle.⁹ Additionally, the rate of negative absorption (when space returned by existing tenants exceeds space occupied by new tenants) that characterized many of the Mid-Atlantic's major office markets in 2001 subsided in the first half of 2002. Nonetheless, some of the Mid-Atlantic's office markets, primarily northern New Jersey and **Baltimore**, warrant monitoring, as demand for space has declined sharply while a moderate amount of new supply is projected for completion. Additional layoffs in key industries, including financial and business services and telecommunications, could further weaken office market demand.

Sluggish Economic Environment May Challenge Banks Holding Higher Concentrations of CRE Loans

Commercial real estate (CRE) loan quality reported by the Mid-Atlantic's insured institutions has deteriorated only moderately during this economic downturn. The median percentage of delinquent CRE loans reported by the Mid-Atlantic's insured institutions increased from .86 at year-end 2000 to 1.12 as of second quarter 2002

⁷ TenantWise.com. "WTC Tenants Stabilize With 53 Percent Returning Downtown; However, Downtown Continues to Weaken With a 20 Percent Availability Rate." TenantWise.com. July 2002.

⁸ "The Region's Commercial Real Estate Markets (CRE) Appear Better Positioned than a Decade Ago," *Regional Outlook*, third quarter 2000.

⁹ "New Projects Grind to a Near Halt in San Francisco," *The Real Estate Journal*, September 9, 2002. "A Look at Residential and Commercial Real Estate Markets," The Federal Deposit Insurance Corporation Real Estate Study, September 19, 2002, also notes that the volume of speculative construction (nationwide) has been reduced from six months earlier.

¹⁰ Ratios represent two-quarter moving averages of median CRE delinquency ratios. Delinquency is defined as loans 30 days or more past due or in nonaccrual status. Ratios are for institutions at least three years old and with CRE loans at least 10 percent of assets.

and remained well below CRE delinquency rates experienced a decade ago.¹⁰

However, institutions with high CRE loan exposure and those that increased CRE loan concentrations as the Mid-Atlantic's office markets peaked may be more susceptible to credit quality weakness.¹¹ In particular, institutions that made CRE loans that assume a continuation of high rents, low vacancy rates, and strong property cash flows could experience credit quality weakening if CRE market conditions remain soft for a prolonged period. Two-thirds of the Mid-Atlantic's institutions that reported high and increasing CRE concentrations are headquartered in the Mid-Atlantic's major metropolitan areas, each of which has experienced weaker CRE market conditions.¹² One-third of the institutions that meet these criteria were chartered during the 1990s expansion and until recently had not experienced an economic slowdown. While capital ratios of the banks that have high and increasing CRE loan concentrations are lower on average than those of the Mid-Atlantic's other institutions, their median ratio of loan loss reserves to delinquent loans is higher.

Strong Housing Markets and a Steep Yield Curve Have Benefited Residential Lenders

During this economic downturn, the Mid-Atlantic's residential mortgage lenders¹³ have benefited from record mortgage originations and a relatively steep yield curve, and have experienced only slight credit quality weakening. After increasing slightly in 2001, the median past-due ratio reported by residential lenders improved by second quarter 2002. Nevertheless, insured institutions with riskier mortgage loan portfolios, such as those

involved in subprime lending, are susceptible to credit quality weakness, particularly should the economy deteriorate or home prices decline.

Although the economic downturn has affected credit quality among residential lenders only moderately, changes in the level and steepness of the yield curve have affected net interest margins (NIMs) profoundly. Residential lenders typically fund short and lend long. As a result, the decline in long-term interest rates during the past two years, which has spurred strong demand for long-term, fixed-rate mortgages, has pushed asset yields lower. Since peaking in 2000, the median asset yield reported by the Mid-Atlantic's residential lenders had declined by 110 basis points through second quarter 2002. During the same period, however, short-term market interest rates declined more than long-term rates, pushing down the median cost of funds by 137 basis points. As a result, four of every five of the Mid-Atlantic's residential lenders reported a higher NIM in second quarter 2002 than a year ago.

...But Challenges Lie Ahead

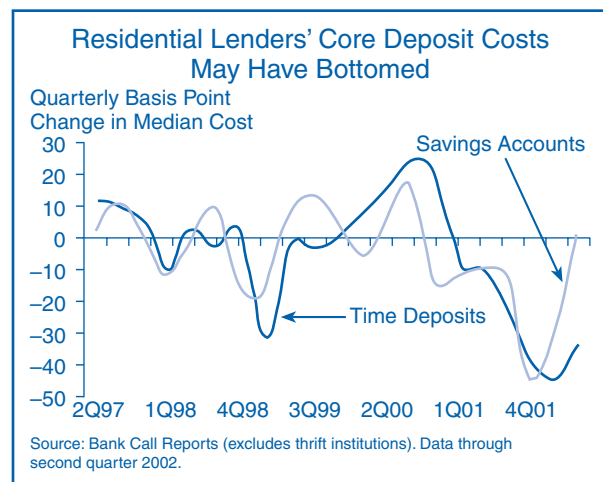
With short-term market interest rates showing signs of stabilizing, the decline in banks' cost of funds will likely slow. As indicated in Chart 2, the rate of decline in the cost of core deposits, which represent about 80 percent of the funding for the Mid-Atlantic's residential lenders, may have bottomed. The median cost of time deposits, which responds more slowly to changes in market rates because of the time needed for these accounts to mature and reprice, continued to decline; however, the rate of

¹¹ Includes institutions that reported a ratio of CRE loans to Tier 1 capital above the Region's 75th percentile and those that reported an increase in the ratio of CRE loans to Tier 1 capital above the Region's 75th percentile during peak market conditions. The peak in market conditions is the time during which office vacancy rates were at the lowest point during the previous economic expansion (i.e., 1999 and 2000). Of the Region's 835 insured institutions, 127, or 15 percent, met the two criteria as of June 30, 2002.

¹² The Region's major metropolitan areas are New York City, Philadelphia, Baltimore, Washington, D.C., and northern New Jersey. Northern New Jersey comprises the Bergen-Passaic, Jersey City, Newark, Middlesex-Hunterdon-Somerset, and Monmouth-Ocean metropolitan statistical areas.

¹³ Residential mortgage lenders are insured institutions in operation at least three years with at least 50 percent of assets in residential mortgage loans and mortgage-backed securities. As of June 30, 2002, 246, or approximately 30 percent, of the Region's institutions specialized in residential mortgage lending.

CHART 2



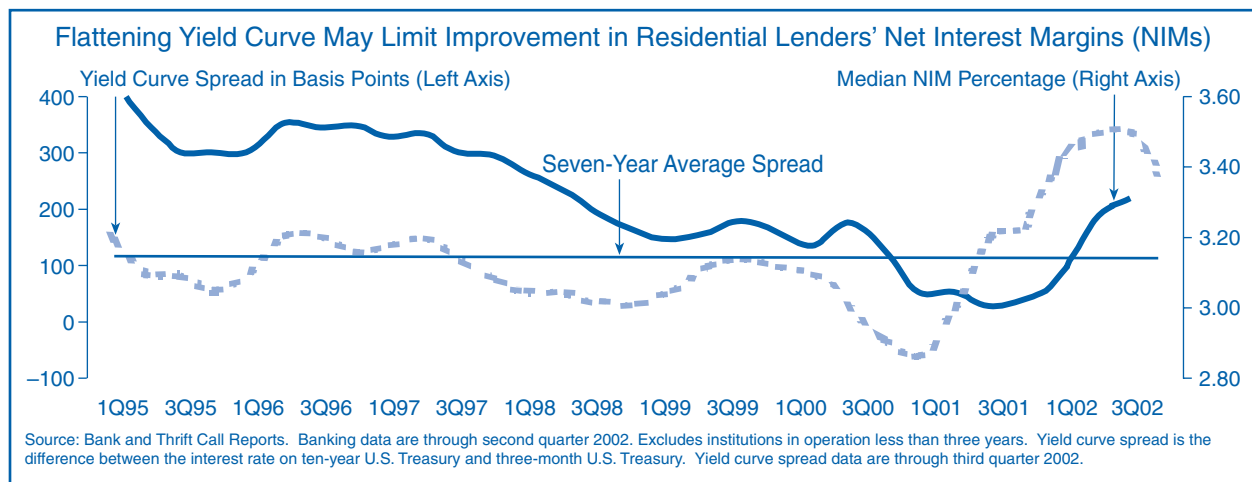
decline has slowed. As a result, future margin improvement may be muted as core deposit costs approach a floor.

The decline in long-term interest rates and flattening of the yield curve in third quarter 2002 also may limit future NIM improvement by residential lenders (see Chart 3). The large volume of mortgages originated at record low long-term rates could pressure loan yields, while increased prepayments on mortgage-backed securities could have a negative effect on yields earned on mortgage related investments. Nevertheless, the yield curve was steeper than its longer-term average (and steepened further at the start of the fourth quarter), which should keep NIMs from returning to lows reached in 2000. Moreover, fee income earned on new mortgages may somewhat mitigate the effect of lower yields on bank earnings.

Residential Lenders' Interest Rate Risk Management May Be Tested

Interest rate risk management by residential lenders likely will be tested following two years of substantial mortgage refinancings and shifting yield curve relationships. Evaluating a scenario in which deposit costs may be bottoming while loan yields have declined will be key to effective interest rate risk management. Assumptions used to determine the amount of deposit inflow and the sensitivity of deposit costs to market interest rates should be reviewed for reasonableness. Assumptions concerning loan prepayment activity also should be evaluated to help ensure that bank management receives accurate information about interest rate risk exposure. (Refer to *New York Regional Outlook*, second quarter 2002, for more information on interest rate risk among the Mid-Atlantic's residential lenders.)

CHART 3



Large Banks' Profitability Is Mixed; Credit Quality Remains a Concern

The Mid-Atlantic's large banks (those with total assets over \$25 billion) reported mixed profitability results in third quarter 2002. Most large banks reported increased loan loss provisions, reflecting concerns over corporate credit quality. Loan delinquency and charge-off rates increased compared with second quarter 2002 and remained well above year-ago levels.¹⁴ Credit quality deterioration was more significant for institutions with greater loan exposure to the telecommunications industry and Argentina, and expectations are for continued commercial credit quality weakness through the remainder of this year. According to *Moody's Investor Service*, the global default rate on speculative-grade bonds will continue to decline from 9.2 percent in September 2002 to 8.4 percent by the end of this year. Moody's, however, cautioned that corporate quality remains under pressure and aggregate default rates will remain high in the near future.¹⁵

¹⁴ Information on large bank performance (excluding credit card banks) comes from company press releases for third quarter 2002.

Noninterest income from investment banking business lines, such as private equity, merger advisory, and trading activities, remained weak, and securities gains moderated from 2001 levels. However, stable conditions in securities servicing business and strength in consumer business lines, such as mortgage origination, bolstered profitability of some of the Mid-Atlantic's large banks. Historically low long-term interest rates spurred strong demand for residential mortgage loans; however, mortgage demand may moderate should interest rates increase. Favorable performance in consumer business lines has helped offset weaker corporate performance. However, should economic weakness spread to the consumer sector, consumers and retail banking business lines may be affected negatively.

¹⁵ Moody's Investor Service, *Press Release: September Default Report*, October 18, 2002.

New York Region Staff

New England Perspectives

Weakness in the Technology and Financial Services Sectors Is Causing the Massachusetts Economy to Underperform Those of Other New England States

The economic performance of each of the six New England states is quite disparate.¹ The **Rhode Island** and **Maine** economies continue to perform relatively well, while nonfarm employment in **Vermont** and **Connecticut** dropped noticeably during the first nine months of 2002 compared with a year ago. Economic conditions remain mixed in **New Hampshire**.

Labor market conditions are weakest in **Massachusetts**; the state's cumulative 2.7 percent job loss from its recent peak through September 2002 is more than double the peak-to-trough decline in the national economy during this recession. Similarly, the Massachusetts unemployment rate has risen and, at 5.2 percent in Sep-

¹ See *Boston Regional Outlook*, third quarter 2002, for more on this topic.

tember, was the highest among the New England states—although below the 5.6 percent national average. Much of the state's continued economic weakness can be attributed to the national slump in business investment and information technology (IT) spending, as well as the bearish stock market. National payroll trends through September reflected continued deterioration in employment among securities and IT manufacturing and service firms (see Chart 1). Employees in these industries are more highly compensated and represent significant concentrations of employment in eastern Massachusetts and southern New Hampshire. Employment, income, and wealth derived directly or indirectly from the equity markets fuel economic growth in many parts of New England, particularly southwest Connecticut and greater **Boston**. As a result, the continued slump in U.S. equity markets likely has impeded New England's economic growth this year.

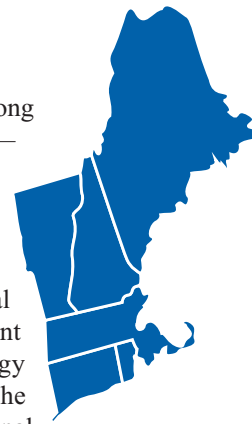
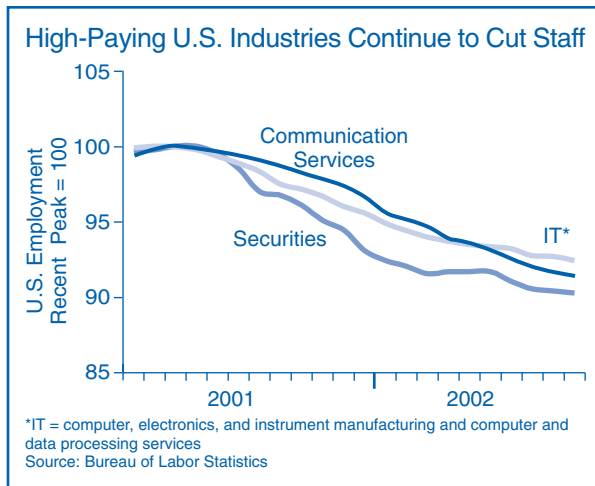


CHART 1

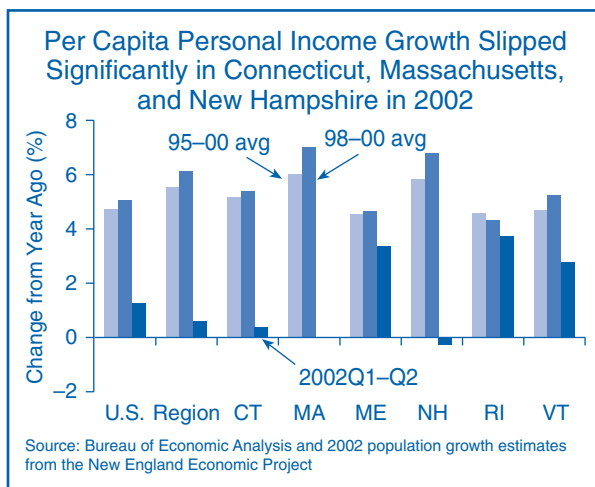


Personal income growth also has been adversely affected by layoffs and pay cuts in New England's highest-paying industries, as well as declines in the stock market. Chart 2 shows first-half data (latest available) on personal income and indicates that per capita income has probably suffered this year. Connecticut, Massachusetts, and New Hampshire—the three New England states with significant concentrations of jobs in IT and the stock market—could report the poorest per capita income performance in more than a decade once the tally is complete for 2002.

Home Price Appreciation Is Abating

Despite the recent recession, home sales, price appreciation, and new construction generally have performed

CHART 2



exceptionally well in most markets across the nation and in New England. However, recent home price gains, in many cases well in excess of income growth, have led to speculation about the existence of a home price “bubble,” implying that prices could soon decline significantly. At least in New England's largest metro areas, this is currently not the case. In fact, the rate of price appreciation already has decelerated in several markets characterized by robust price increases in recent years. The Boston metropolitan statistical area (MSA) is a notable example. Should this trend continue, any price imbalances are likely to realign slowly, avoiding a sudden drop. An aggregate decline in home prices remains a modest risk, but it could become more significant if the current employment and income situation deteriorates further. Some smaller housing markets, characterized by robust price increases as well as rising supply, such as **Portland**, Maine, may be more vulnerable to a rapid deceleration (or possible decline) in home prices should weak economic conditions continue.

The Commercial Real Estate Sector Has Yet to Recover

New England's commercial real estate markets continue to weaken as sublease space remains abundant and employment levels are slow to rebound. Markets appear to be hitting bottom; however, a recovery in this sector is not expected until 2003. According to *Spaulding Slye Colliers*, the Greater Boston office vacancy rate rose 5 percentage points to 10.5 percent during the year ending second quarter 2002. The vacancy rate roughly doubles if the nearly 15 million square feet of available sublease space is included.² The suburbs are the weakest market segment, with 25 percent of inventory on the market as of second quarter 2002. Also, during the past six quarters, office rents fell to 1999 levels. Continued layoffs and weak job growth could exacerbate current conditions, forestalling any recovery. However, the effects on insured institutions in the Boston MSA should be modest, because commercial real estate exposure relative to capital, although rising, remains low compared to the late 1980s.

² Spaulding Slye Colliers tracks vacant (direct space being actively marketed for occupancy) and sublease space separately.

Credit Quality and Coverage Levels Remain Strong

Credit quality among New England's insured institutions has held up well. Increases in delinquency rates have been minor compared with the previous recession. While total loan delinquency rates remain modest as of second quarter 2002, some deterioration has been noted among larger banks (assets greater than \$1 billion), which represent roughly 10 percent of insured institutions in New England. Following strong annual growth during the late 1990s, commercial loan growth tapered off overall among New England's insured institutions during the past two years and remained modest at community institutions through second quarter 2002. Following marginal increases over the past year, commercial loan charge-offs remain low compared with those of the nation but may rise further should noncurrent loan volume continue to grow. Losses also grew in the consumer loan segment, particularly among credit card portfolios, during the year ending second quarter 2002. Consumer loans represent a small share of New England's insured institution portfolios.³ As a result, the effects of a weakening consumer sector on insured institutions will probably be muted. Allowance coverage of nonperforming loans remains strong throughout New England and should provide an adequate cushion in the near term if economic conditions worsen and credit quality deteriorates further.

Interest Rate Risk Is Still a Concern

Concentrations in mortgage-related assets, while bearing nominal credit risk, could heighten the level of interest rate risk for many of New England's insured institutions. This concern was addressed in the *Boston Regional Outlook* (second quarter 2000 and first quarter 2002) and remains today. Rising levels of interest rate risk are particularly evident among small savings institutions (assets less than \$1 billion), which represent nearly two-thirds of New England's insured institutions. Large savings banks and commercial banks reflect similar exposures to interest rate risk, although not as pronounced because of lower levels of long-term, fixed-rate mortgage loans.

The volume of long-term assets held by New England's insured institutions, particularly small savings institu-

tions, has increased steadily since the mid-1990s. The ratio of long-term assets to total earning assets rose from 23 percent to slightly over 40 percent between June 1995 and June 2002 in New England's small savings institutions.⁴ During the same time, the ratio increased from 14 percent to 23 percent in New England's commercial institutions and from 25 percent to 29 percent in its large savings institutions. While growth of long-term assets moderated in 2000 after the refinancing boom of 1998, strong refinancing activity resumed in 2001 and continued into 2002, adding to concentrations of long-term fixed-rate assets. Through June 30, 2002, the nationwide refinancing index⁵ reached relatively high levels, and adjustable-rate loans represented a low 16 percent of mortgage applications. Prepayment rates on the long-term assets booked during the low interest rate environment of the past few years will be low, especially when interest rates begin to rise.

While balance sheets have shifted toward long-term assets, the liability side consists of relatively short-term instruments. As of the end of second quarter 2002, 74 percent of time deposits held by New England's small savings institutions were set to mature or reprice in one year or less. Nonmaturity deposits made up just over 45 percent of interest-bearing liabilities, a number that has been on the rise for the past several years. When rates begin to rise, institutions are more likely to see deposits move to higher-yielding accounts, either in the institution or elsewhere, while assets are held in long-term, fixed-rate loans. As a result, institutions' funding costs will rise. Without a similar rise in asset yields, margins and earnings could be affected adversely.

Controlling funding costs when interest rates rise is challenging. The vast majority of time deposits are set to mature or reprice in less than one year, limiting the ability to control funding costs in a rising rate environment. Furthermore, nonmaturity deposit costs have been low since 1993, and overall deposit costs in New England typically have been lower than in other parts of the country. As a result, insured institutions will have difficulty retaining deposits if management tries to boost margins by lowering rates. Longer-term earnings are at risk if management practices do not reduce exposure to rising interest rates.

Boston Staff

³ Consumer loans, which include credit card, other revolving credit, and installment loans, represent less than 6 percent of average loan portfolios in New England.

⁴ Call Report filers only.

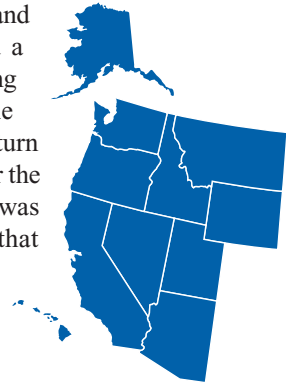
⁵ The Mortgage Bankers Association of America publishes the refinancing index. As of September 20, 2002, the index was 4607.5. The benchmark is 100 as of March 16, 1990.

San Francisco Regional Perspectives

During 2002, the Region's economy slowly recovered from the recession. Seasonally adjusted employment grew a meager 0.1 percent between year-end 2001 and August 2002. Most of the Region's states reported sluggish to negative job growth during the first eight months of 2002; only four (**Wyoming, Nevada, Montana, and Alaska**) reported job growth exceeding 1 percent. Over the period, the manufacturing, transportation and public utilities, and construction sectors lost jobs, while the government and retail trade industries added jobs.

Asset quality and earnings performance weakened among the Region's insured institutions between mid-2001 and mid-2002. This article discusses several additional factors that could pressure credit quality in the near term. High consumer debt service burdens and personal bankruptcy filing rates contributed to higher consumer loan losses and could continue to affect household credit quality adversely. Weak corporate sales and profits, which could be slow to improve, led to higher commercial loan delinquency ratios. Declining office employment and continued construction activity have pushed up office vacancy rates in most of the Region's major markets during the past two years. High commercial real estate (CRE) loan exposures among the Region's insured institutions increase their vulnerability to sustained weakness in CRE markets.

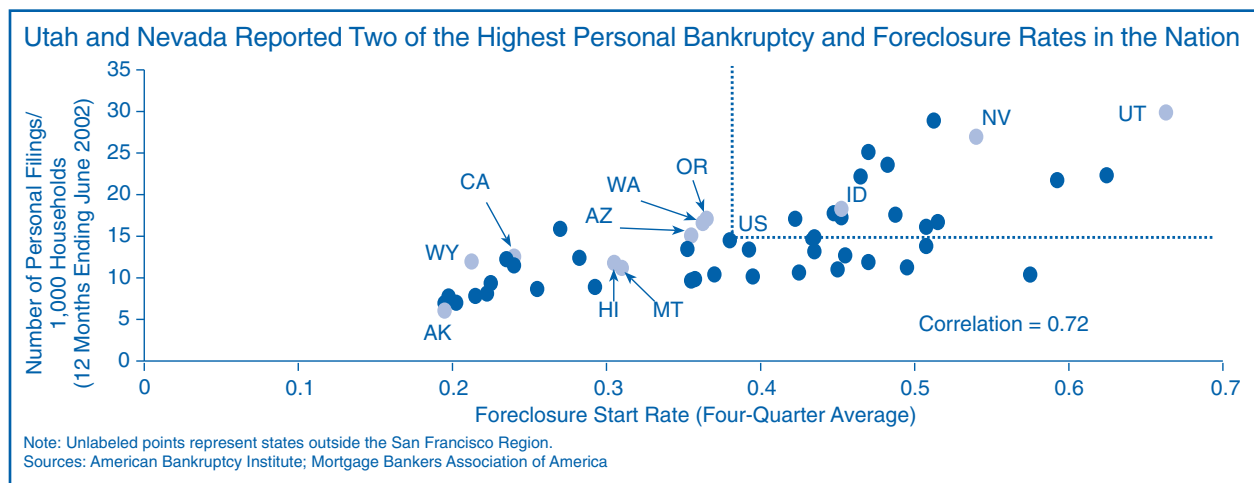
In addition, economic softness and interest rate declines have had a negative effect on earnings among some insured institutions. The second quarter 2002 median return on average assets (ROA) ratio for the Region's insured institutions was 1.08 percent, comparable to that reported by institutions elsewhere in the nation. However, earnings performance was uneven across institutions of various sizes and lending specialties.



Personal Bankruptcies Aggravated Consumer Credit Quality Problems

Nationally, the personal bankruptcy filing rate continued to climb this year, reaching a ten-year high during the second quarter. Personal bankruptcy trends were in part a reflection of near-record consumer debt service burdens. **Utah** and Nevada reported personal bankruptcy filing rates nearly twice the national average, and **Idaho, Oregon, Washington, and Arizona** also reported above-average rates. Similar trends were evident in residential foreclosures; Utah, Nevada, and Idaho reported rates higher than average for the Region and for the nation (see Chart 1).

CHART 1



Consumer loan¹ delinquency and net charge-off ratios tracked trends in bankruptcy activity. The Region's consumer lenders² reported pronounced softening in asset quality. Among these institutions, the median past-due consumer loan ratio increased from 2.62 percent to 2.92 percent, and the median consumer loan net charge-off ratio rose significantly, from 1.46 percent to 2.05 percent between mid-2001 and mid-2002. Continued increases in household debt service burdens and bankruptcy rates, both within and outside the Region, could affect these institutions adversely, because they hold high consumer loan concentrations and often lend money on a broad geographic scale. In addition, some credit card lenders might be required to bolster loan loss reserves or adjust revenue recognition practices to conform to proposed guidelines for credit card account management and loss allowance.³

Among the Region's community institutions,⁴ the median past-due consumer loan ratio increased slightly from 0.94 percent to 0.98 percent between June 2001 and June 2002. Delinquencies were highest among institutions headquartered in Utah and Montana, where median past-due consumer loan ratios topped 2 percent. Although increases in consumer loan delinquency were generally moderate, the median annualized consumer net charge-off ratio nearly doubled year-over-year, from 0.10 to 0.18 percent.

Unlike consumer loans, 1 to 4 family mortgage delinquency ratios did not rise uniformly across the Region. The Region's past-due 1 to 4 family mortgage ratio declined from 0.81 percent to 0.69 percent between June 2001 and June 2002. However, community institutions headquartered in Washington, Alaska, Wyoming, and Nevada reported year-over-year delinquency increases. Robust refinancing activity during 2001 and 2002 may have contributed to lower delinquencies in certain areas, allowing previously delinquent borrowers to restructure their debts.

¹ Consumer loans include credit cards and other non-real estate-secured loans to individuals.

² Consumer lenders include insured institutions with consumer loan to Tier 1 capital ratios exceeding 200 percent.

³ For additional details, refer to the FFIEC *Account Management and Loss Allowance* guidelines issued for comment on July 22, 2002 (http://www.ffiec.gov/PDF/pr072202_guidance.pdf).

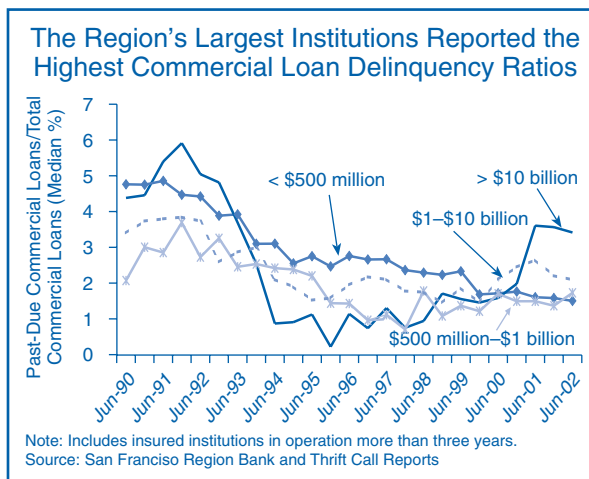
⁴ Community institutions are defined as insured institutions in operation more than three years, with consumer loan-to-Tier 1 capital ratios below 200 percent and total assets of less than \$1 billion. Industrial loan companies are excluded. Community institutions tend to be more geographically focused, and their performance may be more reflective of economic trends within a local market.

Consumer and residential lenders could experience additional credit softening despite the Region's economic recovery. Continued weak job creation (a "job-less recovery") could limit households' ability to sustain debt payments. Moreover, once the recovery takes hold, or should inflation fears return, future interest rate increases could raise household debt service burdens and dampen home price appreciation trends. Markets with already low housing affordability (e.g., several California metropolitan statistical areas (MSAs), including **Salinas, Santa Barbara, San Luis Obispo, San Francisco, Santa Rosa, San Diego, and Orange County**) could be susceptible to the effects of rising interest rates on home prices. The pool of potential buyers is limited in these markets because median family incomes are too low to finance median-priced homes. If interest rates rise, resulting in even higher debt service requirements, it is reasonable to expect home price appreciation to moderate.⁵

Commercial and Industrial Credit Quality Softened Significantly among Large Institutions

The Region's larger institutions, in particular those holding more than \$10 billion in total assets, reported pronounced deterioration in commercial and industrial (C&I) loan quality (see Chart 2). The recession-related squeeze on corporate profits and cash flows contributed to the trend. In addition, increasing stress in certain industries, such as telecommunications and high tech,

CHART 2



⁵ For additional information on housing affordability and residential real estate risks within the Region, refer to "San Francisco Regional Perspectives," *Regional Outlook*, fourth quarter 2001 (<http://www.fdic.gov/bank/analytical/regional/ro20014q/na/index.html>).

became evident in larger institutions' syndicated loan exposures.

The Region's commercial lenders could continue to experience weakness in C&I portfolios until corporate earnings improve. While showing some improvement from year-earlier rates, U.S. corporate bond defaults remain near the levels experienced during the 1990–1991 recession.⁶ *Moodys* expects corporate bond defaults to moderate through the remainder of 2002 but remain at relatively high levels, which could portend continued stress in C&I portfolios.⁷

Rising Office Market Vacancy Rates Contributed to an Increase in Delinquencies in Some Areas

By mid-2002, the Region's office vacancy rates had risen substantially from year-earlier levels in almost all 17 MSAs tracked by *Torto Wheaton Research*. The **San Jose**, **San Francisco**, **Portland**, **Seattle**, **Sacramento**, and **Oakland** MSAs experienced the greatest vacancy rate increases during the past year. Vacancy rates were between 8 and 12 percent in these markets in mid-2001; one year later, rates ranged from almost 13 to 19 percent.

Second quarter 2002 vacancy rates in some markets topped levels reported during the early 1990s; however, CRE loan⁸ problems in the Region's major MSAs remained relatively muted. Exceptions included community institutions headquartered in the **Provo**, **Stockton**, **Salt Lake City**, **Cheyenne**, Santa Rosa, and San Diego markets, where median CRE loan delinquency ratios exceeded those reported one year and ten years earlier. Although the median past-due CRE loan-to-total CRE loan ratio in each of these markets was below 2 percent, loan quality deterioration is relevant, given the level and trend of concentrations in these markets. With the exception of Provo, the median CRE loan-to-Tier 1 capital ratio exceeded 150 percent in each of these MSAs as of mid-year 2002, and CRE loan concentrations were up significantly from the early 1990s.

⁶ Standard and Poors, "S&P Global Bond Markets' Weakest Links & Monthly Default Rate," September 13, 2002 (http://www.standardandpoors.com/PressRoom/Ratings/Articles/091302_weakest.pdf).

⁷ Moodys, "Corporate Defaults Refuse to Yield in 2002," *Special Comment*, July 2002 (http://riskcalc.moodysrms.com/us/research/defrate/Q202_comment.pdf).

⁸ Because this discussion focuses on office vacancy trends, CRE loan data were limited to nonfarm-nonresidential-secured loans.

Although vacancy rate increases abated in more than half the Region's office markets between the first and second quarters of 2002, Torto Wheaton forecasts continued vacancy increases in the **Ventura**, **San Jose**, **Sacramento**, **Los Angeles**, **Seattle**, and **Portland** MSAs through the first half of 2003.⁹ The median CRE loan-to-Tier 1 capital ratio among community institutions in these six markets exceeded 200 percent in mid-2002, double the ratio reported by MSA-based institutions elsewhere in the nation. Thus, lenders in these areas could be especially vulnerable to additional market softening.

Weakening Asset Quality and Lower Interest Rates Resulted in Irregular Earnings Trends

Although almost 90 percent of the Region's 784 insured institutions were profitable through second quarter 2002, earnings trends were uneven. The Region's community banks¹⁰ reported slightly higher provision expense-to-average asset ratios and narrower net interest margins (NIMs). Between June 2001 and June 2002, the median year-to-date NIM among the Region's community banks declined from 4.95 percent to 4.79 percent. Quarterly NIMs recovered somewhat in second quarter 2002. Banks appear to have stemmed declines in earning asset yields by diverting assets into higher-yielding loans, in particular C&I and CRE credits. Such shifts might have introduced additional liquidity and credit risks, especially in light of lingering problems in the CRE sector.

The effects of declining interest rates were more pronounced among community banks in the Region than in other areas of the nation, in part because of the structure of bank balance sheets in the West. Within the Region, the level of assets scheduled to reprice within one year tends to be high compared with the amount of liabilities scheduled to reprice in the near term. This mismatch likely relates to relatively high concentrations of C&I and CRE credits and lower investments in single-family mortgages. In general, C&I and CRE credits are structured on a short-term or variable-rate basis, whereas

⁹ Torto Wheaton Research, *Fall 2002 TWR Office Outlook*.

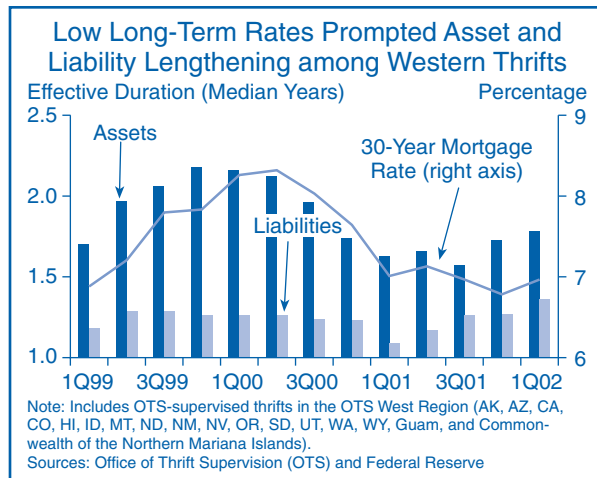
¹⁰ Community banks are defined as insured commercial banks of all ages holding less than \$1 billion in total assets. Net interest margins among these institutions tend to behave differently than those of thrifts, because commercial banks specialize in shorter-term commercial lending and are less reliant on wholesale borrowings. Community bank NIMs also tend to behave differently from large bank NIMs, because large banks are often more dependent on short-term, wholesale funding sources.

one-to-four-family mortgages are typically longer term or fixed rate.

Unlike community banks, savings institutions saw funding costs decline more quickly than asset yields; thus, the steeper yield curve boosted thrift NIMs and ROA ratios. However, sustained refinancing activity adversely affected fee income levels among some institutions. One-quarter of the Region's thrifts that service mortgages for others reported servicing asset impairments sufficient to offset all servicing fee income.¹¹ Such impairments could increase by year-end 2002, given very high mortgage prepayment speeds in the third quarter. Heavy refinancing activity and the popularity of fixed-rate and hybrid adjustable-rate mortgages during the period also might have increased concentrations of low-yielding long-term assets among thrifts. According to the Office of Thrift Supervision (OTS), the effective duration of assets and liabilities among thrifts in the OTS West Region grew between March 2001 and March 2002, and thrift assets continued to be supported by relatively shorter-term

¹¹ Per generally accepted accounting principles, one-time write-downs to mortgage servicing assets are netted against mortgage servicing fee income.

CHART 3



funding sources (see Chart 3).¹² Should rates rise, new mortgages might not reprice in tandem with funding costs, thereby compressing thrift NIMs.

Judy Plock, Senior Financial Analyst

¹² Office of Thrift Supervision, *The Quarterly Review of Interest Rate Risk*, vol. 7, issue 1, first quarter 2002 (<http://www.ots.treas.gov/docs/11210.pdf>).

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