Regional Outlook

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FDIC
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Regional Perspectives

◆ **The nation's economic landscape has altered dramatically over the past year, resulting in perhaps the most challenging environment in a decade for insured institutions.**

◆ **The Atlanta Region's insured institutions that hold large concentrations (at least 15 percent of assets) in traditionally higher-risk loan categories, as well as non-recession-tested banks, may be more vulnerable to the effects of the current economic downturn.**

◆ **These types of insured institutions that have adopted a business model that relies on rapid economic growth should evaluate their ability to operate during a period of slow economic growth.** ***See page 3.***

By the Atlanta Region Staff

In Focus This Quarter

◆ ***Housing Market Has Held Up Well in This Recession, but Some Issues Raise Concern—*****Recent trends in mortgage underwriting are of particular interest, as an estimated $2 trillion in mortgage debt, approximately one-third of the total outstanding, was underwritten during 2001. Nonconstruction residential mortgages traditionally have represented one of the better-performing loan classes during prior downturns. The level of credit risk, however, may be higher this time around because the mortgage lending business has changed since the last downturn. This article examines these changes, including increased involvement by insured institutions in the higher-risk subprime credit market, the acceptance of higher initial leverage on home purchases, and greater use of automated underwriting and collateral valuation processes, which have not been recession-tested.**

◆ **Home price softening could have an adverse effect on residential construction and development (C&D) and mortgage portfolios. In the aggregate, the level of risk appears modest. However, insured institutions with significant C&D loan exposures in markets that experienced ongoing residential construction during 2001, despite slowing local economies, are at higher risk. Weakening home prices could hurt loan quality in selected markets. The San Francisco Bay area stands out as a place to watch in this regard.** ***See page 9.***

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Regional Perspectives

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Region's Economic and Banking Conditions

The National Economic Downturn May Have an Adverse Effect on Certain Types of Insured Institutions in the Region

The nation's economic landscape has changed dramatically over the past year, resulting in perhaps the most challenging environment in a decade for insured institutions. One year ago, many analysts were beginning to debate the alternative scenarios that might emerge if the nation's longest economic expansion ended.[1] Unlike the last recession in 1990/1991, which was preceded by regional economic downturns in many areas of the country, the current recession is being felt both domestically and globally. Global economic weakness may affect the depth and duration of the current national recession and the subsequent timing and strength of a recovery. This article analyzes the recent economic downturn, prospects for recovery, and effects the recession may have on certain segments of insured institutions within the Atlanta Region.

Roots of the Economic Downturn and Forecast Risks

Supply-side excesses are a major factor in the current downturn. A number of economists believe that the size of these excesses is unparalleled compared with other post–World War II economic cycles.[2] Manufacturing activity started to deteriorate as early as August 2000, well before employment peaked in March 2001. The uncertainty and subsequent disruptions caused by the events of September 11 further intensified the economic downturn that started in the spring. The behavior of the current downturn is unusual, which further complicates economic forecasting. Consensus economic forecasts in 2001 consistently underestimated the timing and depth of the downturn.[3] Currently, the consensus forecast is for real gross domestic product (GDP) to grow 1.3 percent in first-quarter 2002 and 2.9 percent in second-quarter 2002.[4] *If the consensus real GDP growth estimates are accurate, this downturn would rank as the shallowest and as one of the shortest of the post–World War II recessions*.

What Could Spark an Economic Recovery?

Business investment does not appear to be a strong source of growth. A decade of expansion has led to significant overcapacity within the nation's industrial infrastructure. Accordingly, many industry sectors have seen significant downward pricing pressures on intermediate and finished goods. The manufacturing utilization rate has slipped to levels not seen since the 1982/1983 recession. Hence, the weaknesses in the corporate sector—reduced cash flow and underutilized plant and equipment—will likely mute any rebound in business investment during 2002.

[1] A good discussion of the "V," "U," and "L" scenarios can be found in Peter Coy, Marcia Vickers, Rich Miller, Charles Whalen, and Jim Kerstetter, March 12, 2001."How Bad Will It Get?" *Business Week*.

[2] See Stephen Roach, December 14, 2001, "The Character of Economic Recovery—Part I," *Global Economic Forum*, Morgan Stanley, for a good analysis of the bursting of the bubble-induced excesses of capital spending.

[3] The quarterly median real GDP forecast surveys from the National Association for Business Economics (NABE) consistently called for real GDP growth of 3 percent in 2001.

[4] February 2002 median real GDP forecast survey from NABE.

Questions remain about consumers' ability to sustain spending at current levels. Consumer debt levels and service burdens are at or near all-time highs.[5] Increasing unemployment is beginning to reduce personal income, and 2002 may see sharper declines in personal income because of cutbacks in flexible compensation such as bonuses, stock options, and stock grants.[6] Also, consumers may need to increase their savings from income because of the decline in equity markets. During fourth-quarter 2001, purchases of large deferrable items—housing and automobiles—reached near-record levels because of low interest rates and aggressive manufacturer incentives. Usually, consumers scale back on purchases of such items during a recession, leading to pent-up demand. Traditionally, during previous recessions consumers' willingness to borrow to satisfy this demand has been key to reviving economic growth.

The outlook for a quick turnaround domestically has been further complicated by global economic weakness. It has been nearly 30 years since the last global recession. ***DRI-WEFA*** recently estimated that the global economy expanded by less than 2 percent in 2001—2 percent is often considered the threshold for defining a global recession—and will see only limited improvement in 2002.[7] Weak growth globally coupled with continued strength in the trade-weighted value of the U.S. dollar could restrict export opportunities, weakening recovery prospects.

Fiscal stimulus under consideration may have less effect on the condition of the economy than commonly thought. In early 2002, Congress had yet to reach an agreement on any additional fiscal stimulus package. As the economy slowed, many states and municipalities experienced declining income and sales-tax revenue collections. In response, many entities have enacted or proposed budget cuts or increased taxes, which may offset the benefits of any federal stimulus.

Downward Pressures on Prices Could Heighten Risks to Lenders

It may take some time for monetary policy to spur economic growth. Although the targeted federal funds rate was lowered by 4.75 percentage points in 2001, real short-term interest rates (federal funds rate less inflation rate) remain positive.[8] After the recession of 1990/1991, economic growth did not begin to accelerate until real short-term interest rates fell to zero or went negative. With a targeted federal funds rate of 1.75 percent in January 2002, there appears to be very little room for further rate cuts should disinflation persist.

Recessions are typically disinflationary events and can lead to deflation under certain circumstances. Supply-side overcapacity, competitive global markets, and softening demand have put downward pressure on many prices.[9] A much rarer consequence of a recession can be a prolonged period of broad decline of prices *and nominal wages*, an event known as *deflation*.[10] A persistent disinflationary or outright deflationary environment could have negative effects on profits and on real asset and liability values. Consequently, loan quality may be lessened if collateral asset values decline and if borrowers' ability to service debt is reduced because of lower income and cash flow.

The Recession Has Implications for Insured Institutions in the Region that Are Reliant on Rapid Economic Growth

The Region's insured institutions that hold relatively high lending concentrations or those experiencing a recession for the first time may be more vulnerable to the effects of the current economic downturn.[11] The Region's economic growth outpaced the nation's during the economic expansion. As a result, many community banks[12] headquartered in the Region grew construction and development (C&D)

[5] "Do worry, be happy," *Financial Times,* January 31, 2002.

[6] David Leonhart, December 10, 2001. "Recovery and the Reluctant Consumer," *New York Times.*

[7] DRI-WEFA teleconference, November 13, 2001.

[8] Federal funds targeted rate less year-over-year change in personal consumption expenditure deflator. Monetary policy actions lowering interest rates to revive the economy generally become most effective when real short-term interest rates are negative; see Greg Ip. November 12, 2001. "The Outlook—Deflation Concerns," *Wall Street Journal* (online edition).

[9] The year-over-year percent change in the consumer price index declined substantially during 2001 from a peak of 3.7 percent in January to 1.6 percent in December.

[10] The likelihood of the United States experiencing a prolonged bout of deflation during the present downturn appears low, but the probability of such an event may be rising as nominal GDP (preliminary) declined on a quarterly basis during fourth-quarter 2001.

[11] See Federal Deposit Insurance Corporation, 1997. *History of the Eighties—Lessons for the Future,* for a lengthy discussion and analysis of the role that large lending concentrations played in the potential for failure, the frequency of problem bank ratings, and the higher failure rate of new banks during an economic downturn.

[12] Insured commercial banks with assets of $1 billion or less. The analysis is limited to this set of institutions because large commercial banks (over $1 billion) have decreased lending concentrations and become geographically more diverse during the past decade. Also, the thrift industry has undergone significant changes in capitalization, limiting the ability to make comparisons.

loans or commercial and industrial (C&I) loans faster than the national average. This above-average growth rate among the Region's community banks has resulted in concentrations in these business lines that exceed the national averages. Currently, the Region has 286 startup insured institutions[13] that are experiencing an economic downturn for the first time (these institutions began operations during the ten-year economic expansion from March 1991 through March 2001).

During the last recession, community banks with a large lending concentration (15 percent or more of assets) in traditionally higher-risk loan categories[14] were more likely to receive a problem bank rating.[15] As seen in Table 1, 417 community banks held more than 15 percent of assets in C&D loans or C&I loans at year-end 1989. Of these banks, 225, or 52.2 percent, received a problem bank rating at some point from year-end 1989 through year-end 1992. As depicted in Chart 1, community banks with a large lending concentration were twice as likely to receive a problem bank rating as those without a large lending concentration. The last economic downturn had a lagged effect on community bank performance, as the peak level in problem bank ratings occurred after the economy had started to expand. Specifically, the period-end high of problem designations occurred during second-quarter 1992—more than a year after the conclusion of the 1990/1991 recession.

During the current recession, the Region has a greater share of community banks with a large lending concentration in C&D and C&I loans than the nation does. At third-quarter 2001 about 34 percent of community banks reported a large lending concentration in either C&D or C&I loans, versus 27.5 percent at year-end 1989. The location of community banks with large lending concentrations is shown in Map 1 (next page). Most are in metropolitan areas where economic growth was well above the national average during the last expansion.

The number of community banks in the Region with a large C&D lending concentration has increased significantly, and the growth rate of this lending has not abated despite slowing economic conditions. The number of community banks with 15 percent or more of assets in C&D loans has more than tripled, from 29 banks at year-end 1989 to 104 at third-quarter 2001. Community banks with this risk exposure represent nearly 10 percent of all community banks in the Region, up from nearly 2 percent at year-end 1989. Of greater concern, however, is the substantial increase in very large C&D lending concentrations. Currently, 26 community banks have concentrations above 25 percent of assets, versus only one at year-end 1989. The substantial increase in C&D lending concentrations is further illustrated in Chart 2 (next page), which shows a rapid expansion in this lending category since year-end 1997.

TABLE 1

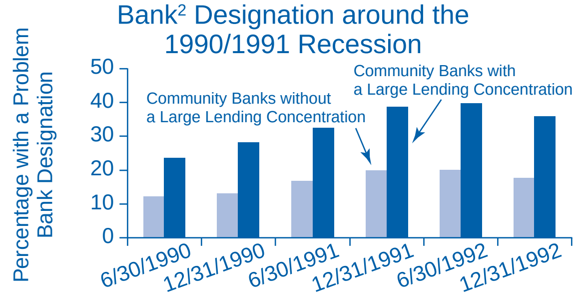
LARGE LENDING CONCENTRATIONS ARE MORE PREVELANT AT COMMUNITY BANKS[1] IN THE ATLANTA REGION DURING THIS ECONOMIC CYCLE THAN THE LAST

	12-31-1989	9-30-2001
TOTAL COMMUNITY BANKS	1,519	1,067
C&D LOANS 15% OF ASSETS	29	104
C&I LOANS 15% OF ASSETS	388	263
C&D LOANS 25% OF ASSETS	1	26
C&I LOANS 25% OF ASSETS	119	64

[1]COMMERCIAL BANKS WITH ASSETS OF $1 BILLION OR LESS.
NOTES: C&D = CONSTRUCTION AND DEVELOPMENT
C&I = COMMERCIAL AND INDUSTRIAL
SOURCE: BANK CALL REPORTS

CHART 1

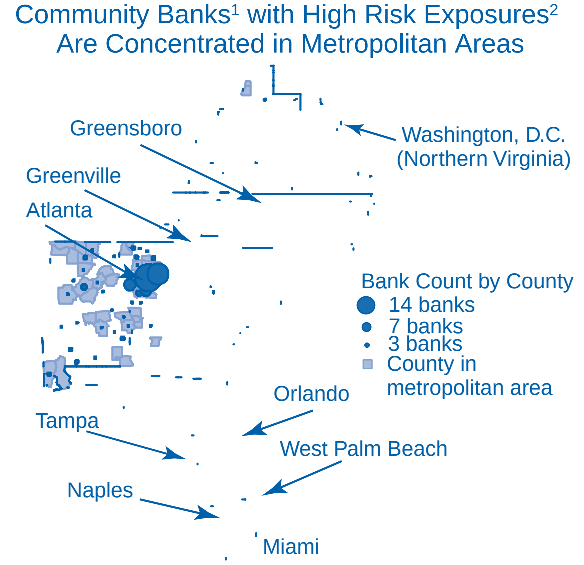
Community Banks with a Large Lending Concentration[1] More Often Received a Problem Bank[2] Designation around the 1990/1991 Recession



[1]Commercial banks with assets of $1 billion or less and construction and development loans or commercial and industrial loans 15 percent or more of assets
[2]Uniform Bank Rating of 3, 4, or 5
Source: Bank Call Reports, FDIC Examination Database

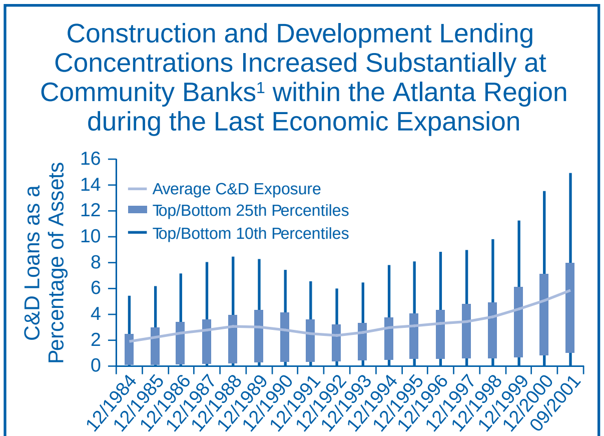
[13] Startups include all commercial bank openings except special-purpose entities, those that opened with an affiliate relationship (financial or managerial), or those resulting from mergers and acquisitions or intercompany reorganizations.
[14] The analysis of lending concentration is focused on two loan categories—C&D and C&I—because they historically exhibit higher loss rates.
[15] Problem bank rating is a Uniform Bank Rating (CAMELS) of 3, 4, or 5.

Map 1



[1]Insured commercial banks with assets of $1 billion or less
[2]More than 15 percent of assets in either C&I or C&D loans
Source: Bank Call Reports, third quarter 2001

Chart 2



[1]Commercial banks with assets of $1 billion or less
Source: Bank Call Reports

Most community bank C&D lending is for residential housing construction, a sector that is not immune to downside risk. Although home prices have been fairly resilient during the current downturn, in each of the past three recessions home prices fell on a real basis.[16] Although residential real estate construction lending is not considered as risky as C&D lending for other property types, historical experience suggests that this type of lending is not without risk. The community banks with a large C&D concentration at year-end 1989 were lending primarily in a major Southeastern metropolitan market where residential real estate prices were comparatively unaffected by the economic downturn. Median home prices declined by less than 2 percent on average, and the price decline was recaptured nominally within four quarters.[17] Although residential real estate prices declined modestly during the last downturn, 20 of the 29 (69 percent) community banks with a large C&D concentration in 1989 eventually received a problem bank designation.[18] Hence, a modest adjustment in home prices can contribute to elevated numbers of problem banks.

The capital cushion at Atlanta Region community banks with a large lending concentration has declined modestly, but capital levels among other community banks have increased. The average concentration has declined slightly from year-end 1989 to third-quarter 2001 among community banks with a large C&I lending concentration. Over the same period, however, the average equity-to-asset ratio at these banks has moderated by 40 basis points to 10.68 percent. For community banks with a large C&D concentration, the average lending exposure has increased while the average capital ratio has decreased. Hence, community banks in the Region with a large lending concentration have about the same capital protection as they did going into the last economic downturn. In sharp contrast, average equity-to-asset ratios for other community banks in the Region have increased from 11.63 percent to 12.51 percent.

Competitive pressures may be reducing the returns to commercial banks involved in C&D lending. Although the Call Report does not contain detailed information to calculate the yield of this lending category, return on assets (ROA) for community banks with a large C&D lending concentration has been falling. Specifically, the average pretax ROA[19] for community banks with a large

[16] Jathon Sapsford and Patrick Bara, January 2, 2002. "Precarious Balances: Spending Tempers Downturn, but Debts May Slow Recovery," *The Wall Street Journal.*

[7] In sharp contrast, some economically diversified markets outside the Region, such as Boston and San Francisco, experienced median home price declines of more than 5 percent and far longer recapture periods stretching up to 30 quarters.

[18] See FDIC, "Metropolitan Atlanta Construction and Development Lending Trends," *Bank Trends,* Number 98-06, for further discussion and analysis. Insured institutions in this market with large C&D loan concentrations exhibited a 21 percent failure rate versus 5 percent for institutions without large concentrations.

[19] Pretax versus after-tax ROA is a better comparative measure because of variations in tax positions of individual commercial banks (i.e., Subchapter S). Includes community banks with a large C&D lending concentration in operation before first-quarter 1991 and still open third-quarter 2001.

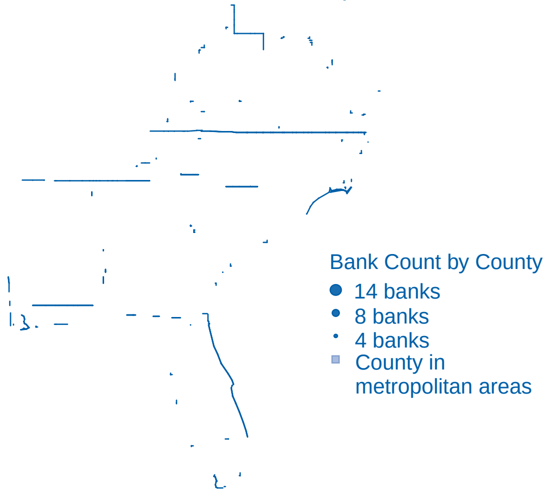
C&D lending concentration declined from 1.91 percent at year-end 1995 to 1.68 percent at third-quarter 2001. This decline is consistent with anecdotal reports from bankers at various outreach meetings conducted by the FDIC in early 2001.[20] In general, bankers reported that the pricing of a residential C&D loan had been greatly reduced over the past decade.[21]

Non-Recession-Tested Institutions May Be Challenged

The Region is home to 25 percent of the nation's non-recession-tested insured institutions (see Map 2), which history indicates are more likely to receive a problem bank rating when they first encounter an economic downturn. As discussed in ***Atlanta Regional Outlook,*** first-quarter 2000, commercial banks located in urban areas within the Region experiencing their first recession in 1990/1991 were almost twice as likely to receive a problem bank rating as their established or recession-tested counterparts. The likelihood of a new commercial bank receiving a problem rating (or failing) increases during its formative years and then decreases as it reaches maturity (about ten years). In 1990/1991, commercial banks that began business more than three years before the onset of the recession were more likely to receive a problem bank designation than those open less than three years. Initial capitalization was not a significant variable in determining problem bank status when the age of the startup institutions was controlled. Currently, the Region has 286 "true" startup institutions, and 99 had been open longer than three years before the start of the current recession in April 2001.

MAP 2

Non-Recession-Tested Banks[1] Are Concentrated in Metropolitan Areas



[1]Includes all commercial bank openings occurring after the 1990/1991 recession except special-purpose entities, those that opened with an affiliate relationship (financial or managerial), or those resulting from mergers and acquisitions or intercompany reorganizations

Source: Bank Call Reports, third quarter 2001

Conclusion

Community banks with a large C&D or C&I lending concentration or newly opened commercial banks are located primarily in urban centers within the Region that may exhibit a boom/bust economic growth pattern. As discussed in ***Atlanta Regional Outlook,*** Fourth Quarter 2001, five metropolitan areas—**Atlanta, Naples, Orlando, Sarasota,** and **Tampa**—were identified as exhibiting a confluence of risk factors that could produce more vulnerable banking markets during an economic downturn. These areas experienced economic and lending growth rates well above national averages, and insured institutions headquartered there generally reported C&D or C&I concentration levels above national averages in addition to a greater reliance on noncore funding sources.[22]

Historically strong financial conditions among many of the Region's insured institutions may erode if the economic downturn continues. Given the robust headwinds the domestic economy is encountering, economic growth may take some time to resume. Moreover, after the recovery starts, there is no assurance that strong economic growth will return immediately. A prolonged period of slow or negative growth combined with a softening in asset prices, particularly for commercial and residential real estate, could have significant repercussions for certain insured institutions in the Region. Such an environment would likely be more challenging for community banks with large lending concentrations and startups experiencing their first recession. Typically, such institutions perform better in

[20] The Division of Supervision and Division of Insurance of the FDIC's Atlanta Region conducted a series of outreach meetings with bankers in Atlanta, Georgia; Charlotte, North Carolina; and Orlando, Florida.

[21] Before the recession of 1990/1991, the yield on a C&D loan was the prime rate plus 2 percentage points with an added 2-percentage-point commitment fee. Last year, bankers reported that they were fortunate to receive prime plus 1 percentage point with a 1-percentage-point commitment fee. In some markets, pricing had fallen to prime without a commitment fee.

[22] Noncore funding sources include brokered deposits, time deposits of $100,000 or more, federal funds purchased, securities sold subject to repurchase agreements, and other borrowed funds. The latter category consists largely of Federal Home Loan Bank advances.

a rapidly growing economy. For this reason, banks with concentrations in traditionally higher-risk assets or that have adopted a business model that relies on rapid economic growth should evaluate their ability to operate during a period of slow economic growth.

By the Atlanta Region Staff

Housing Market Has Held Up Well in This Recession, but Some Issues Raise Concern

Trends in housing markets are important performance drivers for many FDIC-insured institutions. The health of residential markets can affect the credit quality of residential mortgage loans, home equity loans, and loans to finance residential construction and is linked indirectly to the performance of other types of consumer and small-business debt. Further, an estimated $2 trillion in mortgage debt, approximately one-third of the mortgage market, was underwritten during 2001, with 56 percent of this activity in refinancing transactions.[1] This activity makes recent trends in underwriting of particular interest. An ancillary issue for many mortgage lenders, interest rate risk, is not addressed in this article.[2]

The U.S. economy entered a recession in March 2001, and the question arises as to how consumer creditworthiness, housing values, and recent mortgage-lending practices will fare during this downturn. Developments contributing to increased credit risk include higher consumer debt burdens, looser mortgage loan underwriting standards, and the emergence of subprime mortgage lending as a significant line of business for some banks. Mitigating this risk has been the steady appreciation of home prices, which have shown signs of softening in some markets but not to the extent seen at a comparable stage in previous recessions.

Home price weakness may be more pronounced in 2002 as the effects of the recession take hold, but in the authors' judgment, systemic weakness in home prices is unlikely, absent a deep and long recession. Adverse mortgage lending trends are not expected to threaten the capital or earnings of the vast majority of insured institutions. Nonconstruction residential mortgages, even during the most pronounced periods of stress in the 1980s and early 1990s, remained the best-performing loan class, especially for lenders specializing in residential real estate; and, historically, these mortgages have been one of the lowest credit-risk loan types for all manner of insured institutions.[3]

That said, however, there *are* pockets of risk for insured institutions. There is evidence that borrowers with weak credit may be experiencing greater repayment difficulties, elevating the risks faced by subprime mortgage lenders. Further, a slump in residential real estate markets could be especially detrimental to insured institutions with significant exposures to housing construction because projects might not sell at projected asking prices or as quickly as anticipated. Finally, in specific markets where housing prices may have achieved unsustainable levels, some increase in housing-related credit quality problems can be expected, and in this regard, the San Francisco Bay area stands out as a place to watch.

The Recession Thus Far Has Had a Minimal Impact on Mortgage Delinquencies at Insured Institutions

Despite three quarters of recession, most housing indicators remained quite healthy this past year relative to trends seen in past recessions. For example, new and existing home sales both set records during the year, while new home construction failed to decline, an occurrence not seen in the past six recessions. Another indicator, year-over-year growth in existing home prices—as measured by either the ***Office of Federal Housing Enterprise Oversight (OFHEO)*** repeat sales price index or the ***National Association of Realtors (NAR)*** median single-family price statistic—showed deceleration but remained well above trends seen at similar points in past recessions. This behavior partly reflected the early robustness of household income in the face of recession and relatively low fixed mortgage rates during 2001, which helped to counter some of the

[1] Mortgage Market Forecast, www.mbaa.org/marketdata/forecasts/, January 2002.

[2] For a discussion of this issue, see "Regional Perspectives," Boston and Chicago Regions, *Regional Outlook,* First Quarter 2002.

[3] See "Region's Insured Institutions Exhibit Lower Risk Profile than the Nation's, Appendix: Risk-Weighting Methodology," Table A in Boston Region, *Regional Outlook,* First-Quarter 2000.

Chart 1

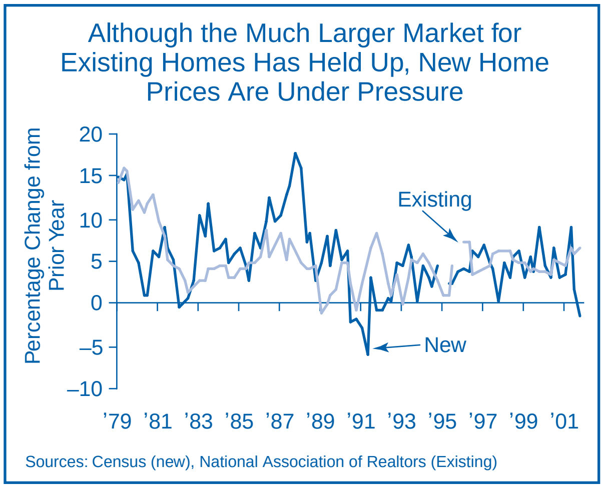
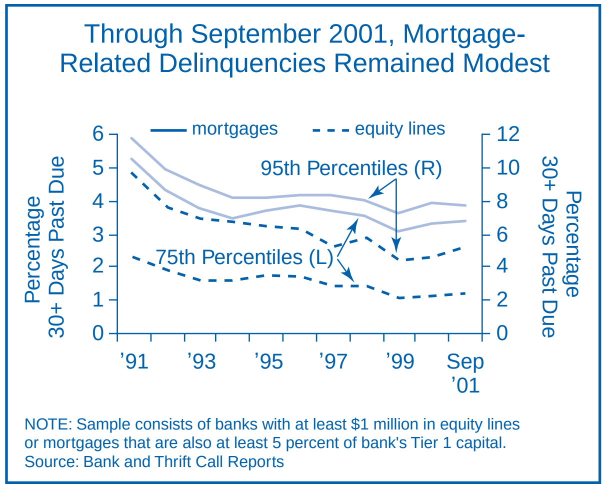


Chart 2



initial adverse effects of the recession on housing demand.

One sign of potential weakness appeared late in 2001 in the modest year-over-year decline in median prices of new single-family homes (see Chart 1). Because existing home sales outnumber new home sales roughly fivefold, price trends in the latter are generally not predictive of prices for the much larger existing home market.[4] However, as discussed later in this article, adverse pricing trends in the new home segment do raise concerns for residential developers and insured institutions that finance residential construction.

The steady increase in prices of existing homes depicted in Chart 1 masks considerable regional variation. As detailed later in this article, home price growth began to weaken in 2001 in a number of metropolitan statistical areas (MSAs). While there is no clear common denominator among the markets in which this occurred, a number of these markets had both extremely rapid home price growth in the recent past and significant slowdowns in employment growth or outright contractions in employment last year.

Credit quality indicators for insured institutions' mortgage loans have shown only preliminary signs of weakness thus far. Through the first nine months of 2001, insured institutions showed negligible advances in median past-due ratios for mortgages and equity lines of credit, although continued strong mortgage origination activity in 2001 may have masked (in the aggregate) developing credit problems for more seasoned mortgage loans. For institutions that held at least $1 million in residential mortgages or home equity lines of credit *and* whose exposures comprised at least 5 percent of Tier 1 capital, some modest deterioration is evident in the worst-performing mortgages and home equity lines since 1999, as seen in Chart 2.[5] Even if this recession lingers, worsens, or both, residential mortgage lending (nonconstruction and development-related) likely poses only modest risk to most insured institutions' earnings and capital, since it has held up better in prior recessions than other loan types.

What Are the Risks Facing Housing Lenders in 2002 and Beyond?

In an environment of significantly slower economic growth than prevailed during the 1990s, can the strength of housing prices and the relatively benign credit quality environment for housing lenders be expected to continue? The answer will depend on the interplay of economic conditions and lenders' risk profiles. In the remainder of this article, we discuss the gradual increase in the risk profile for insured mortgage lenders that appears to have occurred during the

[4] Existing home prices are also more reflective than new home prices of trends in broader economic indicators, such as aggregate per capita personal income.

[5] It is interesting to examine the (adverse) tail of the credit quality distribution when looking at residential mortgage trends, as average and median past-due ratios move little and are typically very low—thus, only the highest 25th and 5th percentiles of past-due ratios are presented in Chart 2.

1990s, as well as some cyclical risks to their performance that may exist as the recession plays out.

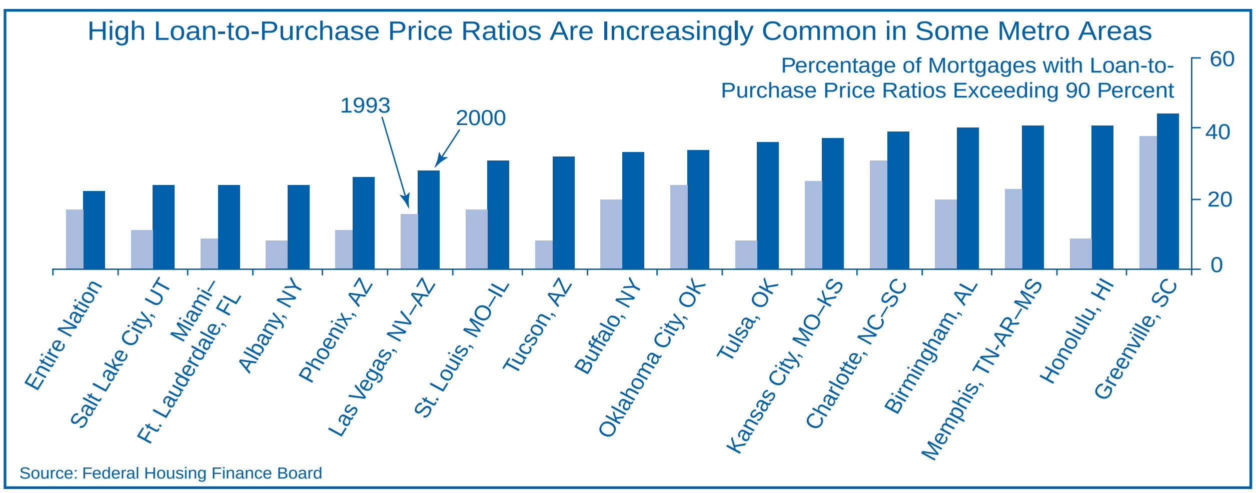
Evolving Lending Practices Have Increased the Risk Profile for Mortgage Lenders

Although history suggests that residential mortgage defaults will be relatively low even in a recession, changes in the mortgage market since the 1990–1991 recession could affect mortgage performance during the present downturn. Many underwriting changes over the past decade have been driven in part by the growing importance of the secondary market for mortgage debt, and of Fannie Mae and Freddie Mac in particular. In 1980, federal and related agencies had direct or indirect interests in approximately 17 percent of all mortgage debt.[6] By 2000, their share of the mortgage market had increased to roughly 41 percent. Insured bank and thrift mortgage exposures grew over the same period, but, as a share of direct mortgage debt, bank and thrift mortgage holdings decreased from 59 to 35 percent. These trends notwithstanding, insured institutions still provide substantial funding, directly or indirectly, to the housing market: as of September 30, 2001, 1 to 4 family mortgage loans and mortgage-backed securities held by insured institutions aggregated $2.3 trillion, up 37 percent from five years earlier.

Although an active secondary mortgage market has broadened homeownership, improved mortgage loan liquidity, and allowed insured institutions to allay credit risk, it has also heightened market competition and transformed the lending process. In presecondary market days, lenders largely had to retain originated mortgages in their own portfolios. Consequently, only lenders with ready funding sources (such as banks, thrifts, and insurance and finance companies) were able to compete in the mortgage markets. The advent of the secondary market enlarged the pool of available funding and permitted both insured institutions and other originators to transfer their mortgage business readily into entities such as mortgage pools and trusts. Consequently, many new players, including on-line and brick-and-mortar mortgage brokers, have entered the mortgage origination market.

The resulting robust mortgage loan competition, combined with Internet-based consumer research tools, has led to considerable commodification of the mortgage market. Rather than competing on the basis of traditional relationships, lenders' market shares are increasingly driven by price. For smaller savings institutions that focus heavily on residential mortgage underwriting, this issue has likely elevated business risk. Heightened competition has caused some loosening of mortgage underwriting standards and pushed lenders to use technology to expedite and streamline the underwriting process. Consequently, credit-scoring mechanisms and automated valuation techniques currently in place have not been tested through a full credit cycle. Because pricing competition has pressured margins, some mortgage lenders have pursued subprime or high loan-to-value (HLTV) mortgages. The ability of insured institutions to mitigate subprime losses through an economic downturn is untested to a large extent as well—finance companies dominated the high-risk mortgage market in past recessions.

CHART 3



[6] These interests include residential, commercial, and farm real estate debts held directly by, or held in mortgage pools or trusts issued by, federal and related agencies. Source: Table 1186, Statistical Abstract of the United States: 2001, page 733.

In general, mortgage underwriting standards have loosened industrywide over the past decade. For instance, lenders have increasingly accepted higher loan-to-purchase price (LTPP) ratios for purchase money mortgages.[7] According to the ***Federal Housing Finance Board,*** LTPP ratios are high and have risen in several metropolitan areas over the past seven years (see Chart 3). Between 1993 and 2000, the **Honolulu, Tulsa,** and **Tucson** markets exhibited the largest increases in mortgages with LTPP ratios exceeding 90 percent.

Although lenders often mitigate the risk of loss associated with low downpayments by requiring private mortgage insurance (PMI), recently the mortgage industry has allowed borrowers to avoid purchasing PMI. In particular, "piggyback" financing has made homeownership increasingly possible for households that cannot afford the traditional 20 percent down payment or do not wish to pay for PMI. With piggyback financing, the borrower often arranges a conforming 80 percent LTPP first mortgage and finances a portion of the remaining 20 percent with a concurrent second mortgage on the property (e.g., "80-10-10"). This type of transaction has become popular because interest paid on the (albeit more expensive) second mortgage is tax-deductible, whereas PMI premiums are not. Thus, piggyback financing is probably most attractive to individuals in higher-cost/tax areas or higher tax brackets, such as those in the **Northeast** and **California.** This trend effectively shifts the first loss position on all low down payment loans to the lender that retains the junior position. These institutions are, of course, compensated for some of this risk with the higher interest rates charged on the piggyback portion of these mortgages.

Competitive factors have prompted the industry to enhance underwriting automation. As part of the push, credit scoring has become a routine part of the credit analysis process, and, increasingly, lenders are using automated valuation models (AVMs) to determine collateral coverage. However, credit scoring and collateral valuation models have been in popular use only since the 1990–1991 recession; consequently, their predictive ability in a downturn is uncertain. Although some have touted AVMs as the answer to appraisal fraud, the ability of statistical models to simulate the qualitative judgments considered critical to traditional appraisals is unknown. Paper appraisals reportedly continue to dominate the industry; however, recently, the two largest government-sponsored enterprises have begun accepting AVMs in lieu of standard appraisals for loans under $275,000.[8] For lenders that specialize in HLTV mortgages, there is less room for error with AVMs.

[7] Purchase money mortgages are loans extended solely for the initial purchase of a home. Statistics on loan-to-value ratios for supplemental home equity loans/lines (e.g., piggyback or "80-10-10" financing), as well as refinanced mortgages, are not readily available.

Cyclical Weakness Is Already Apparent in Subprime Mortgage Lending

Historically, certain insured institutions have made mortgage loans with narrow collateral margins or to borrowers with limited or blemished credit histories. However, significant entry by FDIC-insured institutions into mortgage lending to borrowers with weak or marginal credit, *as a targeted line of business,* generally has occurred only since the early 1990s. These "subprime" mortgages are neither defined nor reported on Bank Call Reports. As a result, gauging the extent of bank involvement in subprime lending at any point in time is difficult. However, the FDIC estimates that fewer than 1 percent of all insured institutions have significant subprime residential mortgage exposures. Nevertheless, according to some measures, subprime mortgages as a share of total mortgage originations peaked at 13 percent in early 2000, before moderating somewhat during the first three quarters of last year.[9] Thus, a much larger number of institutions probably have some limited involvement in subprime mortgage lending. A survey by the ***Minneapolis Federal Reserve Bank*** found that 29 percent of banks in the **Minneapolis District** offered loans to low-credit quality consumer borrowers in 1999.[10]

Subprime mortgage loan performance appears to have deteriorated notably during 2001. One source of support for this observation comes from delinquency trends on Federal Housing Agency (FHA)-insured mortgages, which are often granted to first-time homebuyers with troubled credit histories and borrowers with low down payments. The ***Mortgage Bankers Association*** reports that while the national delinquency rate on conventional mortgages rose 58 basis points in the year ending third-quarter 2001, the delinquency rate on FHA mortgages shot up by 234 basis points, to 11.4 percent (see Chart 4). This growing gap between

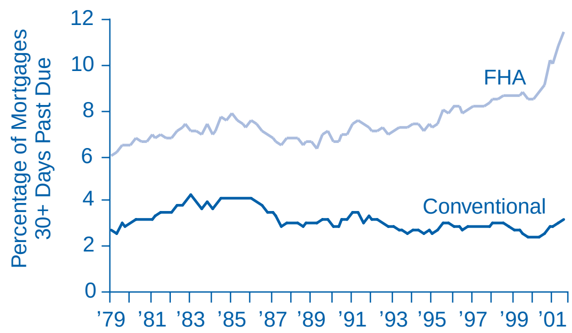
[8] "Automated Appraisals Require Caution by Lenders," *American Banker,* October 10, 2001.

[9] Based on dollar volumes, data from Inside Mortgage Finance Publications, Bethesda, MD.

[10] Ron Feldman and Jason Schmidt, "Why All Concerns About Subprime Lending Are Not Created Equal," *Fedgazette,* Minneapolis Federal Reserve, July 1999.

CHART 4

Recent Mortgage Delinquencies for Higher-Risk Loans Reached All-Time Highs



Source: Mortgage Bankers Association

delinquency rates on conventional and government-insured mortgages suggests that marginal and subprime borrowers are facing growing repayment difficulties.

A database of more than 6.5 million subprime loans tracked by ***Loan Performance Corporation*** (formerly *Mortgage Information Corporation*) reported similar trends. The nationwide third quarter 2001 ratio of seriously delinquent subprime mortgages was 7.3 percent, up from 5.5 percent one year earlier.[11] Moreover, subprime delinquencies significantly exceeded those found among prime mortgages, as just under 0.5 percent of conventional prime mortgages were seriously delinquent.[12] Also of possible concern are vintage data trends, which show how pools of primary and junior-lien subprime mortgages perform over time. Mortgages originated in 2000 are performing poorly in relation to previous years' vintages.[13] This simply could reflect the impact of the current recession. Alternatively, ***Loan Performance Corporation*** analysts have suggested that the 2001 refinancing boom might have created some adverse selection in mortgage pools originated during the relatively higher interest rate environment of late 1999 and early 2000.[14] Because higher-coupon and variable-rate loans comprised a significant share of mortgage originations during that period, overall prepayment rates on the 2000 vintage might have been unusually high during 2001. Consequently, the best-quality loans in the 2000 pool might have refinanced, leaving loans of lesser credit quality behind and elevating the residual delinquency experience in that pool.

Given these trends, an important issue for subprime lenders is their ability to anticipate and plan for the impact of an economic slump on their operations. Some institutions clearly adopt subprime lending as part of an overall business strategy, setting up monitoring and collection departments geared to dealing with such loans. Among large, national lenders, for example, one institution that makes 5 to 10 percent of its loans to subprime borrowers recently provided additional resources to its loan services and default management departments. This action followed a period when one-third of its increase in nonperforming single-family mortgage loans was associated with loans to subprime borrowers.[15]

C&D Lending Risks May Be Elevated in MSAs with Potential Supply/Demand Imbalances

Historically, lending to finance housing construction is riskier than mortgage lending on existing structures. Insured institutions report construction and development (C&D) lending in a single category that includes both commercial and residential construction. While it is thus impossible to ascertain from quarterly call reports the extent of bank involvement in financing housing construction, anecdotal evidence suggests that, although smaller insured institutions engage to some degree in commercial property development, their C&D lending largely finances single-family construction. If markets with an oversupply of housing see weaker economic performance, insured institutions engaged in financing residential real estate development may be at risk. This could result in an increase in C&D loan delinquencies, losses, and other-real-estate-owned (OREO).

Demand for housing can be affected by two distinct trends: secular, or longer term; and cyclical, or shorter term. Over the long term, demographic trends, such as population growth rates and concentrations of households by age cohort, can affect overall demand for housing, as well as the types of homes demanded. Demand in local housing markets also can be affected by more cyclical factors such as recent changes in economic

[11] *The Market Pulse,* Loan Performance Corporation (formerly Mortgage Information Corporation), Winter 2001 and Fall 2001.

[12] *The Market Pulse,* Loan Performance Corporation, Fall 2001.

[13] Per Loan Performance Corporation delinquency data, subprime primary mortgages originated in 2000 displayed higher delinquency ratios for their age compared with similarly seasoned subprime loans originated in 1996, 1997, 1998, or 1999. Moody's second-quarter 2001 *Home Equity Index Update* found the same to be true of subprime home equity loans.

[14] "Another Look at the 2000 Book," *The Market Pulse,* Loan Performance Corporation (formerly Mortgage Information Corporation), Winter 2001.

[15] Calmetta Coleman, "Default Worries on Home Loans Escalate as Lenders Report Delinquency," *Wall Street Journal,* October 29, 2001.

conditions, including interest rates. New supply of homes in local housing markets is produced in response to perceived or estimated future demand. Correct interpretation of market and economic signals is critical to the success of builders in metropolitan areas; however, this activity is complicated by the lags associated with developing, permitting, and constructing properties. The effect of overestimating future demand could be multiplied if several builders inaccurately gauge changes in demand. Consequently, a construction market with numerous smaller developers, such as **Atlanta,** may see amplified swings in construction activity and may experience excess supply during certain periods.

Although conceptually straightforward, measuring the balance between housing demand and supply is challenging, particularly at lower geographic levels. Shortcomings in data availability, quality, and timeliness can limit the effectiveness of this type of analysis. As already mentioned, some insight about current housing market conditions in specific metropolitan areas may be gained by analyzing both secular and cyclical trends. However, given the onset of recession last year, the role of cyclical factors is of prime concern at this time.

To measure the cyclical aspect of the relationship between a market's supply and demand, some analysts rely heavily on the concept of employment-driven demand.[16] Such analysis involves tracking a demand/supply ratio based on employment growth and permit issuance. Areas where permitting activity continues to accelerate while employment levels decrease may produce an increasing imbalance in the local housing market.[17]

Using a simplified version of employment-driven demand, we identified a number of metropolitan areas as being at risk for a rising imbalance in their housing markets (see Chart 5), the largest of which are **Chicago, Greensboro (NC), Minneapolis, Phoenix, Portland (OR-WA), St. Louis,** and, most notably, Atlanta. These markets are displaying signs that residential construction activity may not be responding in kind to local economies that have started to contract during this recession. Further, Phoenix, Portland, and Atlanta were identified previously as banking markets exhibiting elevated risk profiles.[18]

CHART 5

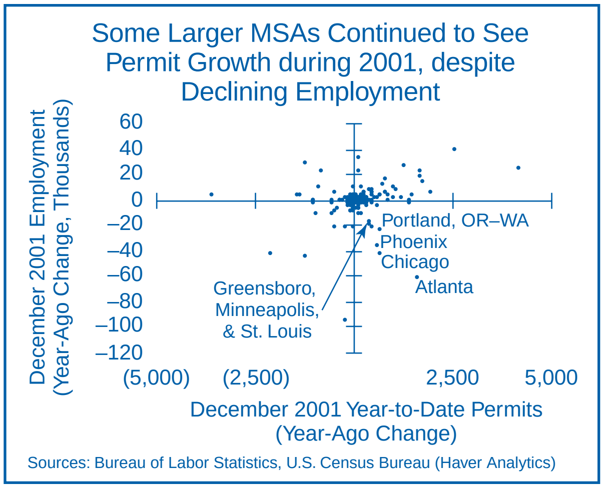


Chart 6 displays the level (y axis) and trend (x axis) in C&D lending exposures for the top 25 MSAs by median C&D concentration as a share of assets.[19] It is apparent that some markets identified in Chart 5 as having significant banking exposure to C&D lending also may have a cyclical imbalance in home building. Atlanta, for example, demonstrates one of the highest exposures, with a ratio of median C&D to total assets of 17 percent in third-quarter 2001, a roughly 100-basis-point increase from year-end 2000. In other words, while employment-driven demand has softened in the metropolitan area, single-family construction activity has continued, and community bank lenders may have increased their level of residential financing commitments.

Cyclical Risks May Be Developing with Respect to Home Prices

Popular comparisons have been made recently between the healthy run-up in housing prices during

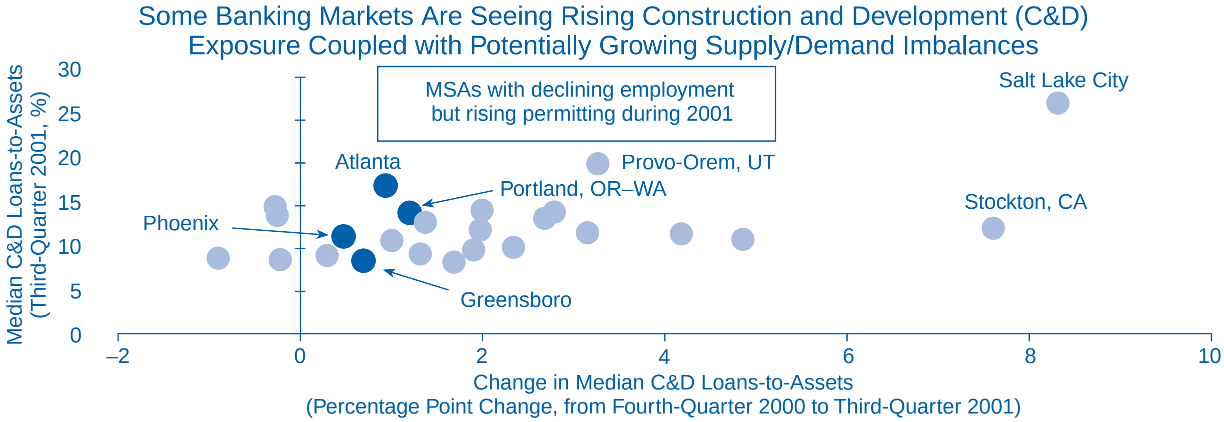
[16] For example, see www.myersgroup.com.

[17] This approach, although more reflective of recent economic events than perhaps more secular measures, is not without its drawbacks. For example, employment data from the Bureau of Labor Statistics' establishment survey are frequently revised, and, consequently, employment-driven demand may need to be reexamined.

[18] See "In Focus This Quarter," *Regional Outlook*, Fourth-Quarter 2001.

[19] We considered only MSAs that had at least six locally headquartered community banks that engaged in C&D lending activity and then charted the top 25 MSAs ranked by September 2001 median C&D/assets.

CHART 6



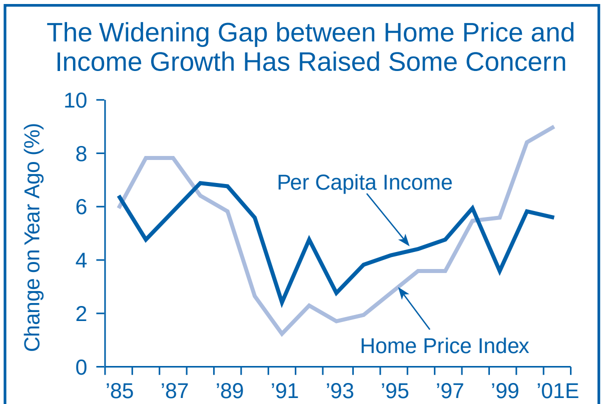
Sources: Bank Call Reports, Bureau of Labor Statistics, U.S. Census Bureau (Haver Analytics)

the past several years and the technology stock-fed speculative "bubble" in equity prices that persisted through early 2000. The subsequent bursting of this bubble and the resulting economic distress have raised concerns of a sequel featuring housing prices.

According to the OFHEO repeat sales price index, there has never been an instance of outright declines in aggregate U.S. existing home prices.[20] However, home prices do exhibit strong cyclical tendencies, with the rate of appreciation slowing during national recessions. In addition, there have been some decidedly negative episodes during the past few decades in various metropolitan markets. At the national level, existing-home price growth historically has followed trends in population-adjusted personal income growth,[21] and some have pointed to a growing imbalance between the two as a sign that home prices may weaken as the effects of the recession take hold (see Chart 7).

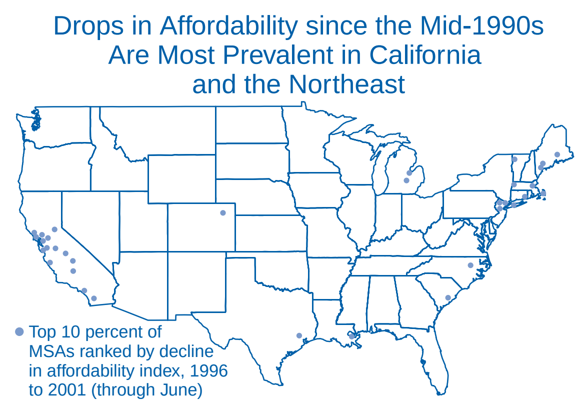
Given that home price bubbles have occurred in the past, most notably in **Texas,** California, and the Northeast during the 1980s, and that their ultimate deflation

CHART 7



Note: E=estimate
Sources: OFHEO, U.S. Census Bureau

MAP 1



NOTE: Anchorage, AK, is included, but not shown.
Source: Economy.com

[20] According to the National Association of Realtors' U.S. median price, a few episodes of price declines (on a quarterly, year-ago basis) are present in the time series—specifically first- and second-quarter 1989; fourth-quarter 1990; and first-quarter 1993—only the 1990 episode occurred during a recession. Also, as shown in Chart 1, U.S. median *new* home prices have experienced meaningful declines.
[21] This relationship is generally true at the metropolitan level as well.

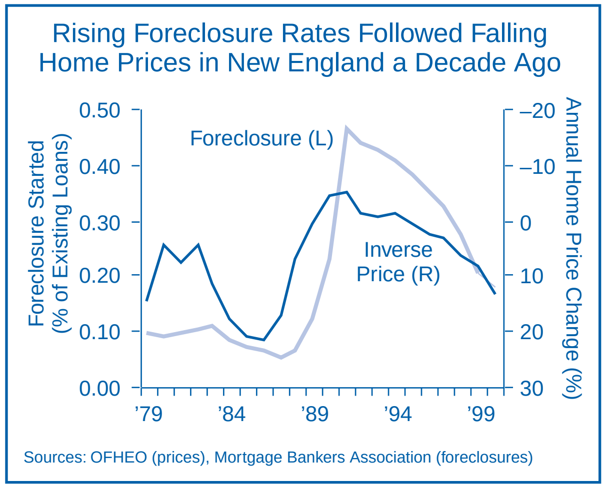
resulted in significant negative fallout for these areas' economies and insured institutions, it is useful to look at these historical examples as a potential "worst-case" scenario (with very low probability) for residential real estate markets during the current recession. It is unlikely that significant, systemic risks from home price bubbles have arisen yet for residential lenders. Of course, this situation could change if the current recession deepens or is protracted, or if growth during the subsequent recovery is anemic. Further, national trends can obscure dramatic variations in local markets, and a handful of MSAs today are coming off several years of rapid home price growth and falling affordability. These markets, and the residential lenders targeting them, may be more at risk as local economic growth falters.

Map 1 shows markets that have seen the most significant reductions in affordability (sharp price gains) during the past several years. Not surprisingly, many of them—namely larger cities in California and the Northeast—are those that historically have seen the biggest swings in prices and a penchant for speculative excess.

In markets with rapidly declining affordability, credit risk arises from the increasing likelihood that new borrowers will commit a greater share of household financial resources to meet monthly payments. Credit problems could become more readily apparent given any subsequent disruptions to employment or income in these markets—especially among households with limited wealth or that require multiple job holders to meet mortgage payments. These risks may be amplified by the increased underwriting of HLTV and subprime mortgages during the past decade.

Disruptions to aggregate household liquidity from lost employment or decreased income can result in rising mortgage *delinquencies*. With respect to *foreclosures,* however, some research has suggested that the decline in prices relative to the balance owed on the mortgage (rising loan-to-value ratio) is the most significant factor.[22] Even in instances of prolonged job/income loss, owners with positive equity are likely able to sell their

CHART 8



homes profitably, thus avoiding foreclosure. Chart 8 shows the strong relationship between declining home prices and increasing foreclosure rates in **New England** a decade ago (the chart plots the inverse price change in order to emphasize the relationship).[23]

The data available through late 2001 were mixed with respect to home resale price trends at the MSA level. On the one hand, while existing home prices as measured by the OFHEO home price index showed no markets with year-over-year price declines in fourth-quarter 2001, NAR's median resale price metric did show about a dozen markets with year-over-year declines, none exceeding four percent. A *deceleration* in year-over-year home price growth was evident for many markets (and the nation) using either measure. It should be noted that the OFHEO data do not include sales of high-priced homes and are less influenced by changes in the mix of homes sold than are average and median prices;[24] this issue is more meaningful in the nation's most expensive markets, such as MSAs in the

[22] For instance, "Mortgage Default Risk and Real Estate Prices: The Use of Index-Based Futures and Options in Real Estate," Case, Shiller, & Weiss, NBER Working Paper #5078, NBER, April 1995, finds this to be the case, while citing past work that identified the link between rising LTVs and foreclosure rates.

[23] In states where dominant metro areas have seen large price declines in past years, such as Massachusetts, this relationship is more pronounced than in larger states or the nation as a whole. For example, the two-decade correlation between foreclosures started and price change is –78 percent in Massachusetts versus roughly –60 percent in both California and the nation.

[24] Data are obtained from aggregating repeat sales or refinancings of the same properties over time and using statistical methods to calculate an overall rate of home price appreciation for each market. Sampled properties are confined to those whose mortgages are "conventional" and do not exceed a conforming loan limit (set at $275,000 in 2001) required for securitization through Fannie Mae and Freddie Mac. For more information, see www.ofheo.gov/house/.

TABLE 1

As Recession Evolved, Home Price Appreciation Waned through 2001 ...Further Deceleration in Growth (or Declines) May Be Possible in 2002							
	Annual Percent Changes						
MSAs Ranked by Deceleration in Home Price Index from 1Q01 to 4Q01	OFHEO Home Price Index					Nonfarm Employment	
	1998–2000	1Q01	2Q01	3Q01	4Q01	1998–2000	2001
United States	6.3	9.6	9.1	8.8	6.9	2.4	0.3
San Jose CA PMSA	17.7	24.4	16.9	8.4	0.6	3.4	–0.4
Santa Cruz-Watsonville CA PMSA	16.8	25.7	17.3	11.9	5.9	N/A	N/A
San Francisco CA PMSA	16.5	19.4	13.9	9.1	3.5	3.3	1.3
Salinas CA MSA	13.7	24.3	22.4	19.0	9.4	3.3	0.9
Santa Rosa CA PMSA	14.8	22.7	19.6	13.6	8.6	4.1	1.6
Oakland CA PMSA	14.7	22.3	18.0	14.1	8.2	3.4	2.0
Austin-San Marcos TX MSA	9.4	15.2	12.1	7.7	5.0	5.9	2.1
Merced CA MSA	6.4	24.6	21.8	17.3	15.7	N/A	N/A
Jamestown NY MSA	4.9	9.9	0.8	7.4	1.6	N/A	N/A
Stockton-Lodi CA MSA	9.0	22.8	25.2	20.6	14.9	3.7	3.0
Wheeling WV-OH MSA	4.1	10.8	7.7	11.7	3.7	1.1	–0.5
Goldsboro NC MSA	4.0	7.9	3.2	1.6	0.9	N/A	N/A
Cumberland MD-WV MSA	2.7	8.6	8.4	8.1	1.8	N/A	N/A
Lewiston-Auburn ME NECMA	4.2	14.0	8.6	10.1	7.1	4.4	–0.4
Bangor ME NECMA	3.7	13.2	7.4	9.3	6.5	N/A	N/A
Fargo-Moorhead ND-MN MSA	4.0	11.1	6.5	5.4	4.6	2.1	–0.3
Barnstable-Yarmouth MA NECMA	12.8	17.6	14.5	14.6	12.5	3.9	1.3
Pine Bluff AR MSA	2.2	6.6	9.7	5.0	0.3	0.8	–1.7
Dubuque IA MSA	3.9	8.8	6.0	6.9	2.5	1.1	–0.6
Boulder-Longmont CO PMSA	10.9	14.6	11.7	11.7	8.3	5.1	3.2
Denver CO PMSA	11.1	13.7	11.8	10.9	7.9	3.8	2.3
Utica-Rome NY MSA	3.5	14.6	9.5	8.4	9.1	2.4	0.1
Vallejo-Fairfield-Napa CA PMSA	11.8	20.0	19.1	16.6	14.7	4.7	2.8
Bryan-College Station TX MSA	4.8	11.1	2.1	5.6	5.8	4.0	0.7
San Diego CA MSA	11.8	15.6	13.8	12.9	10.4	4.3	2.7
San Luis Obispo-Atascadero-Paso Robles CA MSA	11.4	19.2	18.0	17.8	14.2	N/A	N/A
Tucson AZ MSA	3.3	8.6	8.0	6.8	3.6	3.5	0.8
Jersey City NJ PMSA	8.0	11.1	17.6	13.7	6.2	2.1	2.7
Clarksville-Hopkinsville TN-KY MSA	3.3	9.1	4.2	6.5	4.2	N/A	N/A
Rapid City SD MSA	6.2	8.9	9.3	7.7	4.1	3.1	0.1
La Crosse WI-MN MSA	5.7	7.4	5.8	5.1	2.6	2.3	1.0
St. Cloud MN MSA	6.9	10.4	8.5	9.4	5.7	3.8	1.4

Sources: Office of Federal Housing Enterprise Oversight (OFHEO), Bureau of Labor Statistics

San Francisco Bay Area[25] and parts of the Northeast, since prices for high-end homes (typically financed by jumbo mortgages) may be more volatile over the economic cycle.

Table 1 lists markets whose 2001 deceleration in home price growth was in the top 10 percent of the more than 300 metro areas for which the OFHEO statistic is available. The table also provides (where available) each MSA's recent employment trend as an indicator of overall economic conditions. These markets may yet see even more pronounced deceleration in home price growth or even declines in home prices this year (as may others not shown). This possibility will be determined for the most part by the performance of each market's local economy.

The metro areas in the table are ordered by the magnitude of their deceleration in home price growth over the initial quarters of this recession. As a result, the marked deceleration in year-over-year price growth in the recently overheated San Francisco Bay Area puts many of its MSAs near the top of the list. In the table, **San Jose**, **San Francisco, Oakland, Denver,** and **San Diego** also previously were identified as banking markets with elevated risk profiles.[26] For some of the smaller MSAs in Table 1 with more volatile appreciation rates, such as **Utica** and **Fargo,** comparisons of recent price trends are more appropriate using the 1998–2000 average as a benchmark, as these markets experienced pronounced spikes in year-ago price growth during first-quarter 2001.

It is hard to generalize about which markets will see the most pronounced home price weakness as the recession continues. However, certain markets have shown a tendency in the past to be driven to a greater degree by speculative, rather than fundamental, factors. These markets are more likely to see significant downward corrections in price when economic activity falls for a prolonged period or by a sufficient magnitude. One study from the mid-1990s found, in comparing 14 cities in the **Northeast** and **West** with 16 inland cities, that while both groups tended to respond similarly to local and national economic forces (fundamental, or "equilibrium," price drivers), prices in the former group tended to be influenced to a greater degree by speculative, or "disequilibrium," variables, including recent trends in price appreciation.[27] Cities along the nation's coasts also have tended to see the most significant price swings over the past 20 years.

History also provides some insights into the nature and extent of any price declines in markets where economic conditions deteriorate. A study of two significant examples, Boston and Los Angeles in the 1980s and early 1990s, concluded that declines differed by property type (i.e., condos versus single-family) and price class (i.e., high-end versus entry-level).[28] This dispersion in price declines arose from differing rates of appreciation (properties that experienced the greatest inflation during the boom saw the largest deflation) and from the nature of each city's economic decline, which differed according to concentrations of job losses by industry and wage type, underlying demographic factors, and housing supply trends.

Looking at recent developments, it seems that the greatest near-term risk of a significant downward adjustment in housing prices is in the San Francisco Bay area. In recent years, this area witnessed double-digit home price appreciation that exceeded growth in per capita income by a wide margin. A recent analysis from the ***University of California-Berkeley's Haas School of Business*** forecast that prices in the Bay Area housing market will decline by 15 percent overall (and by 30 percent for luxury homes) by the time the local economy's recession ends late this year.[29] Meanwhile, the larger MSAs in **Southern California** have not seen as significant a disparity between home price appreciation and personal income growth during this cycle as during the 1980s. Also in contrast to the 1980s, New England (and the Northeast generally) has seen little speculative purchase or construction activity in recent years, which should help to mitigate any price weakness through the current recession in these markets.[30]

[25] As considered here, this includes the following MSAs: San Jose, Santa Cruz-Watsonville, San Francisco, Santa Rosa, Oakland, Salinas, and Vallejo-Fairfield-Napa.

[26] See "In Focus This Quarter," *Regional Outlook,* Fourth Quarter 2001.

[27] Jesse M. Abraham and Patric H. Hendershott, "Bubbles in Metropolitan Housing Markets," Working Paper #4774, NBER, June 1994.

[28] Karl E. Case and Robert J. Shiller, "A Decade of Boom and Bust in the Prices of Single-Family Homes: Boston and Los Angeles, 1983 to 1993," *New England Economic Review,* March/April 1994.

[29] David Goll, "Bay Area Housing Market Will Remain Slow," *East Bay Business Times,* January 23, 2002.

[30] "Regional Perspectives," Boston Region, *Regional Outlook,* First Quarter 2002.

Conclusion

Home prices are holding up in most markets, and, generally, permanent residential mortgages have fared well in prior recessions. However, history might understate credit risks for insured institutions during this cycle because the mortgage lending business has changed since the last recession. Chief among these changes are robust mortgage market competition, which has contributed to narrower collateral margins; increased reliance on underwriting automation; and expanded involvement in the subprime credit market. In addition, residential C&D lenders in certain markets might be particularly vulnerable, since C&D credits typically undergo higher loss rates and some areas are experiencing continued construction despite a cyclical slowdown (as measured by employment trends). Permanent mortgage lenders in certain areas, such as the San Francisco Bay area, could also face higher loss rates and foreclosures going forward, as the current economic weakness places downward pressure on home prices and dampens the ability of households to meet mortgage payments.

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