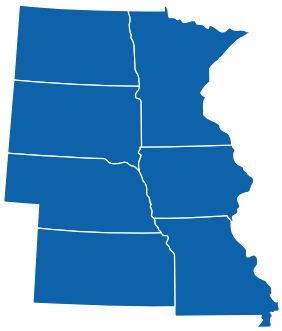
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — THIRD QUARTER 2001

FDIC
KANSAS CITY
REGION



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A Message to Our Readers

The FDIC community extends its deepest sympathy to the families, friends, and co-workers of the victims of the attacks on September 11, 2001.

The articles in this edition of the *Regional Outlook* were prepared before the tragic events of September 11. We will assess the implications of these events in future issues of the *Regional Outlook*. The public can rest assured that deposit insurance is in full force—money is safe in an FDIC-insured account.

Regional Perspectives

◆ **Regionwide, farmers relied on government payments for more than half their net cash income in 1998 and 1999. Farmers in Iowa and North Dakota demonstrated even greater reliance.** *See page 3.*

◆ **Indirectly, farm banks also rely heavily on government payments for loan repayment. However, the timing and amount of these payments are uncertain, which makes it difficult for lenders to assess borrowers' creditworthiness.** *See page 5.*

◆ **High levels of government payments also could be exerting substantial influence on farmland prices, representing as much as half the value of the Region's farmland. A sudden or significant reduction in government payments could contribute to higher levels of farm loan defaults, while at the same time putting downward pressure on land values.** *See page 6.*

By Richard D. Cofer, Jr., Senior Financial Analyst

In Focus This Quarter

◆ ***Slowing Economy Reduces Demand for U.S. Office Space*—A slowing economy has contributed to softening in many U.S. office markets during the first half of 2001. The office vacancy rate has recorded the largest six-month increase in the past 20 years. A combination of trends—a substantial drop in demand for office space and an uptick in construction activity in some markets—has led to this slackening.**

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness. It notes the role played by the changing fortunes of high-tech firms in a number of U.S. metro areas and how this situation has contributed to large increases in the volume of space available for sublease. Finally, the article focuses on the local construction and commercial real estate loan exposures of FDIC-insured banks and thrifts that have the task of managing their risks under changing market conditions. *See page 9.*

By Thomas A. Murray

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Regional Perspectives

- **Regionwide, farmers relied on government payments for more than half their net cash income in 1998 and 1999. Farmers in Iowa and North Dakota demonstrated even greater reliance.**

- **Indirectly, farm banks also rely heavily on government payments for loan repayment. However, the timing and amount of these payments are uncertain, which makes it difficult for lenders to assess borrowers' creditworthiness.**

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Farmers and Lenders Continue to Rely on Government Payments to Support Cash Flows and Farmland Values

Kansas City Regional Outlook, second quarter 2001, explained how continued low prices for corn, soybeans, and wheat have contributed to a stressed agricultural sector in the Region. Government payments to farmers, coupled with strong sources of off-farm income, have helped many farmers remain in business. However, uncertainty exists about the future of government payments and the outcome of the 2002 farm bill debate.

As a result, a discussion of how a reduction in payments could affect farmers and their lenders is timely and important. Any substantial reduction in government support could have an adverse effect on farmers' ability to repay their loans and could contribute to a decline in the value of farmland collateral held by farm banks.

Government Payments Have Aided Farmers and Farm Banks; However, the Uncertainty of These Payments Is a Downside

Government payments have increased during the past three years and reached record amounts during the past two years, helping to maintain net farm income near historical levels. As a result, the Region's farm banks continue to report sound asset quality despite historically low commodity prices. Loan delinquencies and loan losses remain low by historical standards. As of December 31, 2000, total delinquent loans at farm banks accounted for 2.1 percent of total loans; by comparison, at year-end 1996, prior to the current problems in the farm sector, 2.4 percent of loans were past due. Farm banks charged off 0.2 percent of total loans in 2000, the same ratio as in 1996.

Much of the government aid during the past couple of years has taken the form of emergency assistance and loan deficiency payments,[1] the amounts of which were uncertain prior to the growing season. Last year, emergency payments totaled $8 billion, or 35 percent of the $23 billion in total payments. Farmers and their lenders could not count on these payments until Congress passed the necessary legislation during the growing season. Deficiency payments accounted for another $6 billion, or 26 percent of the total. These payments are also uncertain because they depend entirely on the variance in crop prices during the marketing year and the level at which farmers opt to "lock in" the government payments. Additionally, the U.S. Secretary of Agriculture has the authority to change loan deficiency payment rates each year; this could be an issue next year, as the rates were not changed for 2001.

How Important Are Government Payments to Farmers and Farm Banks?

How dependent are farmers and their lenders on federal payments? To answer this question, we measured farm banks' reliance on government payments using two

[1] For the purposes of this article, deficiency payments signify government payments paid to farmers under both the loan deficiency program (LDP) and the marketing assistance program.

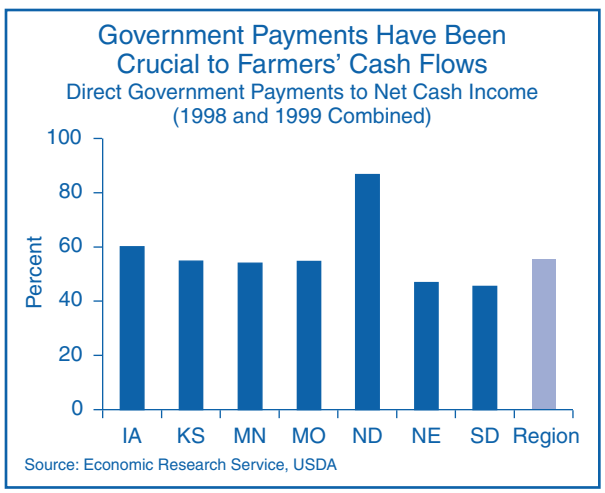
general barometers: the proportion of farmers' net cash income that consists of farm payments and banks' concentration of total assets in agricultural lending.

Farm banks in a given area, such as a state or state district, tend to have borrowers with similar farm operation characteristics, such as row crop and livestock operations. Therefore, understanding farmers' cash flows should help us understand how critical government payments are to borrowers' repayment ability.

Nationally, direct federal government payments represented 38 percent of farm net cash income in 1999;[2] in the Kansas City Region, however, they represented 71 percent. In fact, without farm payments, farmers in the Region would have posted a net loss in 1999, and our estimates for 2000 do not look any better. The Region's higher-than-average dependence on government payments can be attributed to its high concentration relative to the rest of the country in production of wheat, corn, and soybeans—crops whose prices are depressed but for which farmers receive government payments. Nationally, farmers produce hundreds of commodities; they receive no government assistance for most of them, and most are doing relatively well.

Chart 1, which shows the ratio of government payments to net cash income by state in 1998 and 1999,[3] illustrates farmers' tremendous reliance on government payments across the Region. **North Dakota,** where government payments represented about 87 cents of every dollar in farm net cash income, has by far received the highest amount. However, even in **Nebraska** and **South Dakota,** where the ratios were the lowest in the Region, farmers relied on government payments for almost 50 cents of every dollar of net cash income during this period.

CHART 1



The level of government payments differs significantly according to the type of agricultural product. Most direct government payments are tied to crop commodities; livestock production is not subsidized. Therefore, states where livestock production constitutes a high percentage of total farm cash receipts tend to receive lower levels of government payments. For example, crop cash receipts are more than triple the amount of livestock cash receipts in North Dakota; livestock cash receipts exceed crop cash receipts by a two-to-one margin in **Kansas.** As a result, North Dakota receives a higher level of government payments than Kansas.

Of course, individual farm banks may have few borrowers who are reliant on government support even though these farmers reside in states that are heavily dependent on government payments. For instance, some farm banks may develop a niche in extending credit to hog production or cattle finishing operations or making loans to farmers raising nonprogram crops.

Farm Banks, by State, Have Vastly Different Agricultural Loan Concentrations

Assessing insured institutions' level of exposure to the agricultural sector is another means of evaluating the vulnerability of farm banks to declining government payments. Simply by definition, almost all farm banks have a high agricultural exposure compared to other banks.[4] For example, fewer than 1 percent of all 1,212 farm banks[5] had less than 10 percent of total assets concentrated in farm lending. Most had much higher concentrations. We gauged farm banks' overall exposure to farm lending by grouping them into three ranges according to the farm loan-to-total asset ratio. The results, shown in Table 1, clearly demonstrate that the Region's states vary considerably in the level of concentration in agricultural lending among farm banks.

[2] The most recent year for which data are available at a state level.

[3] Chart 1 shows combined results for 1998 and 1999 income data. This represents a more accurate measure because farm marketing years typically overlap two calendar years.

[4] The Federal Deposit Insurance Corporation defines a farm bank as an insured institution that holds farm production or farmland-secured loans equal to at least 25 percent of total loans.

[5] Total number of farm banks in the Kansas City Region as of December 31, 2000.

Table 1

Farm Loan Concentrations of Agricultural Banks Vary Widely among the Region's Banks			
Percentage of Each State's Banks in Each Ratio Range			
State	Range of Farm Loans-to-Total Assets Ratios		
	Less than 30%	30%–45%	More than 45%
IA	65%	27%	7%
KS	62%	29%	9%
MN	57%	34%	9%
MO	85%	15%	0%
ND	49%	37%	14%
NE	34%	40%	26%
SD	29%	46%	26%

The aggregate median farm loan-to-total asset ratio of all 1,212 farm banks is 28 percent.

Source: Bank Call Reports

This variance can be explained, at least in part, by urbanization influences. Farm banks located near metropolitan areas can diversify their lending more readily than can their more rural counterparts. This strong influence affects banks in metropolitan counties as well as banks in counties adjacent to metropolitan counties. To illustrate, farm banks with loan-to-asset ratios under 30 percent constitute over two-thirds of the farm banks in metropolitan and surrounding counties, but less than one-half of farm banks in rural counties not adjacent to metropolitan areas.

Therefore, states with fewer metropolitan areas tend to have higher farm loan concentrations. For instance, Nebraska and South Dakota have much lower ratios of urban area (metropolitan and surrounding counties) to rural area (other counties), at 1:4 and 1:9, respectively, than other states; **Missouri** and **Iowa** have the highest, both at 2:3. As Table 1 shows, farm banks in Nebraska and South Dakota exhibit a much higher exposure to farm lending than those of other states, particularly Missouri and Iowa.

North Dakota stands out from the rest of the states in the Region in terms of dependence on government support and farm banks' concentration in farm lending. North Dakota's farmers are the most dependent on federal payments, and farm banks in the state tend to be relatively highly concentrated in farm lending. The other states present a more mixed picture. For example, although Iowa exhibits a relatively high dependence on government payments, its banks tend to be less concentrated in farm lending. Conversely, Nebraska and South Dakota farm banks tend to be much more concentrated in agricultural lending, but these states' farmers appear to be less reliant on government payments. However, the fact remains that all states in the Region are home to farmers who are highly reliant on government payments and to farm banks with relatively high concentrations in agricultural lending. As a result, the entire Region appears to be vulnerable, to some degree, to a significant reduction in government payments.

Carryover Debt Continues to Rise despite Several Years of Record-Setting Government Payments

Even though record levels of government payments have helped maintain farmers' debt repayment ability and have contributed to relatively low levels of past-due loans, increasing levels of carryover debt indicate potential problems. Carryover debt consists of loans that could not be retired in one period and were "carried over" into subsequent periods, often with amortization periods of several years and additional farmland collateral. Carryover debt is not reported on the Call Report either as a separate asset category or as a past-due loan.

While reported financial data do not contain carryover debt information, other sources of data indicate that carryover debt levels have risen significantly in the Region. Surveys completed by Federal Deposit Insurance Corporation (FDIC) examiners point to higher levels of carryover debt. As shown in Chart 2 (next page), FDIC examiners report that the share of examined banks experiencing a "moderate" to "sharp" increase in carryover debt levels jumped from about 10 percent in March 1998 to more than 40 percent by September 1999. Although the number of insured institutions exhibiting increases in carryover debt has moderated since then, the number of institutions reporting increases continues to outpace the number reporting decreases.

In addition, rising levels of carryover debt appear to be reflected in aggregate loan data. These data show increasing levels of loans secured by farmland; at the same time, the level of operating loans remains stable or is declining, trends that suggest increasing carryover debt levels. As seen in Chart 3 (next page), farm-operating loans have declined by $380 million since

CHART 2

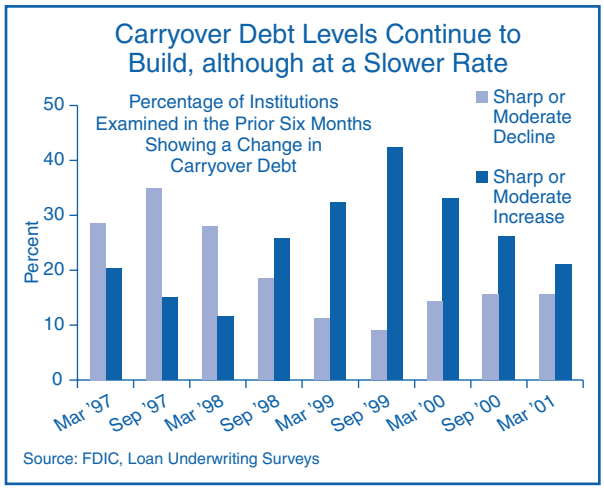
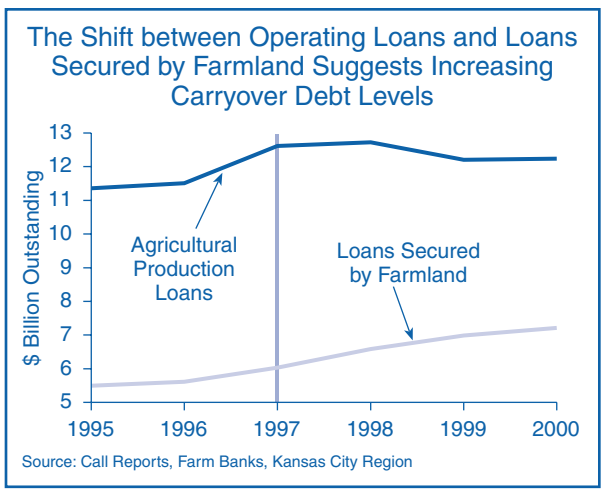


CHART 3



1997, while loans secured by farmland have increased by $1.2 billion. As a result, farmland-secured loans increased from 32 percent of all farm loans in 1995 to 37 percent by 2000. Although some of the increase in farmland-secured loans may be unrelated to carryover debt, the change in loan mix suggests higher carryover debt levels.

Greater reliance on government payments, rising levels of carryover debt, and increased emphasis on farmland collateral suggest the importance of understanding the effect of government payments on farmland values.

Farmland Prices Have Risen despite Historically Low Commodity Prices

Given the significant decline in farm operating net cash income during the past few years, one could reasonably expect that farmland values would decline. Farmland, like any business property, derives its value from its income production potential. Instead, prices have held steady or posted moderate gains despite falling farm revenues. The current situation differs from that of the late 1970s and early 1980s, when the Region experienced a rapidly expanding price bubble caused largely by strong export demand and low or negative real interest rates. As the dollar strengthened and exports fell, the bubble burst.

According to the U.S. Department of Agriculture (USDA), cropland and pastureland values across the nation rose 4.5 percent and 3.6 percent, respectively, between year-end 1996 and year-end 1999, the year for which the most recent data are available.[6] Cropland prices in the Kansas City Region rose 3.6 percent and pastureland rose 4.3 percent during the past three years.

However, there are vast differences in the changes in land prices among the Region's seven states. Missouri and **Minnesota** experienced the greatest increases in cropland values at 6.7 percent and 5.5 percent, respectively, while Kansas posted a 0.9 percent increase; the value of cropland in North Dakota declined slightly. South Dakota and Missouri pastureland values increased 7.5 percent and 6.6 percent, respectively, the largest gains in the Region. Pastureland values in Kansas and Iowa posted smaller increases. Given the significant decline in farm production revenue, the fact that prices have increased or remained flat raises the question, what could explain the resiliency of farmland values during this period?

The influence of urbanization is important, as farmland near expanding metropolitan areas continues to be purchased (for much more than its farming economic value) and developed into nonfarm properties. Given the tremendous economic boom during the past decade,

[6] The land price data in this section and in Table 1 are derived from information in USDA, *Agricultural Land Values*, http://usda.mannlib.cornell.edu/reports/nassr/other/plr-bb/land0300.pdf, National Agricultural Statistics Service, March 2000.

encroaching development has certainly supported farmland values in most metropolitan areas and even adjacent counties. Moreover, rising wealth and incomes have contributed to an increase in hobby-farming, rural estates, and even farmland purchases for recreational uses such as hunting. While much of the land continues to be farmed, some of its value stems from these alternative uses.

Although these influences may be contributing to increases in farmland prices in some areas, they do not explain the entire story. The most likely explanation appears to be the record-setting levels of government assistance.

How and to What Extent Do Government Payments Influence Land Prices?

Because farmland value is derived from capitalization of income, the proportional influence of government payments on land prices is related, to some degree, to government payments as a proportion of total net cash flow. That is, as government payments represent more of the total value of net cash income, these payments represent much more of the land value, and vice versa.

Mitchell Morehart presented a method for calculating the upward influence of government payments on farmland prices at the USDA's Agricultural Outlook Forum in February 2001.[7] Using the direct income capitalization method,[8] Morehart estimated that nationally, farmland values would have declined substantially if it were not for government payments. Presented in a time series graph, the analysis showed a dramatic widening between the actual and estimated land prices if government payments are excluded as agricultural problems worsened from 1997 to 2000. In 2000, estimated land prices if government payments are excluded are about 24 percent lower than actual land prices. In other words, in 2000, government payments may account for as much as 24 percent of the aggregate national value of farmland.

[7] Morehart is an agricultural economist with Economic Research Service, USDA.

[8] Morehart used existing land values and farm cash flow information to calculate capitalization rates for farmland. He adjusted the cash flows to discount direct government payments and divided the adjusted cash flows by the capitalization rate to determine an estimated land price if government payments are excluded. An explanation of the methodology and the results is available at http://www.usda.gov/oce/waob/oc2001/speeches/morehart.txt.

The influence of direct government payments on land values in the Kansas City Region is certainly greater because the Region has a higher concentration of the types of crops that are eligible for government assistance. Our replication of Morehart's analysis using regional data is shown in Chart 4, which shows that direct government payments could be responsible for as much as 52 percent of the value of the Region's farmland in 1999. This figure has increased considerably from 14 percent in 1996.

Table 2 shows that government payments could account for as much as 59 percent of the value of farmland in North Dakota at the high end, and 39 percent in South Dakota at the low end. This analysis indicates that even

Chart 4

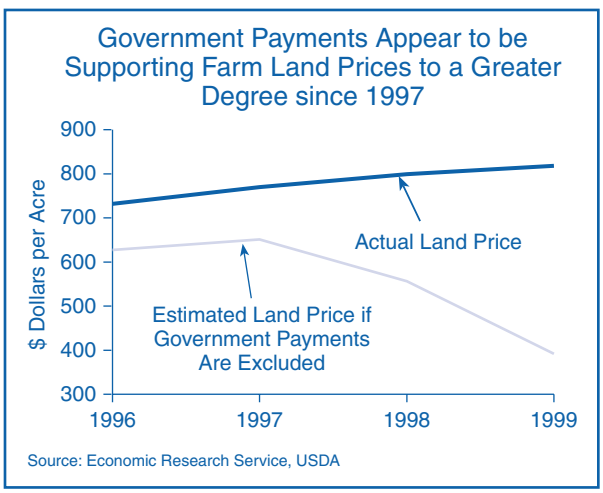


Table 2

The Estimated Percentage of Land Value Associated with Government Payments Has Increased Dramatically

State	1997	1998	1999
IA	12%	27%	53%
KS	19%	33%	55%
MN	21%	33%	57%
MO	14%	29%	58%
ND	24%	44%	59%
NE	14%	27%	47%
SD	13%	29%	39%
Region	**15%**	**30%**	**52%**

Source: Economic Research Services, USDA, and National Agricultural Statistics Service, USDA

a small reduction in government payments could affect farmland values negatively, and a significant reduction in assistance could have more adverse results.

However, it is important to keep in mind that the numbers in Table 2 should be viewed as a general description. The methodology is based on the assumptions that future income expectations are derived from current income, change annually, and are immediately incorporated into the value of land. Moreover, the methodology does not differentiate between government payment cash income and operating cash income. As discussed earlier, the analysis does not incorporate nonfarming influences on land values.[9]

[9] James Ryan, Charles Barnard, and Robert Collender discuss assumptions contained in this analysis in "Government Payments to Farmers Contribute to Rising Land Values," USDA's *Agricultural Outlook*, June–July 2001.

Conclusion

Farmers in the Region continue to rely greatly on government assistance to meet debt obligations. Significant reductions in emergency payments in 2001 or 2002, or reduced support in the next farm bill, could have a significant impact on farmers and their lenders. Farmers like those in North Dakota and Iowa, who are highly dependent on government payments, or farm banks with high concentrations in agricultural loans could be more vulnerable. In addition, should these payments decline, collateral protection could be eroded in areas where farmland values are supported by current government payments and the expectation that these payments will continue. Collateral protection for farmland is becoming more important as the level of carryover debt secured by farmland continues to increase.

Richard D. Cofer, Jr.
Senior Financial Analyst

Slowing Economy Reduces Demand for U.S. Office Space

- **Demand for U.S. office space contracted during the first half of this year as the amount of newly vacated space exceeded the amount of newly occupied space for the first time since at least 1981.**

- **The U.S. office vacancy rate jumped 250 basis points in the first half of 2001, from 8.3 percent to 10.8 percent.**

- **With construction levels remaining high and demand still weak, the vacancy rate could rise further by year-end.**

Overview

Commercial real estate (CRE) markets traditionally have been—and remain—highly cyclical. During the 1990s, most U.S. office markets experienced a strong upswing. However, declining office employment growth along with other recent signs point to a possible downturn. As reported by ***Torto Wheaton Research*** (TWR), the U.S. office vacancy rate, which stood at a 19-year low of 8.3 percent at the end of 2000, jumped in only six months to 10.8 percent, the largest six-month increase in the 20 years TWR has tracked these data. Office vacancy increases range from modest levels in some markets to high levels in markets where supply and demand imbalances are more pronounced.

An uptick in construction activity combined with a substantial drop in demand for office space has led to a slackening of office market conditions. In light of the ongoing uncertainty as to the near-term direction of the U.S. economy, these trends make the current situation difficult for office market participants to read.

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness.[1] It notes the role played by the changing fortunes of high-tech firms in a number of metropolitan areas and how this situation has increased the volume of space available for sublease. Finally, the article focuses on the local construction loan exposures of insured banks and thrifts that have the task of managing their risks under changing market conditions.

Vacancy Rates Have Risen Quickly from Cyclical Lows

At year-end 2000, the U.S. office vacancy rate stood at 8.3 percent—a 19-year low. Many individual metro areas posted even lower vacancy rates. For example, at year-end 2000, vacancies were 4.4 percent of available space in Seattle, 1.3 percent in San Jose, and 3.0 percent in Oakland. Beginning with first quarter 2001, as a result of a slowing economy and the fallout from the so-called "tech-wreck," the U.S. vacancy rate rose by 120 basis points to 9.5 percent—the highest absolute quarterly increase since these data were first published in 1981. Another record increase of 130 basis points occurred during the second quarter, bringing the vacancy rate to 10.8 percent. To put these increases in perspective, consider that the national office vacancy rate has increased more than 50 basis points in any given quarter only twice.[2] Nonetheless, the current vacancy rate of 10.8 percent remains low by historical standards, as the average rate for the past 20 years has been 13.9 percent.

Most of the nation's large metro areas saw increases in office vacancies during the first half of 2001. Forty-eight of the 53 major metropolitan areas tracked by TWR recorded a higher vacancy rate in June 2001 than at year-end 2000. Thirty-eight markets experienced increases of at least 100 basis points, and four markets saw vacancy rates jump by more than 600 basis points. As shown in Table 1 (next page), most of the markets experiencing the largest jump in vacancy rates also are home to concentrations of high-tech employment.[3] As

[1] For further discussion of demand and supply trends, see Sally Gordon, "CMBS: Red – Yellow – Green™ Update, Second Quarter 2001 Quarterly Assessment of U.S. Property Markets," *Moody's Investors Service,* July 6, 2001.

[2] TWR notes increases of 60 basis points in the second quarter of 1989 and in the first quarter of 1999.

[3] Seven of the ten markets with the highest first-half 2001 vacancy rate increases are also among the top ten cities having the greatest levels of high-tech employment.

Table 1

In Many Markets, Office Vacancy Rates Reflect Concentrations of High-Tech Employment				
Metro Area	Vacancy Rate as of 6/30/01 (%)	Vacancy Rate as of 12/31/00 (%)	Increase in Vacancy Rate (basis points)	High-Tech as % of Total Market Employment
Austin	11.8	5.0	680	10.1
San Jose	8.1	1.3	680	27.4
Oakland	9.3	3.0	630	6.5
San Francisco	10.3	4.1	620	8.3
Seattle	9.4	4.4	500	6.6
Kansas City	15.9	11.0	490	2.7
Boston	8.7	3.9	480	8.2
Phoenix	16.9	12.5	440	4.7
Wilmington, DE	10.4	6.2	420	3.8
Washington, DC	7.8	3.9	390	7.8
Nation	10.8	8.3	250	4.8

Sources: Torto Wheaton Research, Economy.com, Inc.

high-tech markets spurred higher demand for office space in the recent past, these markets are now giving back greater quantities of previously occupied office space. Table 2 (see page 18) lists office vacancy rates and changes along with lending concentrations, construction activity levels, and high-tech employment percentages for 53 major metropolitan areas and for the nation.

Unlike the last cycle, during which office vacancies shot up primarily in overbuilt downtown areas, recent increases are occurring more sharply in suburban than downtown sections of metropolitan areas. As of June 30, 2001, the average downtown office vacancy rate was 8.5 percent, and the average for suburban markets was 12.1 percent. Increases in office availability are dispersed among Class A office properties as well as Class B/C properties, yet vacancy rates do show disparities across many submarkets. For example, the South of Market area in San Francisco reports significantly higher office vacancy rates than the Financial District.[4] Similarly, in the Washington, DC, metropolitan area, the technology-intensive northern Virginia office market has experienced higher office vacancy increases than downtown Washington, DC, or suburban Maryland.

[4] Louis, Arthur M. July 24, 2001. "Empty Offices, Economic Downturn, Overconstruction Leave Commercial Landlords with More Space on their Hands." *San Francisco Chronicle.*

Office Demand Drops

Net absorption, the primary indicator of demand for office space, was negative during first quarter 2001 for the first time since TWR began reporting the series.[5] (Negative absorption occurs when space returned to the market by existing tenants exceeds the space occupied by new tenants.) This negative performance was repeated in the second quarter. The decline in the volume of competitively leased space totaled 30 million square feet during the first half of 2001. (See Chart 1.)

The bulk of negative absorption in the first half of 2001 is due to the return of office space to the market through subleasing.[6] TWR reports that there were 43 million square feet of space "give-backs" through subleasing in the first half of 2001, and after offsetting absorption of 13 million square feet, negative absorption was 30 million square feet.

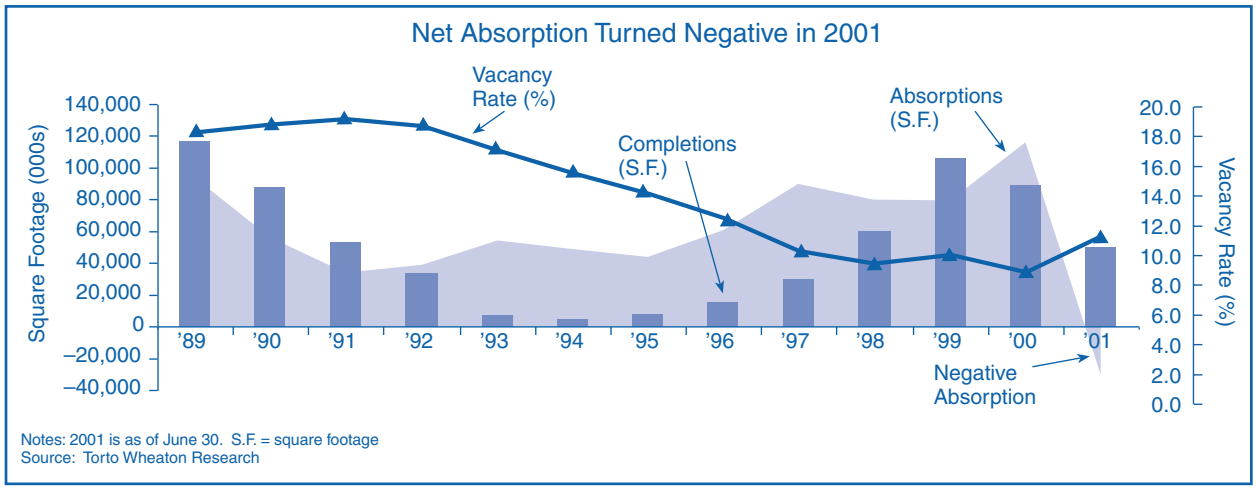
Office employment growth, the source of new office space demand, tends to be driven by the finance and services sectors.[7] Year-over-year job growth in the finance,

[5] Net absorption is the net change in total competitively leased space per period, as measured in square feet.

[6] In some metropolitan areas, over half the total office space available for rent (vacant space) is sublease space.

[7] TWR constructs its office employment index based on trends in the FIRE sector plus selected categories of the services sector. See *TWR Office Outlook,* Spring 2001, Vol. II, p. A.1.

Chart 1



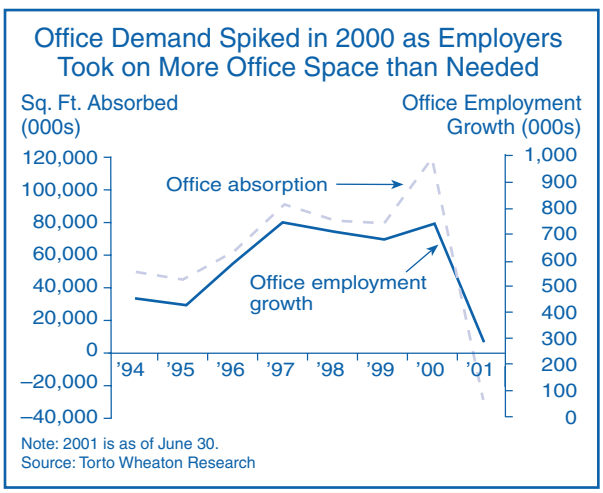
insurance, and real estate (FIRE) and services sectors combined was more than 3 percent in every month from January 1993 through June 2000. Since the middle of 2000, job growth in these sectors has fallen steadily to a year-over-year rate of less than 1.5 percent in June 2001. A spring 2001 survey conducted by ***Salomon Smith Barney*** indicated that tenants estimated their growth in office space demand to be only 0.6 percent over the following 12-month period.[8] Also contributing to reductions in demand are increases in worker layoffs. Announced layoffs during the first seven months of 2001 totaled over 983,000 individuals, more than triple the number of announced layoffs during the same period last year.[9]

The slowdown in the demand for office space contrasts sharply with the situation last year, when absorption rates and office employment growth were robust in most markets, and leases were executed quickly for newly constructed properties. As shown in Chart 2, absorption of office space in 2000 actually outstripped the trend in office employment by a considerable margin. Why? With relatively easy access to initial public offering and venture capital funding, many startup firms anticipated rapid growth and leased office properties accordingly. In fact, venture capital funding facilitated historically higher rates of office space absorption by high-tech and other startups. In active bidding wars, new high-tech firms increased their office space holdings. A phenomenon of *space hoarding* developed in which some high-tech companies leased large quantities of office space in anticipation of future expansion.

More recently, because of a slowing economy, curtailed funding, and failures to achieve sales expectations, many high-tech and dot-com firms have closed or scaled back operations significantly. At the same time, traditional firms have reconsidered plans to expand, adopting a "wait and see" attitude. Consequently, as demand for space declines, large blocks of office space are returning to markets for sublease.

Space available for sublease is similar to landlord-offered space available for rent—space under both categories should count toward a market's available rental space. However, in the case of subleasing, tenants, rather than landlords, offer properties for rent. Tenants may attempt to sublease the property themselves or use a broker; however, in general, only space handled by a broker is included in the tally of a market's available rental space. Consequently, current office vacancy increases could be higher than reported.

Chart 2



[8] Boston, Gary, Ross Nussbaum, and Jonathan Litt. May 16, 2001. "Real Estate Demand Survey." *Equity Research: United States, Real Estate Investment Trusts.* Salomon Smith Barney.

[9] Data provided to Haver Analytics by Challenger, Gray & Christmas.

Meanwhile, Construction Continues

An uptick in office construction activity that began in many metro areas during the late 1990s has been a key element contributing to recent increases in office vacancies. According to the ***Bureau of the Census***, U.S. expenditures on office construction totaled $47.5 billion in 2000, continuing a seven-year cycle of expansion. Adjusted for inflation, this amount represents about 78 percent of the peak level of office construction expenditures that occurred in 1985. Recently, the pace of construction has slowed slightly, falling to an annualized rate of $44.3 billion in May 2001.

Reflecting these large dollar outlays on office construction, TWR projected in December 2000 that 111.3 million square feet of new office space (or 3.6 percent of existing stock) would be completed during 2001. This newly completed space will come on the market following a period of rising construction activity from 1998 through 2000, during which the volume of completed office space averaged 84.9 million square feet per year. As shown in Chart 3, however, current office construction activity as a percentage of existing stock falls well below that of the 1980s.

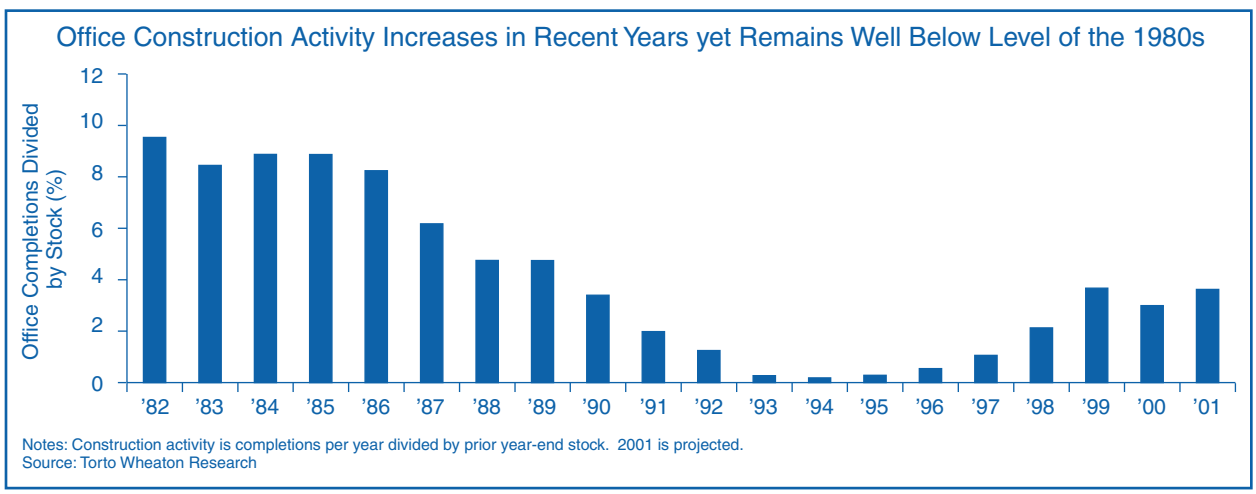
Many metropolitan areas currently experiencing high levels of construction activity also are seeing the largest increases in office vacancies. For example, cities that are positioned toward the upper right quadrant of Chart 4 are characterized by higher vacancy rate increases and more new office space construction. The ten cities with the highest first-half 2001 vacancy rate increases had total square footage of under-construction office space at 6.5 percent of existing stock as of year-end 2000.[10] By comparison, total office space under construction nationally was 4.5 percent of existing stock.[11]

Even as most projects move toward completion, some developers are reconsidering office construction plans. Builders have stopped construction of significant projects midstream in the Austin, Dallas, Seattle, and northern Virginia markets in response to retrenchment by major tenants and competition from subleased space.

Softening Extends to Other Commercial Real Estate

Other major commercial real estate markets are also feeling the effects of a slowing economy and, with the exception of the retail sector, are experiencing increasing vacancy rates.

Chart 3

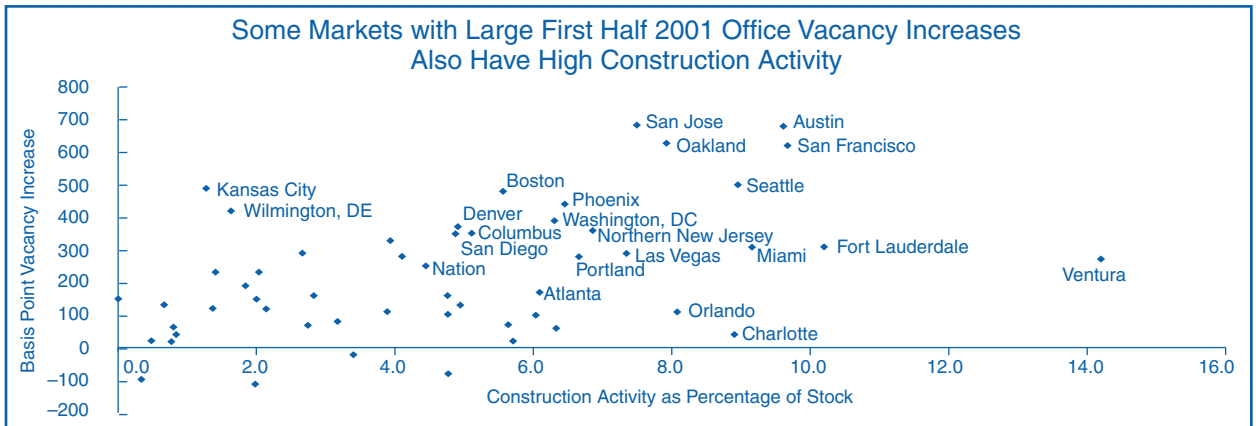


Notes: Construction activity is completions per year divided by prior year-end stock. 2001 is projected.
Source: Torto Wheaton Research

[10] One measure of a metropolitan area's exposure to overbuilding and rising vacancy rates is the degree of construction activity. This measure is found by dividing a metropolitan area's completions square footage or the under-construction square footage by the total stock of office property.

[11] The national 4.5 percent level for office properties *under construction* at December 2000 is higher than the 3.6 percent level for projected *completions* in 2001 because not all properties being built in 2001 will be completed during the year.

CHART 4



Note: Construction activity is measured by a market's under-construction square footage at year-end 2000 divided by total square footage in that market as of year-end 2000.
Source: Torto Wheaton Research, Spring 2001

Industrial vacancy rates had fared well in recent years. As of year-end 2000, the national vacancy rate of 6.7 percent was the lowest since 1984. Now, however, a 150-basis-point increase has occurred, with industrial vacancies increasing to 8.2 percent in the first half of 2001.[12]

As the economy and the nation's high-tech and manufacturing sectors continue to slow, demand for industrial space for research and development and storage and distribution is declining. Industrial property subleasing is on the rise, and negative absorption occurred in the first half of 2001. At the same time, completions of industrial space during 2001 are estimated to exceed 220 million square feet, the highest level since 1988. Landlords are offering concessions, such as lease terms of one year compared with five to ten years, in an attempt to attract new tenants.

Industrial properties are somewhat less exposed to risks from overbuilding than office properties because of shorter construction periods and the ability to respond quickly to any change in demand. An exception is the *telecommunication hotel,*[13] a new entry into this market. This property type is characterized by a longer construction cycle and the fact that it typically has a "single use" design. In recent months, construction of these structures began in many high-tech markets to provide enhanced levels of data service. With declining demand, some telecom hotels stand vacant.

The demand for **hotel** rooms is adversely affected by a slowing economy. Businesses have cut travel budgets and consumers have scaled back leisure plans, contributing to a decline in occupancy levels and revenue per available hotel room in most markets throughout 2001. Currently, upscale and luxury hotels are suffering more than limited service hotels. According to ***Smith Travel Research,*** limited service hotels, particularly budget hotels, represent the only lodging sector with higher occupancy levels through the first four months of 2001 when compared to the same four month period in 2000.

The supply of new hotel properties is lower than in the past, as financing for new hotel construction for the most part has been curtailed in recent years. However, limited service hotels are reported to be overbuilt in a number of markets in the Southeast and Southwest.[14] Annualized expenditures for new construction of all hotel types were $12.1 billion as of May 2001, falling to the lowest level since 1996.[15]

The **multifamily** sector has experienced robust construction and equally strong absorption in recent years as new household formation, the driver for apartment demand, continues to increase. Annualized construction expenditures of $25.5 billion as of May 2001 were at the highest level since 1989.[16] Despite the relative equilibrium between supply and demand for apartments in most markets, vacancy increases and rent declines are occurring in some locations. This decline has been most acute

[12] Torto Wheaton Research.

[13] Telecom hotels are large, high-energy-consuming warehouses that house machinery, servers, routers, and switches that are the physical underpinning of the electronic commerce conducted on the Internet. They are hotels in the sense that they house equipment belonging to many different telecommunication companies. John Holusha, "Home for Machinery of the Internet," *The New York Times,* August 16, 2000.

[14] Kozel, Peter P. June 18, 2001. "U.S. Commercial Property Markets in a Slowing Economy: Implications for CMBS Credit Performance." *Standard and Poor's Structured Finance.*

[15] Data provided to Haver Analytics by U.S. Bureau of the Census.

[16] Ibid.

in the more concentrated high-tech markets, such as San Francisco, where reported average rental rates dropped 8.1 percent between the end of March and the end of May 2001.[17]

Despite a slowing economy, the **retail** sector has performed reasonably well, as consumers maintain relatively high spending levels. Many of the store closings in 2000 and 2001 have been absorbed by new tenants as landlords have acted quickly to avoid letting vacant space linger. Meanwhile, robust construction has continued, with total expenditures in 2000 of $52.6 billion and an annualized level of $52.2 billion as of May 2001. Each of these two years' expenditure levels exceeds all previous years' retail construction amounts since data were first gathered in 1964.[18]

Taking note of the robust level of retail construction activity, a recent ***Moody's*** article finds that the nation's mall retail and "power center"[19] space grew by 3.3 percent in 2000, while population growth expanded by only 1.2 percent. The article raises concerns for potential excess supply of retail space resulting from a construction rate that is almost triple the population growth rate.[20] A negative consequence of the high rate of retail construction is found in a recent ***Standard and Poor's*** study. This article points out that most of the retail mortgages (held in commercial mortgage-backed pools of assets) that defaulted during 2000 did so because of competition from new retail establishments.[21]

Implications for Insured Institutions

Office vacancy rates during the first half of 2001 increased at an unprecedented rate. What does this mean for insured institutions? On the one hand, at mid-2001 vacancy rates remained below their 20-year average. Yet the speed of the increase and the number of metropolitan areas that have experienced softening make this a trend that deserves the close attention of insured institutions, especially those with significant concentrations in commercial real estate and construction lending.

Financial indicators of real estate credit quality in banking remain favorable, with losses and delinquencies trending up modestly from minimal levels. Noncurrent construction and development (C&D) loans as of March 31, 2001, remain at a relatively low .92 percent of all outstanding C&D loans. (Noncurrent C&D loans as a percentage of all C&D loans averaged .93 percent for the past five year-ends.) Similarly, noncurrent CRE loans[22] as of March 31, 2001, were .82 percent of all CRE loans, a level consistent with the average for this ratio of 1.08 percent for the past five year-ends. Charge-off ratios at March 31, 2001, for both C&D and CRE loans were each at .02 percent and remain below the averages of .05 percent for each for the past five year-ends. These favorable numbers are the legacy of a strong economic expansion, whereas current economic events suggest the potential for future deterioration in credit quality.

The outlook for commercial real estate credit quality depends on the depth and duration of the current economic slowdown and on the risk management practices of each institution. In this regard, as signs of increasing risk materialize in conjunction with a declining economy, lenders appear to be managing risks prudently and avoiding speculative lending.[23] Anecdotal information suggests that borrowers are pressed to obtain higher prelease commitment levels in order to gain loan approvals. In addition, lenders are requiring more up-front equity.[24,25]

The importance of risk management practices is magnified by the heightened lending concentrations currently prevailing at some banks. Institutions with elevated concentrations in CRE and C&D lending have been more likely to experience significant problems during times of economic stress (for further details,

[17] Associated Press, News in Brief from the San Francisco Bay Area, June 13, 2001.

[18] Data provided to Haver Analytics by U.S. Bureau of the Census.

[19] According to the Urban Land Institute, a power center is a community shopping center in which at least 75 to 90 percent of the selling space is devoted to multiple off-price anchors and a discount department store or warehouse club. It is the "power" of its anchors that gives the center its name.

[20] Sally Gordon, op. cit.

[21] Kozel, Peter P. April 20, 2001. "Outlook for Property Markets in a Slower-Growing Economy and the Implications for CMBS Credit Performance." *Standard & Poor's Structured Finance.*

[22] CRE loans are nonfarm, nonresidential loans secured by real estate.

[23] Speculative construction lending is defined as a loan not accompanied by a meaningful presale, prelease, or take-out commitment.

[24] "Capital Is Still Plentiful for Right Projects." *Midwest Real Estate News.* July 2001. Vol. 17, No. 7.

[25] Further information on bank underwriting practices can be found in Federal Deposit Insurance Corporation, Division of Research and Statistics, *Report on Underwriting Practices,* http://www.fdic.gov/bank/analytical/report/index.html.

see *History of the Eighties*[26]). As shown in Chart 5, the percentage of insured institutions with commercial real estate loan concentrations between 200 and 400 percent of capital is higher now than it was in the late 1980s. However, there are relatively fewer institutions at the highest concentration level, in excess of 500 percent of capital. In fact, fewer than 1 percent of insured institutions are at this level. A similar story holds true for construction loans, as the increasing concentrations are in the range of 100 to 300 percent of capital (see Chart 6).

There are a number of issues for construction lenders and commercial real estate lenders to consider going forward. Because uncovered loans (C&D loans made without assurances of a firm take-out commitment) tend to be higher-risk, an important part of managing the risk in construction lending has traditionally been the lender's ability to obtain a take-out commitment.

Sources of take-outs for C&D loans include other insured institutions, pension funds, foreign investors, and life insurance companies, along with public-market real estate investment trusts (REITs) and conventional mortgage-backed securities (CMBSs). Anecdotal reports indicate that shifts in market sentiment in recent months have resulted in lowered investments in REITs and consequently less available capital for REITs to purchase real estate.[27] Insured institutions may face increased challenges to convert construction and development loans into permanent loans should the reported REIT situation become a trend and other sources of permanent capital become less available to purchase C&D loans.

Chart 5

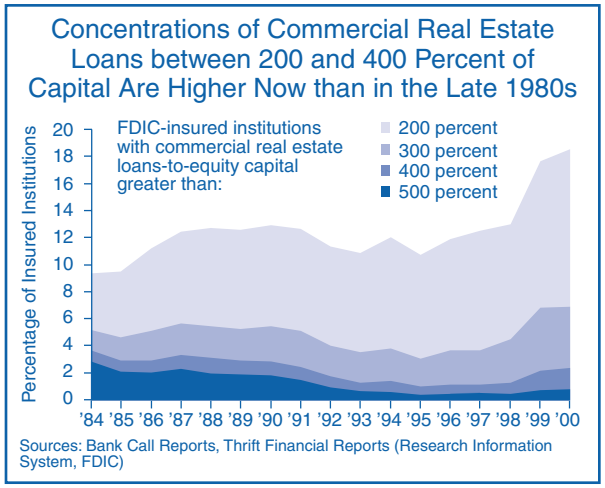
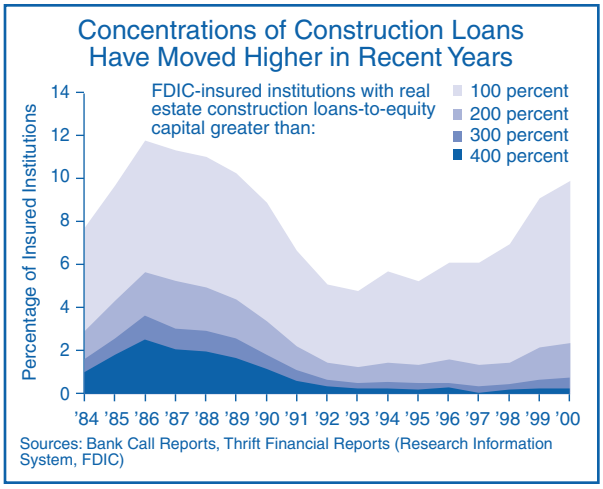


Chart 6



Monitoring economic trends in general, and local real estate trends in particular, becomes even more important during a time of rapid change in market conditions. For example, reliance on appraisals based on outdated or top-of-market assumptions can result in a divergence between expected and realized collateral values or cash flows. Similarly, while preleasing commitments offer significant risk-reduction benefits to lenders, during a time of weakening economic conditions there is at least the possibility that a prospective tenant will be unable to honor a lease obligation, as has been the case with some firms in the high-tech sector in recent months.

Conclusion

Office market trends cannot, of course, be considered in isolation. The recent softening in office markets is a symptom of a slowing economy coupled with a rapid decline in the fortunes of some high-tech firms. Considered in this broader context, the challenge for insured institutions is simply to ensure that risk-management strategies are in place that will succeed under a more challenging economic environment.

Thomas A. Murray
Senior Financial Analyst

[26] Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s,* Chapters 9 and 10. 1997. Washington, DC: FDIC. http://www.fdic.gov/bank/historical/history/index.html.

[27] Smith, Ray A. August 1, 2001. "Property Held by Public Firms Drops." *The Wall Street Journal.*

Table 2

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
Albuquerque	11.6	-110	9	61.0	6.8	2.0
Atlanta	9.8	170	76	172.2	3.8	6.1
Austin	11.8	680	20	53.4	10.1	9.6
Baltimore	8.9	60	60	22.8	3.6	6.3
Boston	8.7	480	100	24.1	8.2	5.6
Charlotte	9.0	40	20	48.5	1.7	8.9
Chicago	8.9	130	225	33.5	4.5	4.9
Cincinnati	10.1	100	58	32.6	3.1	6.0
Cleveland	13.6	40	16	34.8	3.0	0.8
Columbus, OH	16.9	350	20	22.4	3.1	5.1
Dallas	16.4	110	75	84.5	6.5	3.9
Denver	12.7	370	45	70.4	5.2	4.9
Detroit	12.0	160	28	35.2	3.1	2.8
Ft. Lauderdale	12.8	310	13	19.1	2.7	10.2
Ft. Worth	16.4	130	36	71.8	3.4	0.7
Fresno	14.4	20	5	196.0	0.9	0.8
Hartford	14.0	150	11	25.2	3.5	0.0
Honolulu	12.6	-190	3	11.4	0.9	0.0
Houston	13.6	60	48	65.8	3.1	0.8
Indianapolis	15.8	120	21	29.6	3.3	1.4
Jacksonville	11.7	-20	11	65.2	1.8	3.4
Kansas City	15.9	490	86	70.8	2.7	1.3
Las Vegas	14.5	290	19	117.7	1.5	7.3
Long Island	10.9	190	6	19.1	5.3	1.8
Los Angeles	14.1	150	62	35.4	3.7	2.0
Miami	10.5	310	26	28.1	1.8	9.2
Minneapolis	10.8	20	119	44.0	6.0	5.7
Nashville	12.8	230	20	78.4	1.2	2.0
New York	5.1	230	34	10.5	2.4	1.4
Northern New Jersey	10.9	360	66	15.0	5.6	6.9
Oakland	9.3	630	12	120.0	6.5	7.9
Oklahoma City	20.3	20	44	57.8	2.6	0.5
Orange County	14.7	330	14	34.5	6.4	3.9
Orlando	13.1	110	23	72.1	2.3	8.1
Philadelphia	10.7	80	68	22.1	4.5	3.2
Phoenix	16.9	440	27	114.2	4.7	6.5
Portland, OR	9.9	280	14	118.8	6.6	6.7
Riverside	14.4	-100	18	143.5	1.6	0.3
Sacramento	6.6	70	11	106.9	3.9	5.6
Salt Lake City	15.3	280	14	111.7	4.5	4.1

Table 2 (continued)

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year-End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
San Diego	9.7	350	21	57.5	6.6	4.9
San Francisco	10.3	620	21	69.0	8.3	9.7
San Jose	8.1	680	5	174.5	27.4	7.5
Seattle	9.4	500	30	77.1	6.6	9.0
St. Louis	10.1	–80	80	40.4	2.6	4.8
Stamford	11.2	290	10	43.5	5.6	2.6
Tampa	14.8	70	33	40.0	4.2	2.7
Tucson	8.8	100	3	178.4	4.4	4.8
Ventura	14.2	270	8	49.7	5.4	14.2
Washington, DC	7.8	390	61	51.1	7.8	6.3
Wilmington, DE	10.4	420	12	28.4	3.8	1.6
W. Palm Beach	12.2	160	18	37.2	2.3	4.8
Westchester	12.5	120	4	19.5	12.3	2.1
Nation	10.8	250	(1) 3,801	(1) 40.1	(2) 4.8	(2) 4.5

Notes: Only community banks with construction loans are included in this table. Community banks are institutions with assets less than $1 billion. Noncommunity banks are excluded because their lending activities are likely to span a larger area than the MSA in which they are headquartered.
Sources: Torto Wheaton Research; Bank and Thrift Call Reports, FDIC Research Information System data; Economy.com, Inc.
1. Only community banks with construction loans and located within a MSA are included in these figures.
2. Percentages shown are the averages for the 53 metropolitan areas.

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