Regional Outlook

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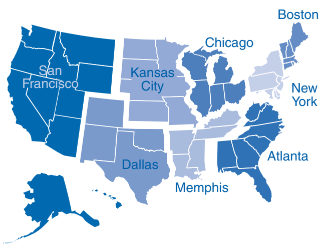

DIVISION OF INSURANCE

In Focus This Quarter

◆ ***Back to the Future: How This Downturn Compares to Past Recessions—***In March 2001, the U.S. economy entered recession after a record ten years of economic expansion. Recent indicators show that the economy may have begun to emerge from recession during first quarter 2002. But uncertainties remain that could slow or even halt the recovery. Some of the factors contributing to these uncertainties include a continuing earnings slump in the corporate sector and the uninterrupted accumulation of debt by the household sector. Such uncertainties shape the credit risk environment for the banking industry. Subprime, commercial, and commercial real estate and construction lending are all areas of concern where the magnitude of future losses will hinge on the speed and strength of the economic recovery. As bank risk managers continue to size up the effects of this recession on their operating performance, they will need to account for these factors and note the similarities and differences between this recession and previous U.S. downturns. *See page 3.*

By Richard A. Brown, Robert Burns, and Lisa Ryu

Regional Perspectives

◆ ***Atlanta—***Economic growth in certain metropolitan markets in the Region has slowed significantly; however, insured institutions in many of these markets are continuing to increase exposures in traditionally higher-risk loan categories. *See page 10.*

◆ ***Boston—***The Boston Region is meeting this recession better than it did that of the 1990s. The Region's economic recovery may lag the nation's because of continued weakness among information technology firms. Insured institution credit quality remains sound despite increases in commercial property vacancy rates and the slowing economy. *See page 14.*

◆ ***Chicago—***Credit quality deterioration is widespread across loan types but is not severe overall and is variable across the Region. However, allowance coverage of nonperforming loans has dropped significantly. *See page 17.*

◆ ***Dallas—***Economic activity slowed during 2001, curbing demand for commercial real estate (CRE). At the same time, the percentage of the Region's insured institutions reporting relatively high CRE concentrations has never been higher. *See page 21.*

◆ ***Kansas City—***Provisions of the next farm bill could affect the creditworthiness of borrowers and asset quality among the Region's farm banks. Margin compression continues to pressure profitability among the Region's community banks. *See page 25.*

◆ ***Memphis—***Lingering economic weakness in the Region and deteriorating credit quality suggest that continued attention to the allowance for loan and lease losses is needed. *See page 28.*

◆ ***New York—***Increased concentrations of long-term assets, particularly among the Region's community banks, have heightened the importance of effective interest rate risk management. *See page 31.*

◆ ***San Francisco—***Commercial real estate deterioration, increases in personal bankruptcy rates, and weakness in the tourism sector pressured insured institution credit quality. Also, declining interest rates challenged community bank net interest margins. *See page 35.*

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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San Francisco revision:

The first quarter 2002 San Francisco *Regional Perspectives* article has been revised to correct labeling errors in Table 1. Column two, which was titled "Assets of CCLs," should read "Assets of Community Institutions." Column three, which was labeled "Number of CCLs," should read "Number of Community Institutions." These changes do not affect the authors' analysis or conclusions.

Back to the Future: How This Downturn Compares to Past Recessions

Introduction

The recession that began in March 2001 represents a new test for risk management practices at U.S. banks and thrifts. Any significant slowdown in economic activity at the national level usually has adverse effects at most insured institutions. Typically, we would expect a decline in the demand for credit along with an increase in the number of borrowers who have trouble repaying existing loans, resulting in lower bank earnings. The ultimate effect of an economic slowdown on the banking industry hinges on three key factors: (1) how severe the downturn is, (2) how long it lasts, and (3) how well banks are prepared for economic adversity.

However, just as in the *Back to the Future* movie trilogy, we see that history does not play out the same way every time. This recession is unique in that it follows the longest economic expansion in U.S. history. This era came to be called the New Economy because of the changes technology and globalization are thought to have brought about in rates of inflation and productivity growth.[1] What effects will a New Economy recession have on the U.S. banking industry? To answer this question, we will go "back to the future" and compare the current situation to past recessions.

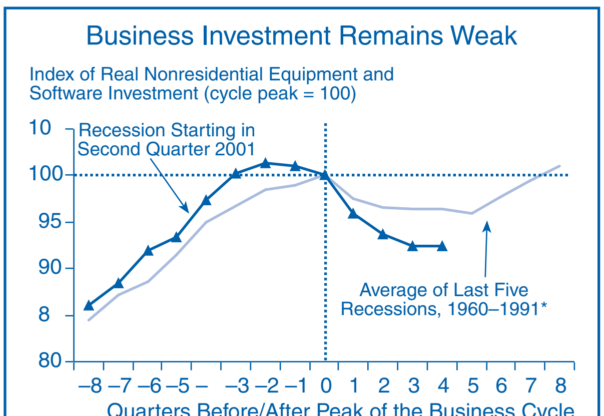
This Is a Corporate Sector Recession

The current recession can be best described as a "corporate sector recession" in that most of the bad economic news over the past two years has been corporate news. First, corporate equity prices tumbled after reaching a peak in the spring of 2000, particularly on the technology-heavy NASDAQ exchange. After-tax corporate profits fell by nearly 16 percent in 2001 from the year before—the sharpest annual decline since 1982. To make matters worse, the collapse of Enron in December 2001 sparked a flurry of questions about the quality of accounting information in corporate earnings reports and audit opinions as well as the reliability of equity analyst reports.

The result of these corporate woes has been a dramatic falloff in business investment spending. Chart 1 compares investment spending in this cycle with its average trend over the last five recessions, dating to 1960. The chart shows that while inflation-adjusted growth in investment outstripped the historical average prior to March 2001, it has significantly underperformed the average since then. Faced with weak earnings, corporations that had been investing billions in information technology (IT) in the late 1990s suddenly cut back. Lower demand for high-tech products in turn hurt the major suppliers of IT equipment and software, including Intel, Dell, and even Microsoft. Also hard hit by this corporate sector recession has been the telecommunications industry, burdened by excess capacity and high debt loads. Capacity utilization for the high-tech industry—including computers, communications equipment, and semiconductors—barely topped 60 percent at the end of 2001.

Earnings for the rest of the corporate sector also have been hurt by slow growth in top-line revenue in a highly competitive, low-inflation world. Total sales of U.S. manufacturing corporations fell by 8 percent in fourth quarter 2001 from a year ago, while their operating profits fell by more than half. Job cuts announced by all U.S. corporations more than tripled in 2001 from a year ago to 1.96 million. A record 255 U.S. corporations filed for bankruptcy protection in 2001, up from 176 the year before.[2] The default rate on speculative

Chart 1



* Treats the 1980s double-dip recession as one.
Source: Bureau of Economic Analysis (Haver Analytics)

[1] See *Regional Outlook,* second quarter 2000, "Banking Risk in the New Economy." See http://www.fdic.gov/bank/analytical/regional/index.html.

[2] Data on publicly traded bankruptcy filings from BankruptcyData.com.

bonds nearly doubled during 2001, reaching 10.2 percent by year-end.[3] In addition, a record-high 60 investment-grade credits were downgraded to junk status ("fallen angels") in 2001.[4] Rising defaults among corporate borrowers pushed up commercial and industrial (C&I) loan losses at large banks that tend to lend more often to large corporate borrowers. C&I charge-offs for large insured institutions (over $1 billion in assets) in fourth quarter 2001 were 1.58 percent of average loan balances, more than twice the level recorded at small institutions (under $1 billion).

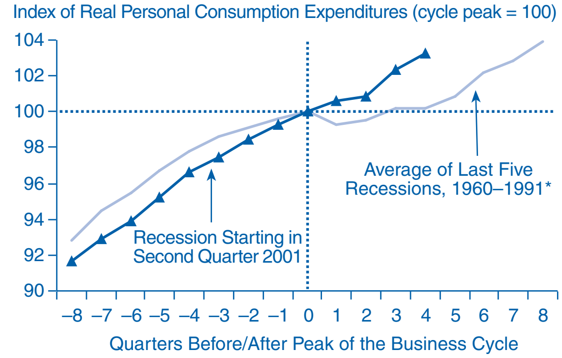
Consumer Spending Comes to the Rescue

While the problems of the corporate sector were driving the U.S. economy into recession, consumer spending has continued to grow with barely a pause. Chart 2, comparing consumer spending growth in this recession with that in previous downturns, shows that consumer spending slowed briefly in the third quarter of last year, and then resumed a rapid growth in the fourth quarter that persisted into early 2002. This performance is all the more remarkable in light of the shock to consumer confidence that was recorded in the wake of the September 11 terrorist attacks. In spite of the turmoil, retail sales grew at a brisk 5.5 percent nominal rate in fourth quarter 2001 on the strength of a 15.5 percent increase in sales of autos and auto parts.

Three related factors may help explain why consumers have continued to increase their spending throughout this recession. First, the Federal Reserve lowered interest rates 11 times in 2001, for an unprecedented cut of 475 basis points in the federal funds rate. As long-term mortgage rates declined late in the year, millions of homeowners were able to refinance their mortgages at lower rates. Moreover, because of high rates of home price appreciation in many markets across the nation in recent years, many homeowners had the opportunity to "cash out" a portion of the equity in their home to pay down nonmortgage debt or finance new purchases.[5] One estimate shows that mortgage refinancing provided about $150 billion in additional liquidity to consumers during 2001.[6] The Federal Reserve *Flow of Funds* data show that total mortgage indebtedness of households and nonprofit organizations grew by $491 billion, compared with personal saving of only $118.6 billion out of current income. Finally, despite the recession-induced job losses, real disposable personal income grew by a solid 3.6 percent last year, helping to offset losses sustained in the slumping stock market.

CHART 2

Consumer Spending Has Continued Strong



* Treats the 1980s double-dip recession as one.
Source: Bureau of Economic Analysis (Haver Analytics)

Continued growth in consumer spending amid corporate-sector distress illustrates the fact that workers and consumers wield a substantial amount of competitive power in the New Economy. For example, during fourth quarter 2001, car buyers responded to zero-percent financing and cash incentives, which boosted sales but left U.S. auto makers with more than $7 billion in operating losses for the year.

Recovery Appears on the Way

Recent signs indicate that the U.S. economy may have begun to recover in first quarter 2002.[7] Chart 3 points to four factors—consumer confidence, housing starts, manufacturing, and job growth—that appeared to head upward simultaneously during the first quarter. Preliminary estimates of first quarter U.S. economic activity reinforce this picture; real gross domestic product

[3] Moody's Investors Service. January 14, 2002. *December Default Report*.

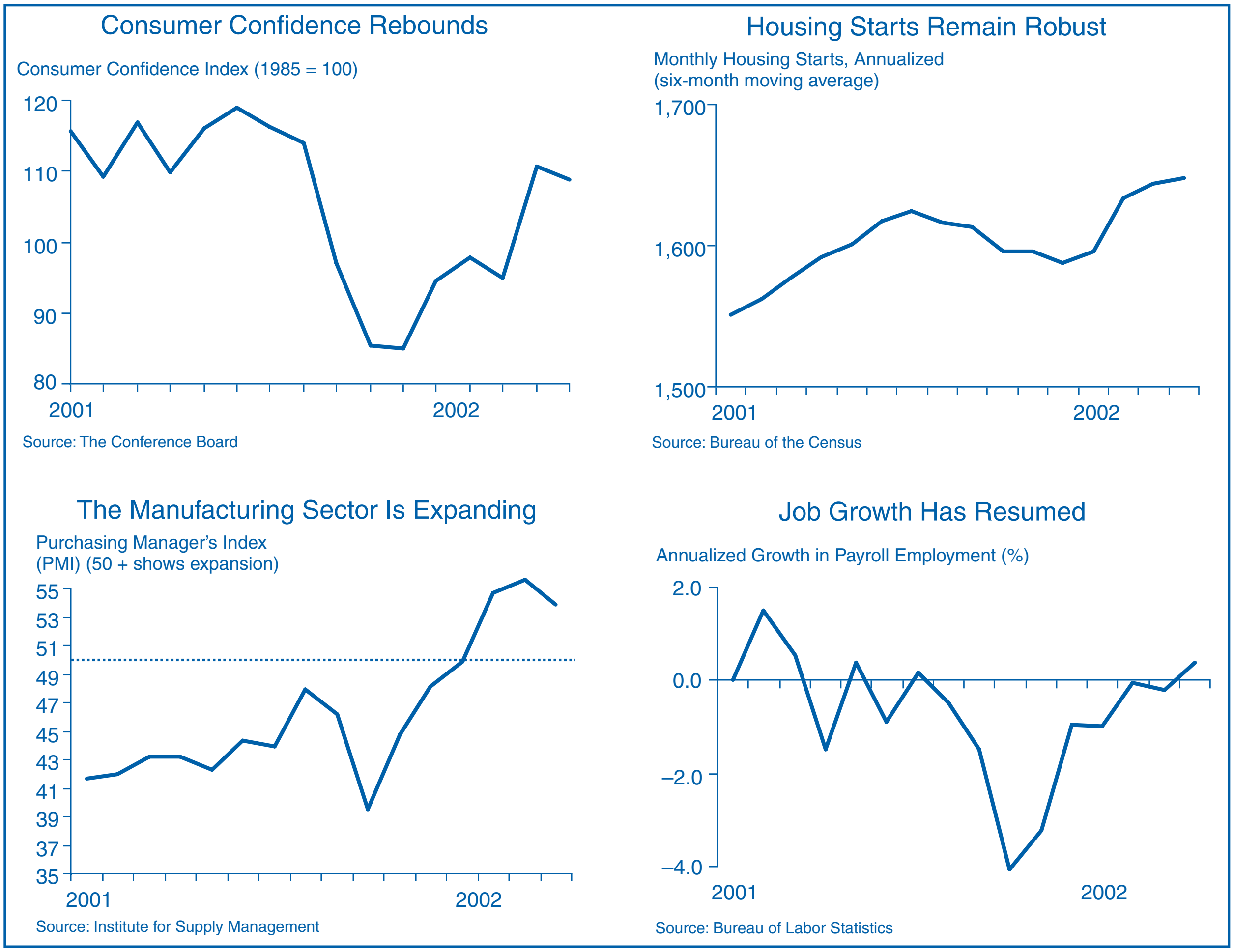
[4] Lori Appelbaum, et al. February 6, 2002. Banks: Regional/Trust & Processing. Goldman Sachs *Global Equity Research.* The previous peak was in 1989, when the number of fallen angels reached 42.

[5] According to Freddie Mac, 60 percent of loans refinanced in third quarter 2001 and 48 percent in fourth quarter 2001 were cash-out refinancing. Freddie Mac defines cash-out refinancing as refinancing activities that result in new mortgages at least 5 percent higher in amount than the original mortgages.

[6] Credit Suisse First Boston. March 14, 2002. *Household Sector Focus: A $300 Billion Puzzle.*

[7] Official starting dates for U.S. recessions are determined by the National Bureau of Economic Research (www.nber.org). Typically, the NBER does not make these official determinations until some months after the fact.

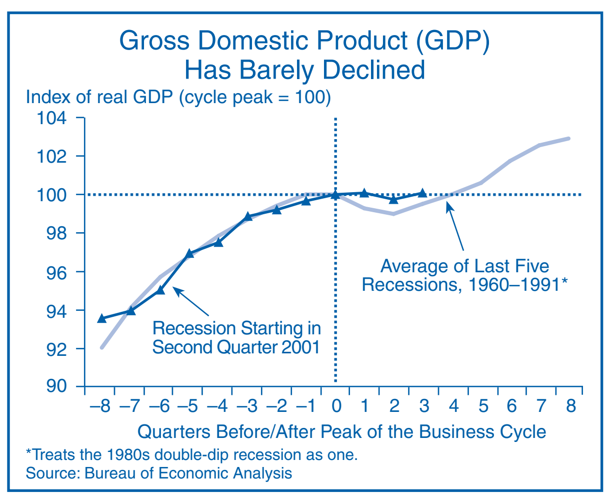
CHART 3



(GDP) grew at an annualized rate of 5.8 percent in the first quarter. A survey of 50 leading corporate economists by *Blue Chip Economic Indicators* shows that analysts expect the U.S. economy to grow at a rate of 3.1 percent in the second quarter and 2.8 percent for 2002 as a whole.[8]

Chart 4 compares U.S. GDP growth during this recession with that in the previous five recessions. It shows that, like growth in consumer spending, the economy barely paused in third quarter 2001 and then began to recover sooner and stronger than the historical norm. If this trend continues, this recession could be one of the shortest and mildest on record. However, a return to a vigorous economic expansion is by no means certain. Given vulnerabilities that still exist in the consumer and corporate sectors, two other scenarios could develop: (1) a slow-growth expansion during the remainder of 2002, or (2) a "double-dip" recession. Either scenario could have significant ramifications for banking industry earnings.

CHART 4



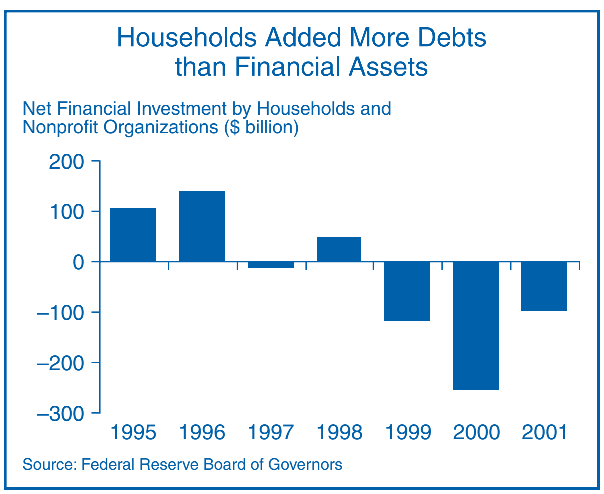
[8] *Blue Chip Economic Indicators.* May 10, 2002.

Certain Factors May Weaken the Recovery

History suggests that a return to consistently high rates of economic growth will require consumer spending to remain strong while business investment stages a large-scale recovery. However, this combination may be difficult to achieve in the immediate future. For the business sector, excess capacity in key industry sectors, high corporate leverage, and a general lack of pricing power could make profit growth a slow process. Many U.S. corporations have taken advantage of the recession to recognize restructuring charges and other one-time expenses that will clean up their balance sheets and set the stage for higher earnings growth during the expansion. However, without a turnaround in demand, these efforts do not guarantee an improvement in the corporate earnings picture to the point where large-scale increases in business investment are imminent. While total business investment grew by $79.1 billion in the first quarter, some $83.1 billion of the growth was simply a reduction in the amount of shrinkage in business inventories. Business fixed investment still fell slightly in the first quarter.

For consumers, two factors pose a threat to continued high rates of spending growth. The first is the large amount of new debt consumers have taken on in recent years. Chart 5 shows that net financial investment by consumers has totaled negative $471 billion over the past three years as households have taken on large amounts of new consumer and, especially, mortgage debt. Mortgage indebtedness of households and nonprofit organizations rose by $491 billion in 2001 alone. The second—and related—threat is the degree to which recent growth in consumer spending has depended on home price appreciation and the ability to borrow against home equity. This source of wealth and liquidity, which is available to the 68 percent of U.S. households who own their own home, has helped to cushion the blow of equity market losses in recent years.[9] If home price appreciation should slow significantly or reverse itself, households may be forced to rein in their spending, lowering the growth rate of the U.S. economy.

CHART 5



The Financial State of the Banking Industry Continues Strong

Bank earnings have continued to be solid in this recession, with commercial banks earning a record $74.3 billion in 2001. However, both large and small banks experienced a slight decline in return on assets (ROA) over the past year. Pretax ROA for large banks slipped by 8 basis points to 1.76 percent in 2001, primarily because of higher provision for loan losses. For small banks, pretax ROA slipped by 13 basis points to 1.58 percent mostly because of smaller net interest margins (see Chart 6).

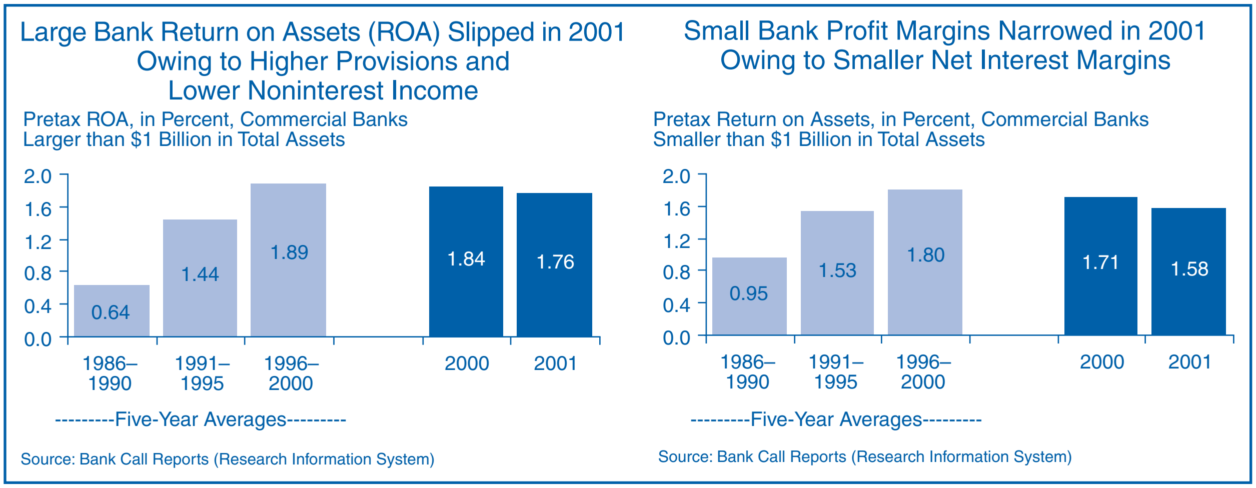
As corporate borrowers experienced significant earnings difficulties, credit quality for C&I loans deteriorated noticeably in 2001. The ratio of noncurrent C&I loans among all insured institutions rose by 75 basis points to 2.40 percent during 2001, while the net charge-off rate for C&I loans rose by 70 basis points to 1.48 percent. Consumer loan losses also rose in 2001, in tandem with a record 1.45 million personal bankruptcy filings. The net charge-off rate for consumer loans among insured institutions increased by 34 basis points to 2.61 percent.

Despite the deterioration in credit quality, problem loans still represent a significantly smaller portion of bank loan portfolios than they did in the 1990–1991 recession. By way of comparison, noncurrent C&I loans among insured institutions were 4.51 percent of loan balances at year-end 1991 (1.8 times higher than now), while noncurrent commercial real estate (CRE) loans totaled 8.19 percent of outstanding balances (8.9 times higher than now).

Because credit problems tend to lag the business cycle, bank credit losses may continue to rise for a number of quarters. However, the industry as a whole appears to be

[9] Data from U.S. Department of Housing and Urban Development, http://www.huduser.org/periodicals/ushmc/winter2001/nd_hinv.html.

CHART 6



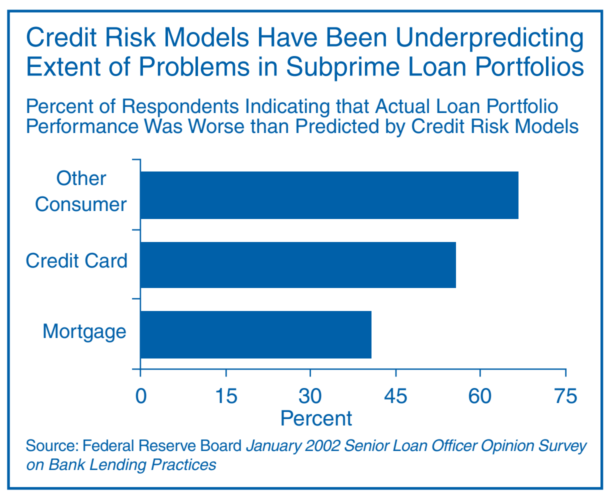
well positioned to withstand further credit quality deterioration. At the end of 2001 the equity-to-assets ratio for all insured institutions stood at 9.22 percent, compared with only 6.51 percent at the end of 1991. Even more important, only 149 insured institutions had an equity-to-asset ratio below 6 percent at the end of 2001, compared with 2,244 at the end of 1991. In contrast to the 1990–1991 recession when widespread banking problems exacerbated the overall economic downturn, the relative absence of capital-impaired institutions in this recession is a key factor supporting the tentative economic recovery. By providing credit to creditworthy borrowers, well-capitalized institutions with relatively low levels of nonperforming loans are likely to play an important role in economic recovery this year.

Banking Risks Remain on the Horizon

In spite of the overall strength in the banking industry, risk management challenges remain in an uncertain economic environment. Given the ongoing distress in the corporate sector, C&I credit losses can be expected to remain at elevated levels. Although commercial loan losses have been more concentrated among large institutions thus far, there are some signs that credit problems may be spreading to small- to medium-size business borrowers, who often depend on small banks for credit. The extent to which commercial loan losses spread from larger banks to smaller institutions will depend in large part on the speed and strength of the economic recovery.

On the consumer side, recent large increases in consumer indebtedness have focused particular attention on subprime and high loan-to-value (LTV) lending.[10] These loan programs, which have been developed largely since the last recession, have grown rapidly in recent years, introducing higher levels of credit risk into consumer loan portfolios. Losses associated with these higher-risk consumer loans have been rising fast over the past year. Chart 7 shows that a large number of lenders experienced higher-than-expected subprime loan losses in 2001.[11]

CHART 7



[10] Subprime loans are loan products specifically designed for borrowers with "weakened credit history." For more details on subprime lending, see the interagency release, *Questions and Answers for Examiners Regarding the Interagency Expanded Guideline for Subprime Lending Programs Issued January 31, 2001,* July 30, 2001, http://www.fdic.gov/news/news/press/2001/pr0901a.html. High loan-to-value loans are usually residential real estate loans that equal or exceed 90 percent of the real estate's appraised value.

[11] Federal Reserve Board of Governors. January 2002. *Senior Loan Officer Opinion Survey on Bank Lending Practices.* http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.

This experience indicates that these institutions may need to adjust their credit risk models to better reflect changed economic conditions. Similarly, credit losses rose sharply last year in the Federal Housing Administration and Veterans Administration loan programs, which provide terms similar to those offered by private high-LTV mortgage lenders. Should consumer credit problems continue to rise in the months ahead, they not only would hurt the earnings of consumer and mortgage lenders, but also could induce consumers to slow their rate of spending.

During the last recession, commercial real estate (CRE) lending was one of the leading sources of credit losses in the banking and thrift industries. Then, much of the problem was related to overbuilding in previously fast-growing metropolitan areas, poor underwriting of CRE and construction loans, and high concentrations in these loan types. During the latter years of the 1991–2001 expansion, the Federal Deposit Insurance Corporation issued a series of reports showing that CRE construction was again on the rise and urged lenders to ensure that their underwriting practices reflected the possibility of higher vacancy rates ahead.[12]

However, few could have foreseen the events of 2001, when demand for office and industrial space in most major U.S. metropolitan areas collapsed. This unprecedented "negative net absorption" of U.S. office space has lifted vacancy rates dramatically in a number of metro areas.[13]

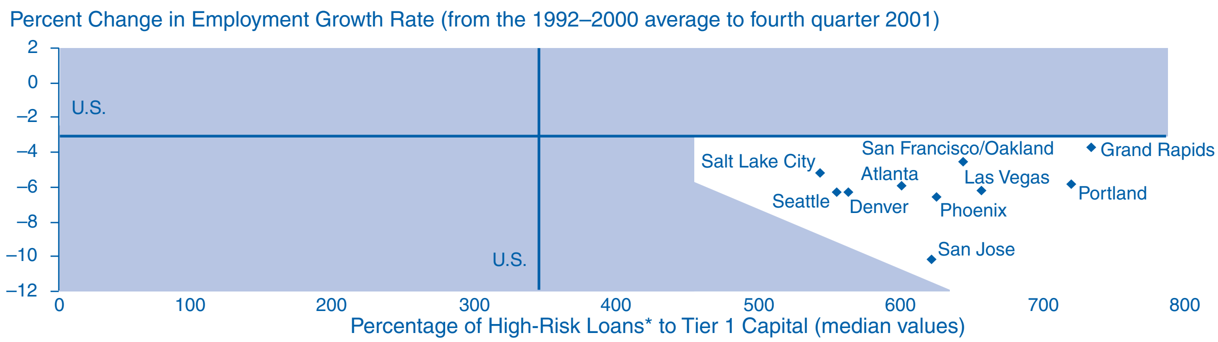
To date there has been little increase in the level of noncurrent CRE loans on the books of insured institutions. While improved market information and more solid underwriting may be helping to keep losses low, CRE credit problems could begin to rise over time if a strong economic recovery fails to materialize in 2002.

Banks May Be More at Risk in Some Metro Areas than Others

The challenge of rising CRE vacancy rates is particularly acute in metro areas that grew faster than the national economy as a whole during the 1990s and in which banks and thrifts have particularly high concentrations of CRE and other traditionally high-risk loans such as commercial and construction loans. Economic conditions in some previously robust metropolitan areas declined sharply in the second half of 2001. The ten markets identified in Chart 8 collectively lost 280,000 net jobs during 2001 after creating an average of 430,000 jobs annually during the preceding five years. The slowdown in many of these markets has been led by weaknesses in the high-tech sector, which had previously contributed to their strong growth.

CHART 8

High Credit Exposures and Economic Weakness May Stress Some Metropolitan Statistical Areas



* High-risk loans include commercial, construction, and commercial real estate loans.
Note: The universe excludes banks over $10 billion, credit card, and other small specialty institutions.
Sources: Bureau of Labor Statistics (Haver Analytics); Bank Call Reports; Thrift Financial Reports

[12] *Regional Outlook,* third quarter 2000, "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," and *Regional Outlook,* first quarter 1999, "Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead." Both articles can be found at: http://www.fdic.gov/bank/analytical/regional/index.html.

[13] *Regional Outlook,* third quarter 2001, "Slowing Economy Reduces Demand for U.S. Office Space." See http://www.fdic.gov/bank/analytical/regional/index.html.

Some of these markets also were affected adversely by disruptions in the travel and tourism sector in late 2001.

With slowing economic conditions, CRE markets in most of these metropolitan areas have deteriorated rapidly and to a greater extent than reported nationally. Absorption of existing space declined significantly in 2001 even as considerable new office and industrial space entered these markets with the completion of projects. This supply and demand imbalance led to rising vacancy rates. In San Jose, for example, vacancy rates soared from less than 2 percent at year-end 2000 to an estimated 14.5 percent at year-end 2001.

Many banks and thrifts operating in these markets continued to add to credit exposure levels even as economic conditions began to deteriorate. In some markets, such as San Francisco and San Jose, the increase in loan volumes was the result of funding commitments to lend that were made before economic conditions began to change. In other markets, such as Atlanta, Las Vegas, Portland, and Salt Lake City, both funded and unfunded credit exposure levels have increased.

Conclusion

Recent economic data have signaled that recovery may be on the way, but lingering uncertainties remain over the strength of the recovery. The recession that began in March 2001 finds the banking industry in generally strong financial condition. Nevertheless, a number of risk management challenges remain for bankers going forward. In particular, credit losses, which have been concentrated among large bank commercial lenders and subprime consumer lenders thus far, may spread to other lenders and remain at elevated levels before leveling off. The history of past recessions is only an imperfect guide for what to expect in this recession. We may find that much history has been rewritten by the changes that have taken place in the economy and the banking system since the last recession. To the extent that this is the case, the best risk management practice is to look forward rather than back.

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Atlanta Regional Perspectives

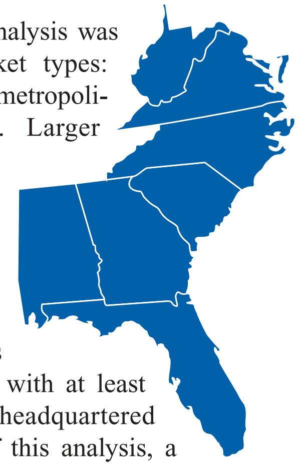
An Analysis of Atlanta Region "Markets at Risk"

A recently issued report[1] by the ***Bureau of Labor Statistics*** provides a sobering reassessment of the Atlanta Region's economic performance in 2001. In many instances, the revised data show that, over the past year, several areas of the Atlanta Region had rapidly fallen off long-term economic growth trends as the nation slipped into recession. Despite this change in the economic climate, the banking industry in several markets continued to report relatively high and often increasing exposures to traditionally higher-risk forms of lending.[2] Our analysis, the methodology for which is explained in the next section, identifies these "markets at risk," where a divergence between economic growth and continued high levels of traditionally riskier lending is most apparent and determines whether a subsequent deterioration in asset quality may be emerging.

Data Methodology

We used data from the Bureau of Labor Statistics to gauge deviation in economic performance among certain geographic areas of the Region. An economy was determined to have diverged from its recent growth trend if year-over-year job growth in fourth-quarter 2001 was significantly below the average growth from 1995 to 2001. Given the fact that the economy was in recession during this period, most areas of the Atlanta Region experienced this divergence; however, owing to differences in industry mix and economic diversity, the effects of the downturn were not uniform. Consequently, while the effects on certain geographic areas were modest, growth in some local economies declined dramatically. Businesses in these areas whose business plans rely on an environment of rapid economic growth may be particularly vulnerable. Layoffs in critical industries could hurt consumer credit quality.

In another measure of potential market vulnerability, the local banking industry's exposure to traditionally higher-risk lending was determined by calculating a market's median ratio of community bank[3] high-risk loans to total capital. Our analysis was segmented into three market types: larger metropolitan, smaller metropolitan, and nonmetropolitan. Larger markets are metropolitan areas with ten or more insured institutions headquartered locally; smaller markets are home to three to nine institutions. Nonmetropolitan markets are counties outside a metropolitan area with at least three insured institutions headquartered locally. For the purposes of this analysis, a market is considered at risk if high-risk loan exposures continue to rise despite a significant negative deviation from the long-term economic growth trend.



Larger Metropolitan Areas. Our analysis identified 18 larger metropolitan banking markets in the Atlanta Region,[4] all of which reported exposure to traditionally higher-risk loan types well above the U.S. metropolitan median of 315 percent. Insured institutions in **Macon, Georgia,** reported the highest exposure, followed by institutions in the **Naples, Florida,** and **Atlanta, Georgia,** metropolitan markets. With the exception of one market, insured institutions in each metropolitan area had experienced an increase in exposures in fourth quarter 2001; at the same time, job growth fell below its 1995–2001 trend.

In the Region, Atlanta may be most representative of a market at risk. Atlanta's economic climate has changed dramatically during the past several months, which may adversely affect market participants whose business plans rely on fast growth. After an economic boom with job growth averaging over 4.5 percent annually from 1993 through 1999, employment gains slowed appreciably in 2000 and 2001, particularly during the second half of 2001. By early 2002, employment in the metropolitan area was down nearly 3 percent from one year earlier. Losses in the high-tech sector, stemming in part from the collapse in the NASDAQ, contributed to slowing growth in 2000 and

[1] *Regional Employment and Unemployment: January 2002,* Bureau of Labor Statistics.

[2] Traditionally higher-risk loan categories include commercial and industrial, construction, and commercial real estate.

[3] For purposes of this analysis, community banks are defined as insured institutions holding less than $10 billion in total assets, excluding credit card banks and other small specialty institutions.

[4] Macon, Naples, Atlanta, Tampa, Sarasota, Orlando, Miami, Ft. Lauderdale, Birmingham, Greenville (SC), Norfolk, Jacksonville (FL), Northern Virginia (Washington primary metropolitan statistical area-VA part), Raleigh, Richmond, West Palm Beach, Greensboro, and Charlotte.

early 2001. The effects of September 11 on critical industries such as transportation, tourism, and lodging, combined with subsequent weakening in other services sectors and retail trade, exacerbated the slowing economic conditions.

Atlanta's real estate markets may be particularly vulnerable to the area's substantial decline in economic growth. After booming for several years along with the economy, Atlanta's commercial real estate markets have experienced a dramatic deceleration in absorption, which has led to increased vacancy rates in some submarkets. In contrast to commercial markets, the housing market has remained comparatively resilient, with demand softening primarily in high-end housing. A boom-bust economic scenario may adversely affect the viability of recently completed commercial projects, as well as those in the pipeline, as developers struggle to find or retain tenants.

Despite the weak economy, home prices continued to appreciate in 2001, although slightly below the national average. Nonetheless, the residential housing market may falter if interest rates rise and economic weakness persists.

Despite weakening economic conditions in the Atlanta market, including increases in personal and business bankruptcy filings in Georgia's Northern District, community banks headquartered locally increased exposure to traditionally higher-risk loans over the past year. Atlanta-area banks may be particularly vulnerable to weakening credit quality, as more than half the institutions in the area are nonrecession tested; many also are engaged in one or more of the higher-risk lending categories. These institutions' lack of experience during a downward economic cycle has become evident, as erosion in credit quality has been significant during the past 12 months. The average ratio of noncurrent high-risk loans to total high-risk loans for nonrecession-tested banks increased significantly, ending 2001 at 0.32 percent, up 14 basis points from a year earlier. While this is a relatively low number, the trend is inconsistent with that of more established banks. Institutions that were chartered before the recession of the early 1990s have yet to show signs of deterioration. In fact, the average ratio of noncurrent higher-risk loans to total higher-risk loans for these banks declined over the same 12-month period. Nevertheless, deteriorating loan performance, which typically lags the start of a recession, may contribute to higher levels of nonperforming loans in the coming quarters.

The **Orlando** metropolitan area also experienced rapid growth throughout much of the 1990s. A robust high-tech sector and substantial expansion in tourist-related industries helped fuel its growth. Between 1992 and 2000, annual job growth in Orlando remained above 3 percent. By mid-2000, however, growth began to decline significantly as high-tech industries started to soften. Economic conditions deteriorated much more rapidly following the September 11 attacks, as Orlando's critical tourist-related industries suffered sharp reversals.

Orlando's commercial real estate markets may be suffering fallout from weak economic growth. The nation's prolonged economic boom during the 1990s fueled rapid increases in the area's hotel room inventory. Between 1996 and 2001, the metropolitan market added more than 20,000 new rooms (23 percent) to market inventory. With the national recession and consumer fears about traveling, occupancy rates plummeted in late 2001. By early 2002, some early indications suggested that domestic tourism was beginning to rebound; however, occupancy rates may be slower to recover as more than 4,500 new rooms are expected to be added to the market in 2002. Growing inventory combined with lower room rates may have an adverse effect on many smaller hoteliers in the area. Other Orlando commercial real estate markets may be vulnerable as well, as years of rapid construction activity have met with weakening levels of absorption associated with the contracting economy.

Job growth in both the Atlanta and Orlando metropolitan areas has departed significantly from recent trends. However, insured institutions headquartered in the Orlando metropolitan area, although continuing to report relatively high volumes of traditionally higher-risk loans, experienced a modest decline in exposure to these loans during the year ending fourth-quarter 2001. This decline has occurred primarily among institutions that have not experienced a recession. Nonrecession-tested banks with at least 300 percent of capital in these types of loans reported an aggregate concentration of 660 percent at December 31, 2001, down from 732 percent a year earlier. Despite the decline, these institutions have continued to grow these loan categories.

In contrast, recession-tested institutions in the Orlando market that meet the same 300 percent threshold reported an increase in total exposure to 560 percent of capital, up from 522 percent a year earlier and much lower than the reported exposure levels at the newer institutions. The divergent trend in balance sheet exposures between nonrecession-tested and recession-tested institutions may warrant closer monitoring over the next several quarters.

Most other metropolitan areas in the Atlanta Region have reported some weakening in economic performance. However, larger markets in **southwest Florida, Naples,** and **Sarasota** continued to experience comparatively high levels of economic growth. In fourth-quarter 2001, higher-risk loans as a percentage of total capital among insured institutions in the Naples area were just under 600 percent (see Chart 1), up more than 200 percentage points from the previous year. Larger divergences in job growth compared with five-year trends have occurred in other larger metropolitan markets, such as **Charlotte, Greensboro, Birmingham,** and **Tampa,** while insured institution exposure to higher-risk loans continued to rise. At December 31, 2001, only institutions in Tampa and Charlotte reported modest signs of deterioration in asset quality.

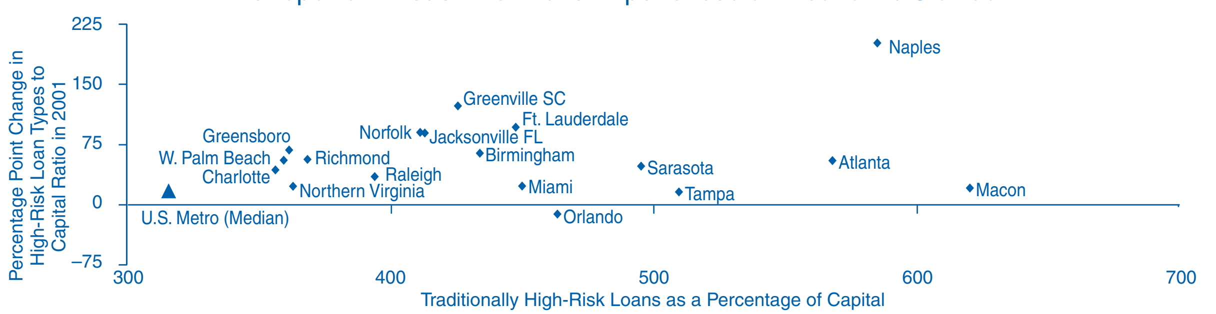
Smaller Metropolitan Areas. Insured institutions in smaller metropolitan markets, like those in larger markets, are increasing their exposure to traditionally higher-risk loans to varying degrees. However, while all larger markets exceeded the national median, only 30 of the Region's 42 smaller metropolitan markets did so. Institutions in the **Pensacola** and **Panama City** metropolitan markets reported the highest exposures; however, the ratio increased slightly or not at all during the past year, and the metro areas' deviation from the job growth trend was modest. In contrast, several other markets experienced substantial increases in higher-risk lending, while job growth has departed more sharply from the long-term trend.[5]

Nonmetropolitan Areas. Economic conditions in the Atlanta Region's nonmetropolitan counties weakened earlier and more quickly than in urban counties, as many traditional manufacturing industries are concentrated outside metropolitan areas. Year-over-year household employment peaked in nonmetropolitan counties in fourth-quarter 2000, one quarter before it peaked in the Region's metropolitan areas. Moreover, the gap in job growth between urban and rural areas widened significantly through the first three quarters of 2001. As the events of September 11 began to affect metropolitan performance more adversely in the fourth quarter, this gap began to shrink. Credit quality is considered to be a lagging indicator of the business cycle, and, because nonmetropolitan areas led the rest of the Region into the downturn, it is here that deterioration would be expected to occur first.

Although exposures remained high in fourth-quarter 2001, only three of the Atlanta Region's nonmetro-

CHART 1

Higher-Risk Loan[1] Exposures Increased during 2001 among Insured Institutions[2] in Metropolitan Areas[3] That Have Experienced an Economic Slowdown



[1]Median level of high-risk loans, which include commercial, construction, and commercial real estate loans.
[2]Insured institutions with assets of $10 billion or less.
[3]Includes only metropolitan areas in the Region with at least ten commercial banks.
Source: Call Reports

[5] These markets included Melbourne, Lynchburg, Ocala, Wilmington, Daytona Beach, and Athens. Insured institutions in the Daytona Beach and Lynchburg metro areas reported an increase in high-risk loans as a percentage of total capital of more than 200 percentage points. Nonrecession-tested banks in Daytona Beach and Lynchburg account for 78 percent and 60 percent, respectively, of banks headquartered locally. These institutions may face greater challenges than seasoned banks during an economic downturn.

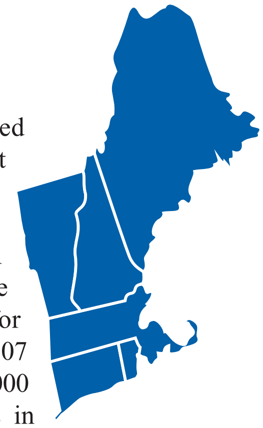
politan counties[6] reported a substantial increase in the median level of exposure to higher-risk loan types while simultaneously experiencing a significant departure from the long-term economic growth trend. As expected, credit quality among these rural institutions has already begun to show some weakness. At December 31, 2001, the ratio of noncurrent high-risk loans to total loans rose to 0.56 percent, 10 basis points higher than one year earlier. Because rural institutions entered the recession before the rest of the Region, the deterioration in noncurrent loan levels can be expected to moderate among these institutions in the quarters ahead.

Although areas of economic weakness have existed in the Atlanta Region for several months, asset quality deterioration may be emerging only now. Insured institutions headquartered in nonmetropolitan counties, which preceded much of the Region into the downturn, have experienced the greatest weakening in credit quality. Banks in metropolitan areas may follow, especially if economic performance in these areas does not improve or improves only modestly.

Atlanta Region Staff

[6] For the purposes of this analysis, we considered nonmetropolitan counties with at least three insured financial institutions headquartered locally. In the 56 counties that met these criteria, nearly 80 percent of the institutions reported higher-risk loan exposures in excess of the U.S. nonmetropolitan median.

Boston Regional Perspectives



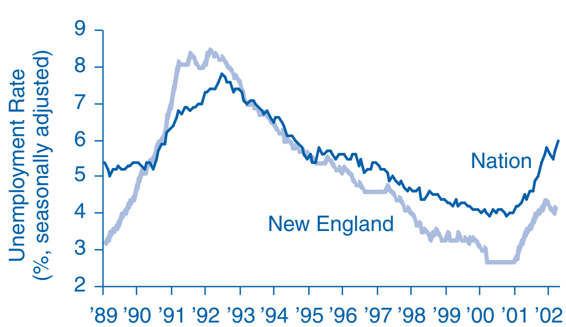
Region's 2001 Recession Was Milder than That of the Early 1990s

Unlike in the recession in the early 1990s, the Boston Region's unemployment rate during this recent economic slump remained below the U.S. average (see Chart 1). New England began this past recession with very tight labor markets—providing some cushion against rising unemployment—but this was also the case over a decade ago. Thus, other factors likely help explain the Region's better relative performance during the current downturn. Specifically, the Region's most recent cyclical downturn was not accompanied by the negative secular factors, such as significant downsizing in the defense industry, that occurred during the last recession.

In addition, imbalances in commercial real estate (CRE) markets were less pronounced entering this recession. In the office segment, rising vacancy rates and falling rents caused by retrenching demand have not been compounded by excessive speculative construction, a development that impeded recovery in office properties following the last downturn. Still, high vacancy rates in **Greater Boston's** commercial office market, which witnessed a significant increase in sublets during 2001, raise some concern (see page 15 for more on this topic). Finally, the widespread speculative purchase activity and abundant new construction of residential real estate that preceded the last downturn were largely absent before this recession. For these reasons, the depth and duration of this recession were more modest than that of the early 1990s.

CHART 1

Region's Unemployment Rate Did Not Exceed Nation's during This Recession



Source: Bureau of Labor Statistics

Overall, the Region's insured institutions continue to report strong asset quality. However, commercial loan portfolios of some institutions have shown signs of deterioration, as the aggregate past-due ratio for commercial loans increased 107 basis points from December 2000 to December 2001. Increases in past-dues primarily have been reported by the Region's largest institutions. These institutions have also reported slight increases in commercial loan charge-offs, although losses remain low compared to the late 1980s/early 1990s. The median past-due ratio is below year-ago levels, suggesting that the deterioration is not widespread.

Similarly, the aggregate past-due ratio for construction and development loans increased slightly during 2001 in the Boston Region. However, the median past-due ratio remains near zero, signaling that problems are not widespread. Despite the downturn in the economy and rising office vacancy rates in 2001, insured institutions did not experience significant deterioration in construction loan asset quality.

New England May Face Some Headwinds in the Current Recovery

The nation's economy continued to show signs of renewed growth during the first half of 2002; however, it appeared likely that New England could experience a more muted recovery, at least initially. This is due in large part to New England's significant concentration of jobs in the information technology (IT) and financial services sectors. These sectors are likely to recover meaningfully only when U.S. corporate profits and capital equipment investment rebound. If future U.S. economic growth is weak or if the nascent recovery in corporate profits and capital spending is lackluster, the Region's economic recovery could be impeded.

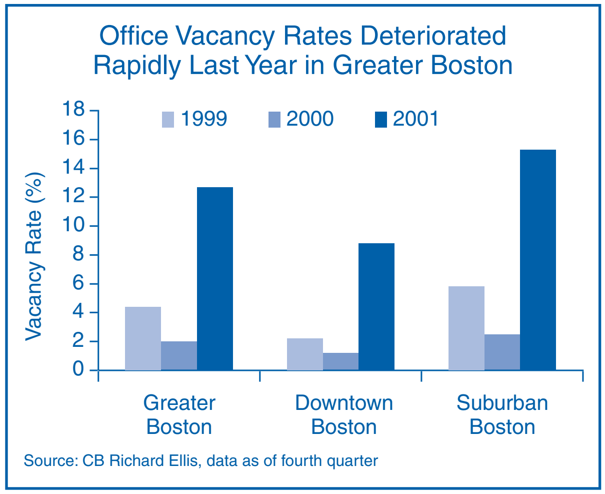
If the economy rebounds and remains healthy after the 2001 downturn, the modest upturn in the Region's asset quality problems should stabilize. However, if the economy slows again in 2002, credit quality problems, particularly in the traditionally higher-risk loan portfolios, may re-emerge, and the level of deterioration may be more serious and widespread. In addition, many of the Region's insured institutions remain exposed to an increase in interest rates following the refinancing waves of 1998 and 2001, as borrowers sought longer-term loans thanks to historically low rates. Many institutions with significant investment in residential mortgage-related assets have shifted asset compositions from largely adjustable rate mortgage (ARM)-dominated portfolios to portfolios weighted more heavily in fixed-rate assets. The significant level of refinancing activity has hit smaller institutions particularly hard, most notably those located in large metropolitan areas. Institutions in these areas are exposed to more competition and hold larger average loan sizes, both of which can foster higher prepayment rates. In addition, unlike larger institutions, smaller institutions may not have the origination network needed to replace a runoff of ARMs. While institutions of all charter types and sizes have noted the lengthening of asset duration, savings institutions have been disproportionately affected owing to their traditional reliance on residential real estate-backed assets as the primary source of revenue. For a more comprehensive discussion of interest rate risk, refer to the ***Boston Regional Outlook,*** first quarter 2002.

Boston's Commercial Real Estate Market Faces Fewer Obstacles than in the Early 1990s

Office real estate conditions in New England's largest market continued to worsen during 2001, but anecdotal reports suggested some stabilization in first-quarter 2002. Office vacancy rates in Boston jumped about 10 percentage points last year (see Chart 2) as the market experienced roughly 7.5 million square feet[1] of negative absorption. Sublease space returned to the market by IT firms (including many Internet companies) was a significant factor in Greater Boston's rising availability rate.[2] Meanwhile, financial services and legal firms introduced a large portion of sublease space within the city itself last year.[3]

According to **Grubb & Ellis,** 12.4 million square feet of space was available for sublet in Greater Boston as of

CHART 2



fourth-quarter 2001—more than the total amount absorbed during 2000 and about two-thirds of untenanted space. The **Cambridge** submarket accounted for many of the Internet firms that either closed or offered up sublease space last year; some estimates put the current vacancy rate in that area at the highest level since the 1990–91 recession. Boston's central business district is faring better, but suburban vacancy rates beyond Cambridge also are high. As expected, lackluster demand has pressured rents. According to **Cresa Partners/Boston,** greater Boston's average Class A office rents are down 20 to 25 percent from the inflated levels reached during 2000.

Mitigating some of the near-term risk, Boston office construction activity slowed as developers adjusted for sluggish economic growth in 2001. Space under construction declined from 7 percent of existing inventory at year-end 2000 to roughly 5 percent at year-end 2001; however, 7.6 million square feet remain in the pipeline. Thus, while availability rates should stabilize as the economy rebounds, they are not expected to decline significantly in the near term.

Boston's industrial market continues to exhibit low vacancy rates. Industrial properties did not experience a run-up in speculative leasing activity in recent years and avoided the office market's current problems with sublease space. Retail real estate conditions also remain stable, likely because consumer spending growth was atypically robust during the recent recession. Finally, the Region's hotel/lodging segment was negatively affected by the aftermath of the September 11 attacks; however, the adverse effects were concentrated in specific markets, such as Boston, that rely on fly-in

[1] *Trends: Boston Office,* Grubb & Ellis Research, fourth quarter 2001.
[2] "Availability" refers to all *physically* untenanted space (truly vacant space plus that available for sublet).
[3] "New England Regional Demographic Market," *Market Outlook 2002,* CB Richard Ellis/New England, 2002.

visitor traffic and convention business. Occupancy rates at Boston hotels dropped after September 11, with December 2001 revenue-per-available-room levels down 35 percent from a year ago.

The Region's Insured Institutions Are Better Prepared than in the Past

Insured institutions in the Boston Region are better poised to weather the current downturn in the CRE sector than they were in the early 1990s. Median concentrations of CRE loans to capital are substantially lower. The highest median CRE concentration in a New England metropolitan area at year-end 2001 was reported in Boston; but Boston's CRE exposure ranked only in the 29th percentile of metropolitan statistical areas nationally. The Region's median past-due ratio for CRE loans, as well as that for charge-offs, remain near historical lows. This is likely due in part to the fact that roughly two-thirds of available office space in the dominant Boston market continues to generate cash flow (assuming tenants offering sublets are making primary lease payments).

Boston Region Staff

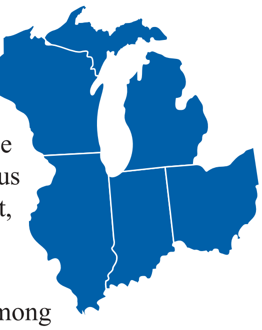
Chicago Regional Perspectives

Adverse Credit Quality Trends Continue

The weakened economy has tempered loan growth, and insured institutions of all sizes have experienced credit quality deterioration. The ratios of both past-due and nonaccrual (PDNA) loans to total loans and net charge-offs to total loans have increased.[1] While the Region's community institutions[2] report lower net charge-off levels than community institutions elsewhere in the nation, they report higher delinquency levels relative to total loans and lower reserve levels relative to nonperforming loans. Although insured institutions in the Region have increased provision expenses, these provisions have not kept pace with the rise in nonperforming loans.

Credit Quality Deterioration Is Widespread across Loan Types, but Not Severe

Although recent credit quality deterioration is apparent across all major loan types (see Table 1), much of the current weakness has been centered in commercial and industrial (C&I) and consumer loans. During the past year, C&I loan portfolios have been hit particularly hard. Aside from credit card lending, which is a relatively small lending segment in the Region, C&I loans have the highest PDNA ratio of any lending category, at 3.15 percent as of year-end 2001. This is the highest year-end level since 1993 but well below the previous recession's peak of 5.43 percent, recorded at the end of 1990.



Aggregate net charge-offs among community institutions' C&I loan portfolios have increased significantly as well. As of year-end 2001, net C&I charge-offs were .72 percent, up from .47 percent a year earlier. During the last recession, net charge-offs in the C&I segment peaked at 1.11 percent in 1991.

Commercial real estate (CRE) lending saw a marked increase in delinquencies during 2001, but the level remains well below those of the early 1990s, at the height of CRE problems. Nevertheless, the historically volatile nature of CRE markets and the fact that a considerably higher share of institutions have concentrations in CRE now than during the last recession underscore the importance of this loan segment. Most metropolitan statistical areas (MSAs) in the Region appear to have fairly solid CRE fundamentals, although office and industrial vacancy rates generally have been trending

Table 1

Delinquencies Are Highest among Commercial and Industrial and Consumer Loans

	Total Loans (%)	PDNA Ratio (%)	
Selected Loan Categories	12/31/2001	12/31/2001	12/31/2000
Construction and development	6	2.82	1.96
Commercial real estate	20	2.14	1.40
Multifamily residential real estate	3	1.43	1.01
1- to 4-family residential	38	2.56	2.09
Home equity	4	1.22	0.92
Farm	3	1.84	1.60
Commercial and Industrial	14	3.15	2.98
Other consumer	8	2.98	2.66

Note: PDNA = past-due and nonaccrual.
Sources: Bank and Thrift Call Reports for Community Institutions in the Chicago Region, excluding de novos and specialty institutions

[1] As of December 31, 2001, the aggregate PDNA ratio stood at 2.47 percent, up from 2.06 percent a year earlier. Aggregate net charge-offs increased more modestly over the same period, to .25 percent from .17 percent.

[2] The designation "community institutions" includes those reporting total assets less than $1 billion, excluding de novos and specialty institutions. The bank statistics cited in this article are for community institutions unless otherwise specified.

upward in the Region, particularly in **Columbus** and **Indianapolis.**[3]

Similar credit quality deterioration is evident in consumer loan categories, reflecting weakening labor markets throughout the Region.[4] Something more, however, is likely behind the deterioration in the one- to four-family residential loan portfolio. While most loan segments have delinquency levels below the peaks recorded in the last recession, 1- to 4-family residential loan delinquencies are above levels recorded in the early 1990s. Collateral protection is likely relatively strong in this loan category because of the strength of housing markets in the Region, but the significant changes in the mortgage lending business since the last downturn may have contributed to an increase in the level of credit risk in this portfolio. (See ***Regional Outlook,*** first quarter 2002, In Focus.)

Allowance Coverage of Nonperforming Loans Dropped Significantly

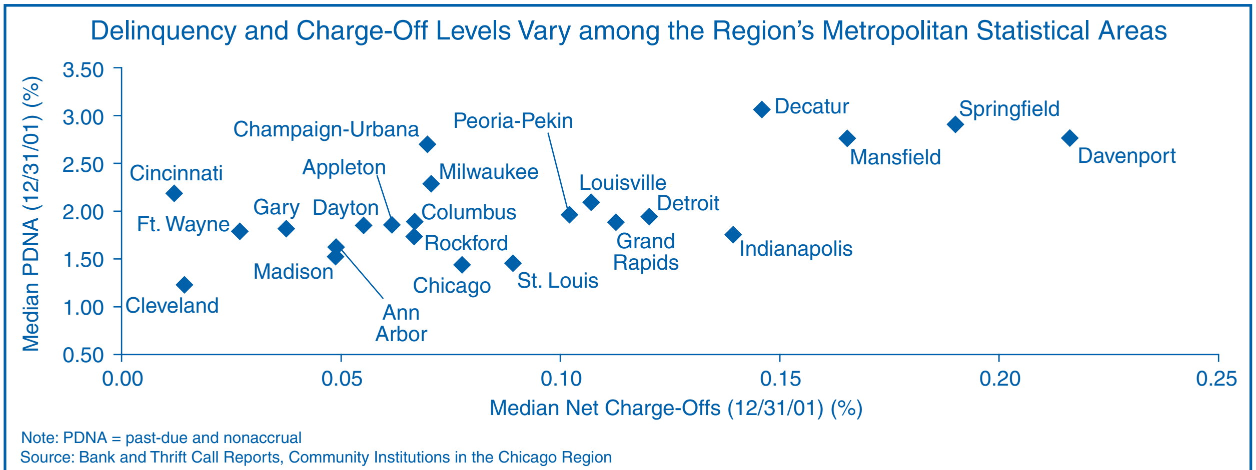
Although overall allowance for loan and lease loss levels have held steady relative to total loans during the past several years, coverage of nonperforming loans has declined considerably. At the end of 2000, just before the start of the recession, the aggregate reserve coverage ratio was 147 percent. Three quarters into the recession, that level had fallen to 112 percent, the lowest year-end level since 1992. The Region's high capital levels relative to the last recession mitigate some concerns, however. On December 31, 2001, community institutions in the Region had an aggregate Tier 1 capital ratio of 9.24 percent, well above the 7 to 8 percent levels reported in the early 1990s. Therefore, while indications are that overall protection (combined capital and reserves) is adequate, continuing economic weakness and further increases in nonperforming loans would likely translate into higher provision expenses in 2002.

Credit Quality Varies among the Region's MSAs

As of December 31, 2001, insured community institutions in **Decatur, Springfield, Champaign, Mansfield,** and **Davenport** reported the highest median PDNA ratios and relatively higher median net charge-off ratios (see Chart 1).[5] In Mansfield, heavy exposure to manufacturing industries (such as steel and autos) that have been shedding jobs has led to rising personal bankruptcies. The Mansfield area experienced the highest increase in median PDNA levels[6] among the Region's MSAs.

Low industrial diversity also has been a problem for Davenport and Decatur. In Davenport, a reliance on traditional manufacturing industries has pressured the local economy. Davenport has experienced the second highest

CHART 1



Note: PDNA = past-due and nonaccrual
Source: Bank and Thrift Call Reports, Community Institutions in the Chicago Region

[3] According to *CB Richard Ellis,* year-end metropolitan area office vacancy rates increased to 20.9 percent in Columbus and 19.0 percent in Indianapolis.
[4] Year-over-year job growth in the Region fell from 2.04 percent in first-quarter 2000 to –1.01 percent in third-quarter 2001 and –0.81 percent in fourth-quarter 2001.
[5] This MSA analysis excludes de novo banks, specialty institutions, and institutions reporting over $1 billion in total assets. Only MSAs with at least ten institutions were included.
[6] In Mansfield, the median PDNA ratio increased from 1.83 percent on December 31, 2000, to 2.76 percent a year later.

increase in median PDNA levels and the largest increase in median net charge-offs in the Region. Unlike Mansfield and Davenport, Decatur's economy had been under pressure for several years, with significant declines in job growth occurring well before the 2001 recession. As a result, current weakness there may be not only the direct effect of the recent recession but also the lagged effect of earlier layoffs. Historically, Springfield, which is close to Decatur, has been somewhat insulated from economic downturns by the relative stability of government employment and by its small exposure to the highly cyclical manufacturing industry. Recently, however, the government and construction sectors have weakened, reflecting the state's tight budget position.

Looking ahead, there is reason to expect some of these pressures to moderate. The sharp reduction in nonfarm private inventories that occurred in 2001 has set the stage for manufacturing activity to strengthen. The Chicago Purchasing Managers' Index bottomed out in the first half of 2001, has improved moderately, and is accompanied by an increase in the production of durable goods. If the previous recession is any guide, commercial and consumer loan quality may strengthen quickly during a recovery. If a recovery is in fact under way, further significant deterioration in credit quality may be avoided.

Chicago Region Staff

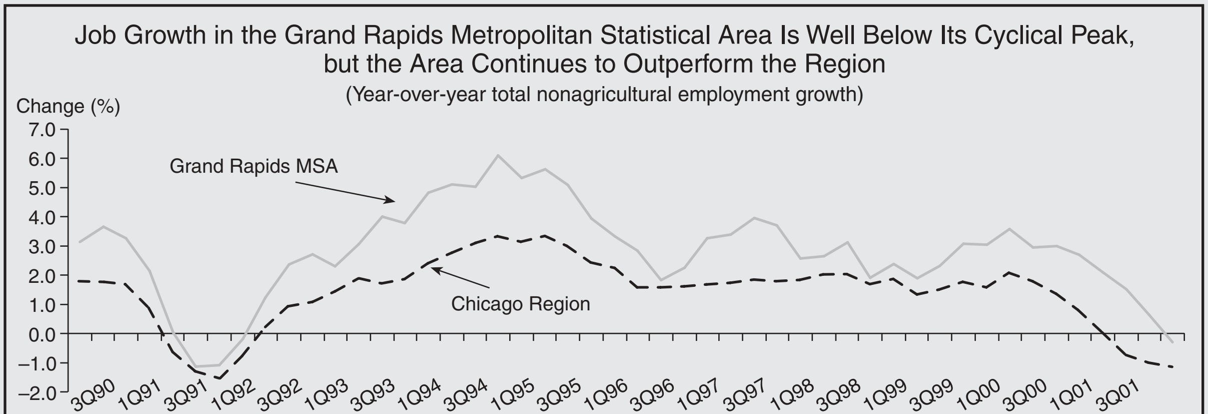
Focus on Grand Rapids

The **Grand Rapids** metropolitan statistical area (MSA) is identified as one of ten metro areas at risk in In Focus This Quarter[7] (see page 8). In recent years, this market stood out at as one of the best performing economies in the Midwest, with employment growth exceeding that of the Region throughout the past decade (see Chart 2). The MSA continues to outperform the Region; however, job growth slowed sharply in 2001 and is well off the peak recorded in 1994.

The most acute reversal in job growth in 2001 occurred in the MSA's large manufacturing industry, which represents 26 percent of total employment. Employment in this sector was 6.5 percent lower in fourth-quarter 2001 than a year earlier. Over the same period, the unemployment rate increased more than 200 basis points to 5.3 percent in fourth-quarter 2001.

Job growth in the area's manufacturing sector will likely remain weak throughout 2002. Grand Rapids' office furniture manufacturing industry was particularly hard hit, with shipments declining more than 17 percent in 2001.[8] The *Business and Institutional Furniture Manufacturer's Association* short-term out-

Chart 2



Note: MSA = metropolitan statistical area.
Source: Bureau of Labor Statistics via Haver Analytics

[7] This finding leverages previous analyses that suggested that some banking markets may be more vulnerable during an economic downturn. See *Regional Outlook,* fourth quarter 2000, In Focus, and *Regional Outlook,* second quarter 2001, Chicago Regional Perspectives.
[8] The Business and Institutional Furniture Manufacturer's Association, February 15, 2002.

look remains very weak, and the association forecasts that shipments will decline 13 percent in 2002 before rebounding modestly in 2003. The area's auto parts supply industry faces obstacles as well. These companies operate in a very competitive environment and exert little pricing power. Suppliers that sell to domestic manufacturers and that are farther down the supply chain, such as Grand Rapids' small tool and die shops, are most vulnerable to slow economic growth.[9]

The banking market in Grand Rapids is competitive, with 36 insured institutions operating 365 offices.[10] At year-end 2001, 20 insured institutions were headquartered in the MSA; only one had assets of more than $1 billion. Regional bank consolidation in the 1990s disrupted the local market and fostered the entrance of new institutions. Nine institutions have been chartered in the past nine years; two of them have been in operation less than three years.

Much like those in the rest of the Region, insured institutions in Grand Rapids reported declining credit quality at year-end 2001. Aggregate net loan losses as of December 31, 2001, doubled to 0.40 percent from 0.19 percent a year ago, and, over the same period, the median past-due and nonaccrual loan ratio increased to 1.98 percent from 1.84 percent. Insured institutions in Grand Rapids appear to have responded quickly to credit deterioration by raising provision expenses. Higher provision expenses boosted the median reserve to noncurrent loan ratio to 1.97 percent. In spite of increased provisions, earnings performance improved over the year, with the median return on assets measured at 1.01 percent, up from 0.94 percent a year ago. Securities gains and lower noninterest expenses offset a declining net interest margin and higher provision expenses.

Looking ahead over the longer term, the Grand Rapids MSA has a number of underlying positive attributes that should support a resumption of stronger economic growth and improved credit quality once the national recovery is under way. Positive considerations include the area's healthy population growth and high level of housing affordability. Grand Rapids' Renaissance Zone has spurred business investment and created new jobs. In addition, the SmartZone program, designed to attract high-tech industries to the area, will help diversify the local economy.

[9] Economy.com, Precis: Metro, October 2001.

[10] *Market Share Report,* Summary of Deposits, Market Share Report, June 30, 2001.

Dallas Regional Perspectives

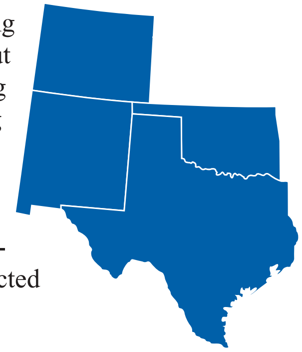
U.S. Recession Affecting Economic Growth and Commercial Real Estate in the Dallas Region

Economic activity in the Dallas Region slowed to a crawl during 2001, turning negative in some metropolitan areas. This economic weakness has curbed demand for new and existing commercial real estate (CRE) space, adversely affecting certain CRE markets in the Region. This article reviews economic conditions in the Region and focuses on how the slowing economy has affected selected CRE markets.

The Dallas Region Experiences Its Worst Recession since the Mid-1980s

The current U.S. recession[1] that began in April 2001 has affected the Dallas Region (see Table 1). It represents the Region's worst recession since the mid-1980s. Economic growth in the Dallas Region was virtually flat (0.1 percent annualized rate), and employment growth fell (1.1 percent annualized rate) during the last three quarters of 2001. The Region's unemployment rate increased 140 basis points during the same period.[2]

In addition to a weakening U.S. economy and the fallout from September 11, during much of 2001, declining energy prices, a strong U.S. dollar coupled with an ailing global economy, and ongoing stress in the high-tech sector adversely affected the Dallas Region.



Oil and natural gas prices fell 36 percent and 63 percent, respectively, during the year ending fourth-quarter 2001.[3] Although lower energy prices in 2001 did not hurt the Region's economy to the same extent as in the past, they were nevertheless a drag on economic and employment growth. The strong U.S. dollar—at its highest level since the mid-1980s[4]—coupled with a weak global economy contributed to a 9 percent decline in exports from the Region during 2001 after a 21 percent increase the year before.[5] In addition, weaker exports and a strong dollar contributed to a loss of 75,000 jobs in the manufacturing sector.

Table 1

The Late 1980s Recession Affected the Dallas Region Economy More Adversely than the Current Downturn or the Early 1990s Recession

	Annualized Percentage Growth Rate, Peak to Trough		
Economic Indicator	1985Q3–1991Q1	1987Q1–2001Q1	1990Q2–2001Q4
Gross Product			
United States	2.9	–2.0	0.1
Dallas Region	–2.7	2.4	0.1
Employment			
United States	2.1	–1.4	–1.1
Dallas Region	–1.8	1.3	–1.1

Sources: Economy.com; U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics (Haver Analytics); Federal Deposit Insurance Corporation

[1] The National Bureau of Economic Research officially designated April 2001 as the beginning of the recession, but as of this writing has not formally declared its ending.

[2] For purposes of these calculations, first-quarter 2001 was taken as the peak, and growth rates were calculated from second-quarter 2001 through fourth-quarter 2001. The change in unemployment rates covered the period from first-quarter 2001 to fourth-quarter 2001.

[3] Calculations were based on the domestic spot prices of West Texas Intermediate, Cushing, and Henry Hub oil and natural gas series as reported in the *Wall Street Journal*.

[4] Based on the Federal Reserve Bank of Atlanta's trade-weighted value of the dollar against 17 foreign currencies.

[5] Based on export data from the Massachusetts Institute of Social and Economic Research.

Finally, unlike most previous recessions, a lack of business investment, rather than sluggish consumer spending, was a key contributing factor to the current downturn. Indeed, Federal Reserve Board Chairman Alan Greenspan noted that "housing and consumption spending held up well [in 2001] and proved to be a major stabilizing force,"[6] supporting what otherwise would have been a weaker U.S. economy. Certain high-tech industries—telecommunications, semiconductors, and personal computers, in particular—suffered from weak demand and bloated inventories. Weakness in these industries resulted in declining levels of capital spending, poor earnings, and increased layoffs. Several of the Region's metropolitan statistical areas (MSAs) have significant employment concentrations in these industries. Many of these MSAs rank among the nation's top 100 metro areas in terms of the share of gross metropolitan product generated by the high-tech sector.[7]

Taken together, these factors have weakened many of the Region's metro economies considerably. As shown in Table 2, output and employment growth rates in each of these markets have slowed significantly from the prior year, often shifting from positive to negative growth.

Weakness in the national and global economies, combined with ongoing stress in the energy and high-tech sectors, is likely to dampen growth in the Region's economy in 2002. The nascent U.S. recovery is widely expected to be mild, at least initially, and therefore not offer much "economic pull" to the Region this year. Prospects for improving U.S. economic growth and lower inflation are likely to keep the U.S. dollar strong, despite this country's high current accounts deficit, which could constrain growth in exports from the Region.

Oil and natural gas prices have firmed since January. However, extremely weak first-quarter corporate earnings, lower than expected exploration and production budgets, and political uncertainty in the Middle East and Venezuela represent ongoing problems for the energy sector. Any initial benefit from higher prices likely will help repair balance sheets rather than result in increased production and employment. Moreover, the lag from rising prices to increased energy activity is variable (sometimes more than a year), and higher energy prices, assuming they can be sustained, probably will not act as a stimulus for the Region's economy until late 2002. Furthermore, if energy prices rise too rapidly, inflation and interest rates could increase, dampening consumer spending and home buying. Finally, excess capacity and weak profits in the high-tech sector are likely to continue in 2002, particularly in the telecommunications industry. Taken together, these factors suggest that, although the Region's economic performance could improve this year, a quick return to the rapid growth of the 1990s is unlikely.

Commercial Real Estate Sector Weakness Could Increase the Vulnerability of Certain Groups of Insured Institutions

Weakness in many of the Region's economic drivers is contributing to a decline in demand for commercial real estate (CRE) in many metropolitan areas. According to a ranking of office vacancy rates by ***Torto Wheaton Research,*** the **Dallas** metropolitan market ranked first and the **Oklahoma City** market ranked fourth in the nation as of first-quarter 2002.[8] The central business district (CBD) markets in these two metro areas have reported high vacancy rates for several years, suggesting that the vulnerability in these areas has been identified and priced into their markets. Both the Dallas and Oklahoma City CBD markets have high levels of B and C office space with vacancy rates that exceed 45 percent. Relatively high rates of outmigration, weak office employment growth, low per capita income, and reliance on cyclical industries such as manufacturing have affected the Oklahoma City economy adversely. This lackluster economic performance has contributed to increasing office vacancy rates, particularly in the CBD. Most of the unoccupied space in the Dallas (and Oklahoma City) CBDs was built in the 1960s or earlier, and is at a competitive disadvantage with newer, more attractive, and more technologically efficient suburban space.

However, areas experiencing rapid deterioration in vacancy rates represent greater concern. The **Austin** office market posted the nation's greatest increase in office vacancy rate (15.2 percentage points) from first-quarter 2001 to first-quarter 2002, and, at 23.3 percent, ranks second in the country. ***Grubb & Ellis Company*** (G&E) expects office vacancy rates to remain high for some time, as employment growth is predicted to be negative through the first half of 2002. Furthermore,

[6] Testimony before the Joint Economic Committee, U.S. Congress, April 17, 2002.

[7] *U.S. Metro Economies: Leading America's New Economy,* by Standard & Poor's DRI for the United States Conference of Mayors and the National Association of Counties, June 2000.

[8] Torto Wheaton Research monitors 56 major metro areas nationwide.

TABLE 2

Many Dallas Region Metropolitan Statistical Areas in 2001 Were Hurt by Waning Energy Prices, a Strong U.S. Dollar, and a Weak Technology Sector				
Area	Employment Growth for the year ending fourth quarter (percent change)		Gross Output for the year ending fourth quarter (percent change)	
	2000	2001	2000	2001
United States	1.6	–0.6	2.8	0.4
Denver, CO	3.6	–2.4	6.6	–2.0
Austin-San Marcos, TX	5.4	–2.0	10.9	–2.1
Boulder-Longmont, CO	9.4	–1.3	10.7	–3.0
Dallas, TX	3.6	–1.3	7.0	1.5
Fort Worth-Arlington, TX	2.7	–0.4	4.9	1.3
Oklahoma City, OK	2.0	–0.4	3.2	0.8
Albuquerque, NM	3.0	0.0	17.5	2.4
Houston, TX	2.8	0.6	4.4	0.3

Sources: U.S. Bureau of Labor Statistics (employment) and Economy.com (gross output)

G&E reports that sublease space in Austin is nearly 3.5 million square feet, or 44 percent of the metro area's total vacant space, and will remain a drag on the recovery of Austin's office market.

The high-tech sector has been a significant economic driver in many of the Region's MSAs, including Dallas, **Denver,** and Austin. (For more information about how this sector affects the Region's economies, see the ***Dallas Regional Outlook,*** third quarter 2000.) The dramatic downturn in high-tech and telecom-related industries has resulted in modest or negative economic growth in these MSAs. Austin, for example, benefited greatly from a significant concentration of high-tech industries during the late 1990s.[9] However, beginning in 2000, evidence of stress in the high-tech industry began to emerge. Consequently, employment growth in the Austin MSA has declined from one of the highest in the country to negative levels, weakening the near-term outlook for any substantive improvement in the office market.

Some submarkets are reporting even more significant deterioration. According to the ***Colorado Office of State Planning and Budgeting,*** the **Boulder-Louisville-Broomfield** submarket reported rapidly increasing office vacancy rates as high as 35 percent for year-end 2001, while the U.S. Highway 36 corridor reports a 50 percent office vacancy rate.[10] According to ***Economy.com,*** the slowdown in the Boulder economy is more severe than anything experienced in the past 15 years, pushing jobless rates to a six-year high.[11] The high-tech sector, including biotech, is a major driver for this MSA, and ongoing weakness in this sector has contributed significantly to declining employment.

Economic fundamentals, such as employment growth, capital spending, and corporate profitability, which are important determinants of the level of CRE absorption, are expected to remain sluggish in the near term. Where construction activity remains brisk, the current supply/demand imbalance could worsen. This is particularly true in the Austin MSA, where office space under construction exceeded a high 7 percent of existing office space at year-end 2001[12] (see Chart 1, next page).

Rapidly rising vacancy rates are not limited to commercial office space, but also are evident in industrial, retail, multifamily, and hotel submarkets, as described in the ***FDIC's Survey of Real Estate Trends and Moody's CMBS Red-Yellow-Green Report.***[13]

[9] According to a study prepared by DRI for the United States Conference of Mayors in 2000, the Austin metropolitan area ranked sixth in the nation based on the metropolitan economy's concentration of high-tech output to total output.

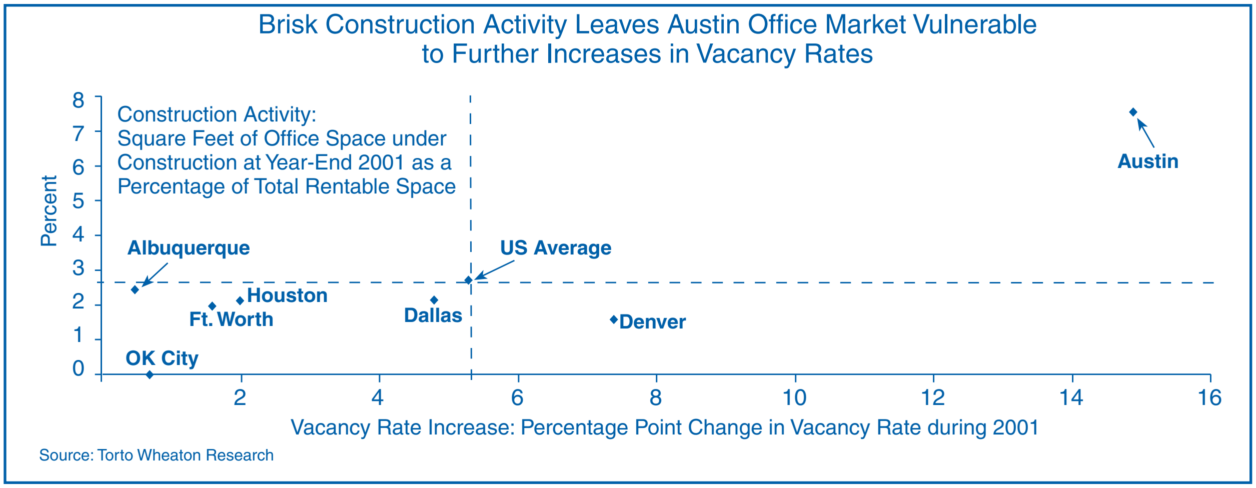
[10] *Colorado Close-Up,* Office of State Planning and Budgeting, February 2002, page 5.

[11] Precis *Metro* by Economy.com, December 2001.

[12] As a percentage of total rentable space.

[13] Gordon, Sally. January 4, 2002. *Moody's CMBS: Red-Yellow-Green Update,* fourth quarter 2001.

CHART 1



The percentage of the Region's insured institutions reporting CRE concentrations greater than 300 percent of Tier 1 capital as of year-end 2001 has never been higher, even during the late 1980s real estate crisis (see Chart 2). Moreover, the share of institutions reporting the highest CRE concentrations (in excess of 500 percent of Tier 1 capital) has steadily increased since the mid-1990s. Each of the five MSAs discussed in this article reported a high percentage of institutions with CRE concentrations.[14] We ranked CRE concentrations in all of the nation's MSAs in which at least seven insured institutions are headquartered. The Dallas, Boulder, Denver, and Austin MSAs fall in the top half of this ranking. In some of these MSAs, the level of CRE exposure has increased rapidly, particularly in the Dallas MSA, where the share of institutions with high CRE exposure has more than doubled during the past five years (see Table 3). The current economic scenario is not as dire as during the late 1980s; however, a weakening CRE sector and increased loan exposure in a less than robust economy could heighten the risk profiles of banks and thrifts lending in these markets.

CHART 2

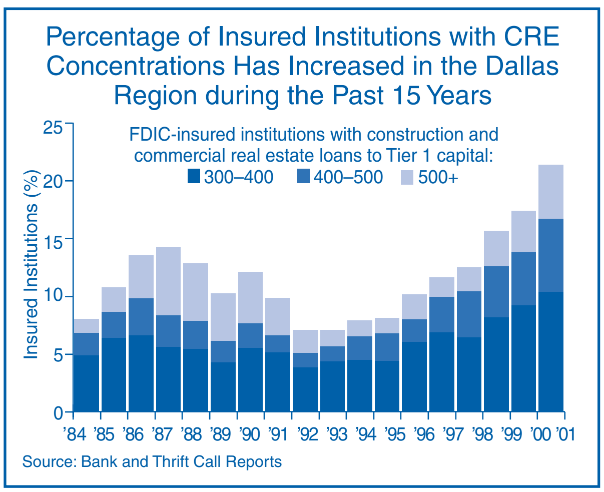


TABLE 3

THE PERCENTAGE OF DALLAS REGION INSURED INSTITUTIONS WITH COMMERCIAL REAL ESTATE CONCENTRATIONS GREATER THAN 300 PERCENT OF TIER 1 CAPITAL HAS INCREASED

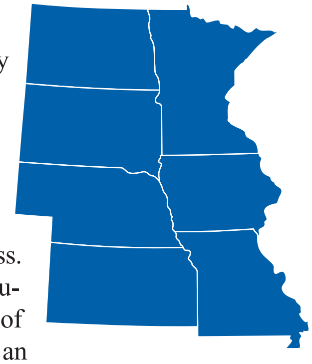
MSA NAME	1996	2001
DALLAS, TX	19.8%	53.0%
BOULDER-LONGMONT, CO	33.3%	42.9%
DENVER, CO	21.9%	33.9%
AUSTIN-SAN MARCOS, TX	19.4%	31.8%
OKLAHOMA CITY, OK	10.5%	27.7%
U.S. AVERAGE	11.6%	22.4%

SOURCE: BANK AND THRIFT CALL REPORTS

[14] Defined as CRE loans in excess of 300 percent of Tier 1 capital.

Dallas Region Staff

Kansas City Regional Perspectives



The Region's Agricultural Sector Remains Stressed

Commodity prices in the Region have remained low since 1997, a trend noted in previous Kansas City ***Regional Perspectives*** articles. According to recent ***U.S. Department of Agriculture*** (USDA) forecasts (see Table 1), wheat and corn prices are expected to rise moderately this year but to remain well below historical levels. Overproduction in soybeans is likely to contribute to a price decline for the fourth consecutive year. On the positive side, livestock prices should improve. Cattle producers have been liquidating animals since 1995, and production should decline during 2002 and 2003, resulting in favorable prices. The USDA expects hog prices to decline modestly in 2002 because of lower exports and continued imports from Canada; however, most producers should be profitable at these prices.

Overall, however, the most important issue facing the agricultural sector is the ongoing farm bill debate; the current farm bill expires this year. Many of the Region's farmers would have ceased operating during the past three years if the federal government had not provided $64.4 billion nationwide in direct support payments. The 2002 Farm Bill will increase funding for farm programs, but it is unclear whether the amounts will equal those received during the past three years, including emergency assistance. In addition, it is unclear if the provisions in the bill will result in funds being distributed differently across farm types.

Farm banks in the Region continue to report sound conditions overall; however, they are exhibiting subtle signs of stress. Aggregate past-due and nonaccrual loans represented 2.43 percent of total loans at year-end 2001, an increase of only 2 basis points from year-end 2000. However, the percentage of farm banks with a significant level of problem loans (a ratio of past-due and nonaccrual loans greater than 5 percent of total loans) increased from 8.6 percent to 11.0 percent during the same period. In addition, carryover debt levels continue to climb, as shown by the results of Federal Deposit Insurance Corporation examiner surveys and increases in farm real estate loans. Even though carryover loans likely have been underwritten soundly, they signify stress in the agricultural community.

Recent Margin Volatility Does Not Signal an End to Long-Term Pressures

Community bank[1] net interest margins (NIMs) have shown substantial volatility during the past several years, primarily because of interest rate movement. While this volatility has short-term consequences for earnings performance, it does not indicate that the pressures affecting the Region's community bank NIMs

Table 1

Prices of Important Regional Crops Remain Depressed while Cattle Prices Remain Strong

	1996	1997	1998	1999	2000	Est. 2001	Proj. 2002
Corn	$3.24	$2.71	$2.43	$1.94	$1.82	$1.85	$1.90
Soybeans	6.72	7.35	6.47	4.93	4.63	4.54	4.25
Wheat	4.55	4.30	3.38	2.65	2.48	2.62	2.80
Cattle	65.05	66.32	61.48	65.56	69.65	72.42	73.50
Hogs	56.53	54.30	34.72	34.00	44.70	45.81	40.00

Note: Grain prices are for marketing year of each crop.
Crop quantities are per bushel; livestock are per hundredweight.
Source: USDA, April 2002

[1] The term "community banks" refers to commercial banks in the Kansas City Region with total assets of $250 million or less that do not specialize in credit card lending and have been chartered for at least three years.

since the early 1990s have abated. Ongoing competitive pressures on margins continue to pose a serious industry-wide dilemma for community banks.

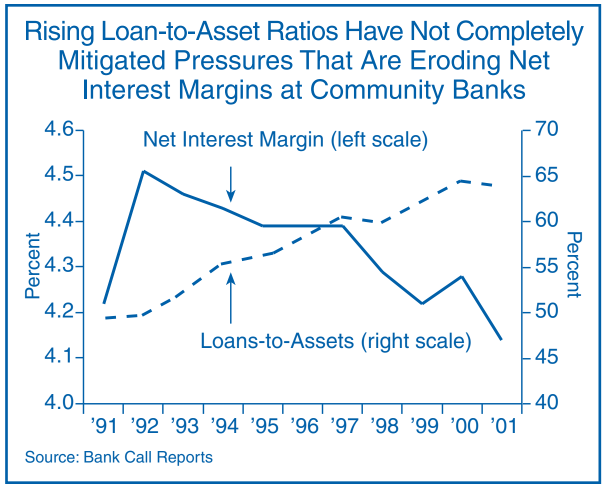
As discussed in the ***Regional Outlook,*** fourth quarter 2000, community bank NIMs have been under pressure since 1992 because of cyclical and secular factors (see Chart 1). These factors, including strong competition for loans, disintermediation of bank deposits, and pricing pressure from increasingly savvy bank customers, have eroded NIMs from both sides of the balance sheet. Community bankers frequently comment about strong loan pricing pressure from other banks, as well as nonindustry competitors such as finance companies and government-sponsored enterprises. Bankers also emphasize that declining population and the increasing availability of bank-like products from nonbanks make it increasingly difficult to attract and retain deposit customers.

While pressures on NIMs have increased during the past decade, substantial loan growth helped to mitigate the adverse effects on earnings. Community banks have increased total loans at an annualized 8.1 percent rate since the beginning of 1991, exceeding 5 percent every year, because of increased demand. When the economy expands, borrower creditworthiness generally improves. As a result, banks begin shifting earning assets from securities into loans to improve margin yields. NIMs tend to track the business cycle because of the economy's influence on the mix of assets. The NIM rises during good times as aggregate credit demand increases and declines when credit demand slackens. However, the secular pressures described above contributed to a different scenario during the strong economy of the 1990s. In fact, NIMs declined despite the rapidly expanding economy.

Community Banks Have Increased Credit Risk Profiles, Offsetting NIM Erosion

Much of the NIM compression that should have occurred during the 1990s was obscured by rapidly increasing loan-to-asset (LTA) ratios (shown in Chart 1) and the resulting higher yields on earning assets.[2] This fact suggests that when LTA ratios stabilize or begin declining, the resulting NIM decline may be more pronounced than in the past. Moreover, since LTA ratios are likely to decline during an economic slowdown because of reduced loan demand, rapid NIM

CHART 1



deterioration could occur at the same time loan loss provisions are rising. The 2001 recession, which many analysts believe may be relatively mild compared with past downturns, demonstrated how a decline in the LTA ratio affects community bank NIMs. In 2001, community banks' aggregate LTA ratio declined for only the second time in a decade, from 64.4 percent to 63.7 percent, and the aggregate NIM declined by 14 basis points.

While much of the drop in the NIM during 2001 can be explained by changes in interest rates, the decline in the LTA ratio also appears to be a contributing factor. During 2001, 57 percent of the Region's community banks reported a decline in the LTA ratio. These banks, in the aggregate, reported a 21 basis point drop in the NIM. However, community banks that reported an increase in the LTA ratio reported only an aggregate 3 basis point decline in the NIM. The disparity is even more pronounced among banks that report greater changes in the LTA ratio. The 342 community banks that reported LTA ratio declines of at least 5 percentage points in 2001 reported an aggregate NIM decline of 35 basis points; the 214 banks that reported at least a 5 percentage point increase in the LTA ratio reported a 2 basis point *increase* in the NIM.

High LTA Ratios May Improve Margins, but Also Could Heighten an Institution's Risk Profile

While increasing LTA levels have yielded NIM benefits in the past, downsides exist. The level of the LTA ratio is generally a good barometer of management's tolerance for risk. In fact, ***History of the Eighties*** showed that, during the agricultural crisis, LTA levels were a key determinant of whether a bank would

[2] Refer to *Regional Outlook,* fourth quarter 2000, Kansas City, for a detailed discussion of this issue.

ultimately fail.[3] Overall, assuming underwriting, reserve protection, and other key measures are equal, banks with low LTA levels typically exhibit a lower risk profile than banks with high LTA levels.

A significant concern in the current economic environment is whether banks with high LTA ratios are continuing to increase loans, even as loan demand has subsided. We segmented the Region's community banks into four quartiles on the basis of year-end 2000 LTA ratios and examined those banks that exhibited aggressive lending activity during 2001. Given the generally soft economic climate in 2001, we considered loan growth of at least 15 percent a relatively strong lending level; 13.5 percent of the Region's banks fell into this category. Many of these institutions reported relatively low LTA ratios at the beginning of 2001, which mitigated much of the concern. However, more than 15.5 percent of banks in the top quartile (banks that began the year with at least a 71.1 percent LTA ratio) experienced loan growth of at least 15 percent in 2001. These 69 banks, in the aggregate, increased loan portfolios by 23.2 percent, and the aggregate LTA ratio rose from 77.5 percent at year-end 2000 to 81.1 percent at year-end 2001.

What Does the Future Hold?

The long-term factors pressuring NIMs are not expected to diminish; therefore, community bankers will continue to be challenged to sustain margins or increase other sources of revenue. Unfortunately, community bankers' well-publicized efforts to lessen dependence on the NIM by increasing noninterest revenue have met with limited success. Community banks have not reduced reliance on interest income significantly during the past ten years.[4]

As a result, community bankers are searching for other solutions to NIM erosion. Some bankers have countered the pressures by increasing credit risk, but this strategy heightens vulnerability to increased loan losses. However, allowing NIMs to decline steadily is not an attractive alternative either.

John M. Anderlik, Regional Manager
Richard D. Cofer, Jr., Senior Financial Analyst

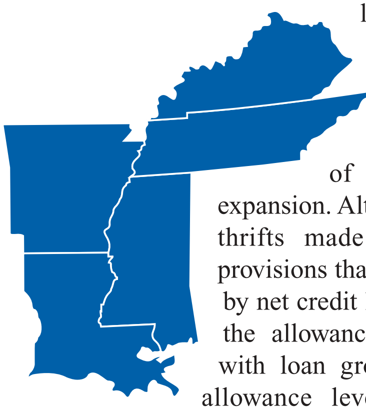
[3] Federal Deposit Insurance Corporation. 1997. *History of the Eighties—Lessons for the Future. Vol I: An Examination of the Banking Crisis of the 1980s and Early 1990s,* Chapter 8. See www.fdic.gov/bank/historical/history/index.html.

[4] Community bank net interest income as a percentage of net interest income plus noninterest income was 86.3 percent at year-end 1991 and 84.0 percent at year-end 2001.

Memphis Regional Perspectives

Allowance for Loan and Lease Losses Requires Continued Attention

Lingering economic weakness in the Memphis Region and deterioration in bank and thrift loan portfolios highlight the importance of decisions by financial institution managers about the adequacy of the allowance for loan and lease losses (ALLL). Allowance levels relative to total loans steadily declined during most of the 1990s economic expansion. Although most banks and thrifts made considerably larger provisions than were being absorbed by net credit losses, the increases to the allowance did not keep pace with loan growth. This decline in allowance levels usually was not cause for concern because of strong credit quality at most insured institutions during the period. The current environment, however, suggests a need for renewed attention to the ALLL, particularly for insured institutions operating in economically stressed areas of the Mid-south.



Regional Economic Conditions Remain Weak, but Are Stabilizing

Although the economies of the nation and the Region are improving, employment conditions in the Region are constrained by the prolonged slump among area manufacturers and by weaknesses in the transportation sector. The Region continued to report year-over-year job losses through first-quarter 2002, although the rate of loss is moderating, as many sectors of the economy began to report positive job creation in the first quarter.

The manufacturing sector continued to shed jobs despite a rebound in orders. Most manufacturers in the Region were hesitant to add workers until they posted a sustained rebound in sales. Meanwhile, some industries, such as automobile parts producers and chemical products manufacturers, continued to cut payrolls. All states in the Region reported manufacturing job losses on both a year-over-year and a quarter-over-quarter basis, but the pace of loss slowed in fourth-quarter 2001 and first-quarter 2002. Going forward, the outlook for the manufacturing sector is generally positive,[1] although certain segments, such as textile and apparel producers, will continue to face ongoing structural challenges.

The transportation sector also reported continuing job losses in first-quarter 2002. Distribution companies, including air freight and trucking, struggled with reduced shipment volumes. Airlines also remained under pressure and cut additional jobs to address profitability concerns. Like manufacturing, the Region's transportation sector should see improvement as the economies of the nation and the Region strengthen.

Credit Quality Lags Economic Conditions

Credit quality among many Memphis Region banks and thrifts deteriorated in fourth-quarter 2001. Loan delinquencies increased notably,[2] driven largely by deterioration in consumer and 1- to 4-family loan portfolios. Rising unemployment levels contributed to weakening consumer balance sheets and rising personal bankruptcy filings. Loan loss rates also were up, with charge-offs concentrated in consumer and commercial loan portfolios. The deterioration in commercial loan portfolios is attributable to growing financial stress at many business creditors, resulting from reduced revenues and profits.

Loan portfolios may deteriorate further as businesses and individuals exhaust savings and refinancing alternatives. Credit quality seems unlikely to strengthen until corporate profitability improves and unemployment levels begin to decline, leading to stronger financial conditions for commercial and household borrowers.

Attention to Allowance Levels Remains of Paramount Importance

Because of weakening credit quality, most banks and thrifts in the Region increased provisions to the

[1] As an indication of the improved outlook for manufacturing, the Institute for Supply Management Index (formerly the National Association for Purchasing Managers Index) steadily climbed from 48.1 in December 2001 to 55.6 in March 2002, a level suggesting that manufacturing activity was expanding at a moderate pace during first-quarter 2002.

[2] The median ratio of past-due and nonaccrual loans to total loans was 2.84 percent at year-end 2001, up more than 20 basis points from the previous quarter and a like amount from one year ago.

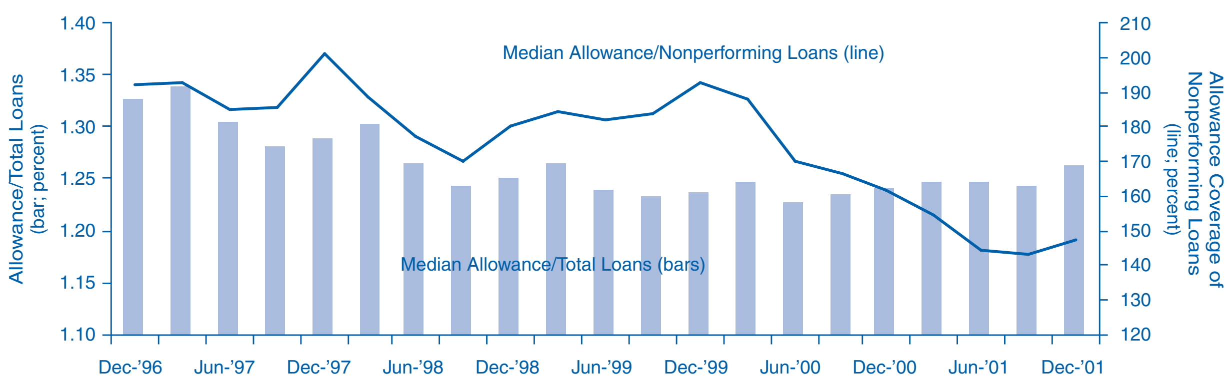
ALLL in 2001. Higher provisions coupled with slowing loan growth led to a modest increase in ALLL levels relative to total loans, despite the increase in loan loss rates previously described (see Chart 1). ALLL levels to total loans are higher among Memphis Region institutions than among banks and thrifts in the rest of the nation, but this may be of limited comfort to bank officers and directors. The ratio of ALLL to total loans does not address the degree of inherent risk in insured institution loan portfolios resulting from such factors as portfolio composition, underwriting and credit administration practices, area economic conditions, or loan performance.

When measured against loan performance, ALLL levels in the Memphis Region generally have declined. Provisions did not keep pace with the sharp rise in nonperforming loans during 2000 and 2001, and the allowance coverage of nonperforming loans fell from over 190 percent two years ago to under 150 percent in late 2001. The ratio increased slightly in fourth-quarter 2001 as banks added to allowances, but it was well below national levels, as shown in Table 1. Similarly, the ratio of the ALLL to net loan losses in 2001 was well below national levels.

Allowance coverage of nonperforming loans and of loan losses is lower in **Arkansas** and **Tennessee** than in other states in the Region. Economic and credit conditions weakened considerably in these two states during 2001. Allowance coverage among **Kentucky** banks and thrifts also declined as the state's economy slowed. **Mississippi** experienced perhaps the most severe economic slowdown among the Region's states in 2001, and insured institutions in Mississippi reported a significant increase in delinquencies and loan losses. Most banks and thrifts

CHART 1

After a Period of Decline, Memphis Region Allowance Levels Increased in the Fourth Quarter



Source: Bank and Thrift Call Reports

TABLE 1

ALTHOUGH ALLL LEVELS IN THE MEMPHIS REGION GREW SLIGHTLY IN 2001, THEY DID NOT KEEP PACE WITH INCREASES IN NONPERFORMING LOANS							
MEDIAN RATIOS AS OF DECEMBER 31, 2001	MEMPHIS REGION	REST OF NATION	ARKANSAS	KENTUCKY	LOUISIANA	MISSISSIPPI	TENNESSEE
ALLL/GROSS LOANS (MEDIAN %)	1.26	1.22	1.23	1.18	1.31	1.41	1.29
ALLL/NONPERFORMING LOANS (MEDIAN %)	147.6	171.0	117.6	151.0	157.5	171.7	149.5
ALLL/2001 NET LOAN LOSSES (MEDIAN X)	4.7	6.0	4.4	5.2	6.1	5.1	4.0

SOURCE: BANK & THRIFT CALL REPORTS

Perspectives from the FDIC Regional Director

The comments you have just read about loan and lease loss coverage among insured banks in the Memphis Region concern all of us. During the past year, a growing number of our examined institutions were determined to need additional provisions to the reserve.

It is heartening to read that the Region's economy is stabilizing, based on the most recent economic data. Banks will obviously play an important and integral role in this recovery by lending to creditworthy borrowers. Even more heartening is the news that banks added to reserves in fourth-quarter 2001. Because of growing expectations for a strong economic recovery and modest increases in reserve levels in the fourth quarter, CEOs may feel pressure from their boards and shareholders to focus on short-term earnings performance and retreat from reserve commitments.

My strong desire for the coming quarters is that bankers will ensure appropriate coverage for nonperforming and high-risk loans. Credit quality deterioration identified in recent examination reports is a lagging indicator of the business cycle. The banking industry will require several more quarters of economic growth before damage to loan portfolios created by the recent recession can be repaired.

While many factors should be considered when evaluating the adequacy of the loan loss reserve, three come immediately to mind. First, the soundness of the bank's loan review and grading program cannot be overemphasized. Second, historical loss experience remains relevant, if adjusted for economic changes since the 1990s. Third, a shift to new or potentially higher-risk credit products, such as construction and development lending, warrants particularly careful analysis. The last factor is particularly relevant to community banks with limited credit administration resources operating in increasingly competitive markets.

The Interagency Policy Statement on Allowance for Loan and Lease Losses (FIL-63-2001) contains a comprehensive discussion of the methodologies and documentation for loan loss reserves that our examiners hope to see when they visit your bank. You will note that the Policy Statement recognizes that institutions with less complex lending activities and products, such as many small banks, will require fewer supporting documents. Please take the time to review the Policy Statement and share it with your staff and board. Additional copies of the Policy Statement are available on our website: www.fdic.gov.

Cottrell L. Webster
Regional Director

in the state, however, have traditionally maintained a high cushion for potential losses, and allowance coverage remains high despite credit quality deterioration. **Louisiana's** economy has proven resilient during the recession.[3] Credit quality conditions among the state's insured institutions remain relatively strong, and allowance coverage has changed little in recent quarters.

As discussed below by the FDIC Regional Director, allowance adequacy is an immediate concern for many insured financial institutions in the Memphis Region. With credit quality in the Region likely to remain weak during coming quarters, insured institution management should continue to carefully evaluate the accuracy of the methodologies and information used to determine appropriate allowance protection. Any shortfall in allowance levels results in an overstated capital position and inflated earnings performance, which could influence strategic decisions by officers and directors on matters ranging from branching plans and asset growth targets to annual dividend and employee bonus payments.

Memphis Region Staff

[3]Louisiana's economy has benefited from recent stability in energy sector employment and from a relatively low dependence on manufacturing sector employment. Manufacturing comprised only 9.3 percent of the state's total employment at year-end 2001, compared with 17.9 percent for the rest of the Memphis Region.

New York Regional Perspectives

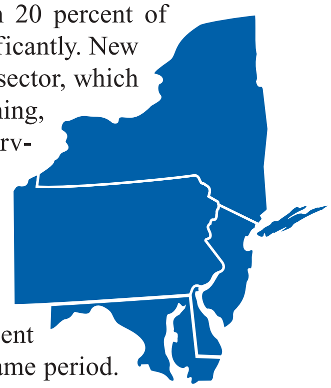
Level of Job Losses Has Been Highest in New York City and in the Region's Manufacturing-Reliant Areas

The Region's economic performance during the recent recession could have been much worse. By one measure—year-over-year employment growth—the Region's metropolitan statistical areas (MSAs) lost a higher share of jobs on average (–0.54 percent) between first-quarter 2001 and 2002 than other MSAs in the nation (–0.27 percent).[1] The incidence of job loss reflects, in part, contraction in the manufacturing and financial services sectors, key components of the Region's economy.

However, compared with long-term employment trends (i.e., employment growth experienced during the most recent economic expansion), the average rate of job loss among the Region's MSAs has been less severe than that of the nation's other MSAs.[2] This difference can be attributed to the fact that employment growth among the Region's cities generally was less robust during the 1990s than that experienced elsewhere, such as in cities in the Southeast and Northwest. (For more information on employment growth trends for the nation's fast-growing economies, see ***In Focus*** article *Back to the Future: How This Recession Compares to Past Recessions*.)

The New York City Metropolitan Economy Has Been More Severely Affected

Although by some measures the Region's economic downturn has been less severe than in other parts of the nation, **New York City** has suffered disproportionately. During the past year, the New York City MSA reported the largest number of employment losses in the nation and ranked among the highest of the nation's MSAs in percentage of jobs lost. The September 11 attack hurt an already weakening economy, as employment growth in the New York City MSA had been declining (see Chart 1).[3] Employment in the area's business services and finance, insurance, and real estate (FIRE) sectors, which account for more than 20 percent of employment, contracted significantly. New York City's business services sector, which includes computer programming, advertising, and temporary services, lost 37,100 jobs, or almost 10 percent of its workforce, from first-quarter 2001 to first-quarter 2002. The FIRE sector eliminated more than 32,500 jobs, or 6.2 percent of its workforce, during the same period.



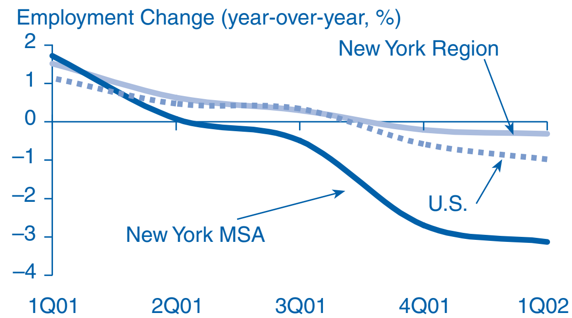
Some of the Region's other MSAs also experienced significant declines in job growth during this recession. The Region's manufacturing-dependent metropolitan areas, which include parts of **Pennsylvania, New Jersey,** and upstate **New York,** experienced sizable cyclical declines in manufacturing employment. In addition, **Newark** and **Pittsburgh** suffered disproportionately from the slowdown in air travel after September 11. However, air travel recently has shown some improvement, as discounted airfares have contributed to increased air traffic, particularly for leisure travel.

Excluding New York City, the Region's Economic Recovery Should Coincide with National Trends

Manufacturing is a key economic sector in many of the Region's smaller MSAs, and manufacturing output nationwide has shown signs of improvement. As a result, economic conditions in many of the manufacturing-reliant cities in Pennsylvania and New York may

Chart 1

New York City MSA Job Losses Have Been More Severe than Those of the Region or the Nation



Note: New York Region excludes New York MSA, U.S. excludes New York Region.
MSA = metropolitan statistical area.
Sources: Bureau of Labor Statistics, Haver Analytics

[1] Changes in employment are measured from first-quarter 2001 to first-quarter 2002.

[2] Long-term trends in employment growth are defined as the compound annual rate of employment growth for each MSA between year-end 1992 and year-end 2000. National data refer to the average of all MSAs in the nation.

[3] The New York City MSA includes the five boroughs and Westchester, Putnam, and Rockland counties.

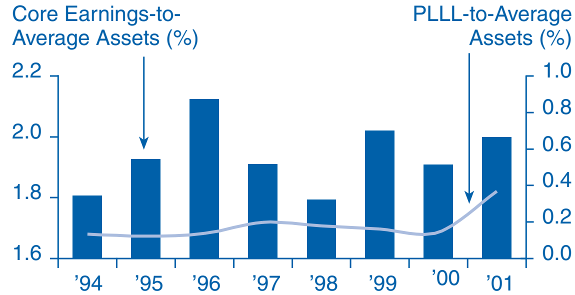
improve in the near term.[4] A slower and more anemic recovery, however, is projected for the New York City MSA because a potentially lackluster recovery in the financial markets is expected to dampen the city's immediate economic prospects. Notwithstanding the $20 billion in federal assistance and the stimulative effects of reconstruction of downtown Manhattan, a rebound in corporate profits and an increase in investment banking activity will be keys to recovery in the New York City MSA.

Despite economic weakness in the MSA, at year-end 2001, community institutions headquartered in New York City reported credit quality deterioration on par with trends in the nation and the Region.[5] However, bank credit quality indicators typically lag economic performance, and the New York City area experienced significant economic deterioration later than other areas of the nation. As a result, credit quality among its insured institutions could weaken further relative to community banks in other metropolitan areas. In fact, recent evidence suggests that low- and moderate-income homeowners in the New York MSA report higher levels of mortgage delinquency than similar borrowers elsewhere in the country.[6]

Large Bank Earnings Growth Has Cushioned the Effects of Increased Loan Loss Provisions. Higher loan exposure to troubled industries, coupled with softening economic conditions, was evident in weakening credit quality among the Region's large banks in fourth-quarter 2001.[7] Loan losses and provisions increased sharply as several of the Region's money center banks reported charge-offs related to the Enron bankruptcy and the financial turmoil in Argentina. Despite credit quality problems, most of the Region's large banks reported higher core earnings in 2001, primarily reflecting net interest margin (NIM) improvement, which cushioned the effects of increased loan loss provisions (see Chart 2).[8] Large banks' NIMs benefited from the 11 cuts in the Federal Funds rate in 2001. Because large bank

CHART 2

Increased Core Earnings Cushion the Effects of Higher Provisions at the Region's Largest Banks



Note: PLLL = provision for loan and lease losses.
Data are median figures for banks with total assets greater than $25 billion, excluding credit card banks.
Source: Bank Call Reports

funding costs are highly sensitive to changes in short-term interest rates, the average cost of funds reported by the Region's large banks declined by almost 250 basis points in 2001. Average asset yield also declined, although more modestly than funding costs, resulting in a 21 basis point increase in the average NIM reported by the Region's large banks. Aided by lower interest rates, almost all the Region's large banks reported securities gains in 2001, helping to offset significant increases in provision expenses. However, should interest rates rise, securities gains may become more modest.

Asset Extension Follows Two Refinancing Waves in Four Years, while Liabilities Remain Short

The unprecedented level of residential mortgage refinancings in 1998 and 2001, fueled by low long-term interest rates, contributed to significant lengthening of maturities in mortgage portfolios held by the Region's commercial banks (see Chart 3).[9] During these refinancing waves, fixed-rate mortgages became increasingly more popular than adjustable rate mortgages (ARMs). According to the ***Mortgage Bankers Association,*** approximately 88 percent of the dollar volume of residential mortgages originated during the previous two refinancing waves were fixed-rate loans, compared with an annual average of 74 percent during the remainder of

[4] Institute for Supply Management Manufacturing Survey, April 1, 2002.

[5] Community institutions are defined as those with assets less than $1 billion, excluding banks in operation less than three years and specialty lenders.

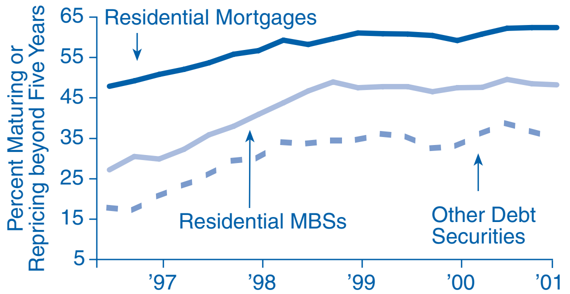
[6] Kershaw, Sarah. March 27, 2002. Failing Mortgages Soar in New York. *New York Times,*

[7] For the purposes of this analysis, large banks are defined as insured institutions with total assets over $25 billion, excluding credit card banks. Banking analysis uses median figures unless otherwise noted.

[8] Core earnings are defined as income before taxes, securities gains, extraordinary items, and provisions for loan losses.

[9] Figures in this article reflect trends for commercial banks in operation more than three years, excluding credit card and specialty banks. Because of definitional differences in reporting information on maturing distribution of loans between commercial banks and thrifts, this discussion excludes thrift institutions. Nevertheless, because of the emphasis on residential mortgage lending, thrift institutions likely exhibit similar trends in loan maturity extension.

CHART 3



Note: MBSs = mortgage-backed securities.
Median data for banks in operation more than three years excluding credit card, specialty, and thrift institutions.
Source: Bank Call Reports

the 1990s. This switch in consumer preference from shorter-term adjustable rate loans to longer-term fixed-rate products contributed to an increase in the concentration of long-term residential mortgage loans among the Region's banks.[10] Between 1997 and 2001, the median percentage of residential mortgage loans that mature or reprice beyond five years increased from 48 percent to 62 percent. Increased preference for longer-term loans also has been evident in commercial lending, as nonmortgage loan maturity has extended moderately over the past four years. In addition to borrower-driven loan extension, the Region's insured institutions are extending maturities in securities portfolios (see Chart 3). This extension likely is a function of the greater yield available from investing in longer-term securities.

While asset maturities have lengthened, liability maturities have remained relatively short-term. Three-quarters of the time deposits (approximately 40 percent of total liabilities) held by the Region's banks mature in less than a year, and essentially all time deposits mature within three years. Maturities of Federal Home Loan Bank (FHLB) borrowings held by the Region's banks also have remained relatively short-term, and some are callable, meaning that the FHLB can reprice loans upward if interest rates rise. Two-thirds of the advances from the Pittsburgh and New York FHLBs have less than one year until maturity or next call date.[11] FHLB borrowings with call options are typically offered at lower rates than noncallable advances and, therefore, may be attractive funding options for banks. Nonetheless, callability is an important consideration when assessing cost and vulnerability to interest rate risk.

The Region's Concentration of Long-Term Assets Is Higher than the Nation's

While asset extension is evident throughout the industry, as of year-end 2001 the Region's banks reported a higher median concentration of long-term assets than banks nationwide. Moreover, the percentage of the Region's banks that hold high levels of long-term assets has increased in the 1990s, more than doubling in the past five years and significantly exceeding the percentage of banks elsewhere in the nation.[12] Increased asset extension among the Region's banks relative to the nation's reflects, in part, the fact that a higher percentage of the Region's banks specialize in residential lending. One-third of the Region's banks are residential lenders, compared with 10 percent in the rest of the nation.[13] Moreover, at year-end 2001, the Region's residential lenders reported a higher concentration of long-term assets than similar institutions nationwide. An intensely competitive banking environment in many of the Region's metropolitan areas may contribute to the higher level of long-term assets. Furthermore, because housing prices are often higher in metropolitan areas in the Northeast, homebuyers can realize greater savings by taking advantage of lower long-term interest rates. The Region's insured institutions that have adopted other business models (e.g., commercial or consumer lending) also reported higher long-term asset concentrations, on average, than their counterparts elsewhere.

Higher Capital Levels Mitigate Heightened Interest Rate Risk, but Challenges Remain, Particularly for Community Banks

High capital levels reported by the Region's banks have helped cushion the adverse effects of increased levels of interest rate risk. During the past decade, the percentage of the Region's banks that reported an equity capital ratio of at least 8 percent has increased from approximately 50 percent to 70 percent. Nevertheless, increasing concentrations of long-term assets have heightened

[10] For purposes of this article, "long-term" is considered to be remaining maturity or time to next repricing date of greater than five years.
[11] Figures obtained from the most recently available FHLB annual reports, which are as of year-end 2001 for Pittsburgh and year-end 2000 for New York.

[12] Excludes credit card, specialty, and agricultural banks; banks in operation less than three years; and thrift institutions.
[13] Residential lenders refers to institutions holding more than 50 percent of total assets in 1- to 4-family mortgage loans and mortgage-backed securities.

interest rate risk pressures. Loan maturity extension during periods of low long-term interest rates largely reflects consumer preferences. By contrast, the lengthening of maturities in securities portfolios during a declining rate environment likely reflects bank management's decision to mitigate shrinking margins but could result in increased exposure to interest rate risk.

The Region's community banks that have higher concentrations of long-term assets may be more vulnerable to interest rate risk; 84 percent of the Region's banks with high levels of long-term assets are community banks.[14] Community banks typically have more modest loan production capabilities than larger banks and find it more difficult to divest long-term loans in the secondary market or increase origination of short-term loans. In addition, call report data show that the use of interest rate hedging by the Region's community banks is modest, as only 6 percent of banks that reported a high level of long-term assets reported any interest rate derivatives at year-end 2001. Should short-term interest rates rise significantly relative to long-term rates, NIMs may be pressured, as funding (predominantly short-term) becomes more expensive. At the same time, high concentrations of long-term assets could constrain asset yields. Moreover, higher interest rates could dampen consumer demand for mortgages, leading to declining levels of noninterest income. Insured institutions now have an opportunity to evaluate interest rate risk management strategies and determine how these strategies could affect NIMs. For additional analysis on interest rate risk trends, see ***FYI-Refinancing Waves Alter the Landscape for Mortgage Specialists*** at http://www.fdic.gov/bank/analytical/fyi/042502fyi.htm.

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[14] Almost one-half of the Region's community banks that reported a high concentration of long-term assets are residential lenders, and many are located in competitive metropolitan areas.

San Francisco Regional Perspectives

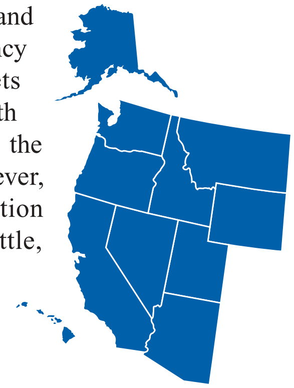
Economic Weakness Adversely Affected Commercial Real Estate Demand

The San Francisco Region's economy softened considerably in fourth-quarter 2001. Economic weakness centered in major metropolitan statistical areas (MSAs) with concentrations in information technology (IT) and tourism employment. Commercial real estate (CRE) conditions also deteriorated in several MSAs, particularly in markets with significant IT employment concentrations. Insured institutions reported modest asset quality deterioration as a result of the weakened economy; however, the greater challenge to community bank earnings during 2001 was compression of net interest margins (NIMs) resulting from declining short-term interest rates.

The ongoing IT sector downturn led to job cuts and rising unemployment rates in **Oregon, Washington, Arizona,** and **Northern California** late in 2001. In particular, the **San Jose, San Francisco,** and **Seattle** MSAs reported year-over-year employment declines exceeding 3.4 percent during fourth-quarter 2001. Furthermore, the events of September 11 contributed to significant tourism-related job losses in **Las Vegas** and **Honolulu** through January 2002.

The weakened economy also affected the Region's CRE markets, especially office and hotel properties. The San Francisco, San Jose, and **Oakland** MSAs reported the greatest year-over-year office vacancy rate increases in the Region, each rising over 800 basis points to 16.5, 14.5, and 11.2 percent, respectively, in fourth-quarter 2001. Furthermore, hotels in San Francisco and **Oahu** reported average revenue per available room (RevPAR) rates at least 25 percent below year-ago levels in November and December 2001 and January 2002.

Softening CRE conditions are a concern given the sizable CRE loan exposures of insured institutions in most of the Region's metropolitan markets. For instance, in the San Jose, San Francisco, Oakland, Seattle, **San Diego, Portland,** and **Phoenix** MSAs, where office vacancy rates increased at least 50 percent during 2001, roughly two-thirds of insured institutions reported CRE loans-to-Tier 1 capital ratios exceeding 300 percent. Although median CRE loan delinquencies increased among lenders in markets such as Seattle and Phoenix, overall delinquency ratios in most markets remained low compared with those experienced during the 1990–91 recession. However, continued CRE construction in markets such as Seattle, Portland, Oakland, and San Francisco could push vacancy and loan delinquency rates higher.[1]



Declining Interest Rates Challenged Community Bank Net Interest Margins

Eleven Federal Funds rate cuts during 2001 proved to be a greater short-term challenge for community bank earnings in the San Francisco Region than asset quality deterioration. The declining interest rate environment adversely affected NIMs among most community banks but benefited thrift earnings. The interest rate cuts affected institutions differently depending on asset size. Banks holding less than $1 billion in assets experienced the most significant declines in quarterly NIMs. In contrast, thrift margin expansion was most pronounced among community thrifts, particularly those with less than $250 million in assets. In part, the sharp decline in short-term interest rates affected commercial bank asset yields and margins more adversely because these institutions hold a relatively greater proportion of variable-rate and short-term commercial credits. Thrift institutions, by contrast, generally hold longer-term, fixed-rate mortgage-related assets. Meanwhile, rates on many deposit categories declined to exceptionally low levels, limiting some institutions' ability to cut funding costs commensurate with declining loan yields.

Rate cuts also spurred significant appreciation in debt securities portfolios. Most banks in the Region reported securities appreciation during 2001, in sharp contrast with widespread portfolio depreciation during parts of

[1] See "Weak Fundamentals for U.S. Office Markets," *For Your Information,* March 21, 2002 (www.fdic.gov/bank/analytical/fyi/032102fyi.html).

1999 and 2000.[2] Nearly half the Region's insured institutions sold investments for a gain. While securities gains boosted current earnings, future income could be hurt if sales proceeds were reinvested in relatively lower-yielding assets.

In addition to affecting current earnings, interest rate changes might have prompted some adjustments to balance sheets among the Region's insured institutions. Because short-term rates were so low compared with long-term rates for much of 2001, some banks may have shortened liability repricing intervals or lengthened asset repricing frequencies. In a rising interest rate environment, such a strategy could moderate the historically beneficial effects of rising interest rates on commercial bank NIMs.

Lower interest rates prompted significant refinancing activity during 2001, which further reduced thrifts' exposure to adjustable rate mortgages (ARMs). According to ***Loan Performance Corporation,*** **California,** Arizona, and **Nevada** experienced particularly high mortgage prepayment rates in third-quarter 2001.[3] ARMs, which are popular in the West's higher-cost housing markets, are often refinanced when mortgage rates fall, possibly contributing to the trend. By fourth-quarter 2001, the median ratio of first lien ARMs to total residential mortgages among the Region's thrifts was 37 percent, off from 46 percent one year earlier and continuing a downward trend from 65 percent ten years ago. Consequently, should rates begin to increase, savings institution yields could be reliant on a greater proportion of fixed-rate loans and securities, funded in part by short-term, rising-cost liabilities.

All else being equal, a rising interest rate environment is expected to improve bank NIMs but pressure thrift earnings. The same rising rates that could compress thrift NIMs could also cause unrealized debt securities losses. As a result, margin-related earnings pressures may not be offset by securities gains.

Higher Unemployment, Household Debt Levels, and Bankruptcy Rates Could Pressure Asset Quality

A worsening employment picture, high consumer debt levels, and the threat of more restrictive bankruptcy legislation[4] prompted many households in the San Francisco Region to file for bankruptcy protection during 2001. During this period, consumer loan delinquency and charge-off rates at insured institutions in the Region rose, particularly among "concentrated" retail and subprime lenders.[5]

Rising unemployment rates throughout the Region are of concern because consumer debt levels are at historic highs. Elevated debt levels could hamper the ability of households to service debts during periods of unemployment. Furthermore, holders of variable-rate debt, such as credit cards, could face higher debt service burdens if interest rates rise.

The Region experienced a 13 percent increase in personal bankruptcy filings during 2001, consistent with a nationwide trend. The increase centered in Chapter 7 (liquidation) filings, which rose 16 percent. Filing rate increases in Oregon, **Utah,** Nevada, **Wyoming, Montana,** Arizona, and Washington outpaced the national average, as shown in Chart 1. Concurrent with rising bankruptcy levels, median consumer and residential loan indicators deteriorated, particularly among retail and subprime specialty institutions.[6]

As of year-end 2001, 181 of the Region's insured institutions (23 percent) reported ratios of retail loans to Tier 1 capital exceeding 300 percent; 21 of these institutions specialize in subprime lending. More than half of the concentrated retail lenders are headquartered in Washington, Montana, Wyoming, Utah, Nevada, and Oregon, which experienced some of the highest bankruptcy increases. Even insured institutions with portfolios diversified outside their home state were not

[2] Thrift Financial Report filers do not report securities in the same way as Call Report filers; as a result, unrealized gain/loss data are unavailable for most thrifts.

[3] *The Market Pulse,* Loan Performance Corporation, Fall 2001, p. 5. The third-quarter 2001, three-month constant prepayment rates on conventional mortgages for California's major markets, Phoenix, and Seattle exceeded 21 percent, the national average.

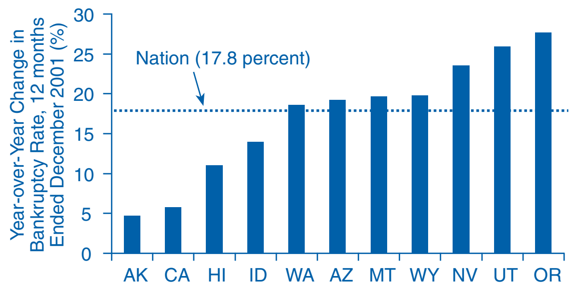
[4] For the past several years, Congress has debated changes to bankruptcy laws. Proposed changes would make it more difficult for filers to qualify for Chapter 7 (liquidation) filing status, thereby reducing their ability to extinguish debts.

[5] Concentrated retail lenders are insured institutions that hold retail loans (first and junior lien residential mortgages, credit cards, and other consumer loans) exceeding 300 percent of Tier 1 capital. Subprime lenders are insured institutions with direct and indirect interests in subprime assets in amounts exceeding 25 percent of Tier 1 capital.

[6] Includes loans such as credit cards, overdraft lines, automobile loans, and other loans to individuals that are at least 30 days past due or on nonaccrual status.

CHART 1

Personal Bankruptcy Filing Rates* Grew Rapidly in Several San Francisco Region States



* Owing to data limitations, the bankruptcy rate was deflated by population growth in the previous year.
Sources: Administrative Office of the U.S. Courts via www.abiworld.org and Bureau of Economic Analysis

immune to the effects of consumer credit softening, as the national personal filing rate increased by 18 percent.

Credit quality slipped among many concentrated retail lenders in 2001, and these institutions are vulnerable to a continuation of this trend in 2002. The Region's concentrated prime retail lenders, which typically specialize in lower-risk residential lending, fared better than their subprime counterparts, which usually focus on higher-risk credit card and other consumer loan categories. Prime retail lenders reported a median overall delinquency ratio of 1.64 percent as of year-end 2001, up slightly from 1.36 percent one year earlier. Similarly, between year-end 2000 and 2001, the median past-due loan ratio among the Region's 30 subprime lenders climbed from 3.87 percent to 5.17 percent. In contrast, institutions that do not hold concentrations in prime retail or subprime credits reported a 1.36 percent delinquency ratio. If unemployment continues to climb after the recession ends, as was the case following the 1990–91 recession, credit defaults and losses among these lenders could worsen before they improve.

Stress in Some Tourism-Exposed Areas of the Region Has Not Abated

The softening consumer sector, combined with the aftermath of the September 11 attacks and waning business travel, disproportionately affected some tourism-exposed areas of the Region, particularly Nevada, **Hawaii,** and California. Job losses in tourism-related industries were significant in several MSAs during fourth-quarter 2001. Furthermore, RevPAR measures and visitor counts remained weak compared with year-ago levels. Insured institutions headquartered in the Region's most tourism-exposed MSAs (Las Vegas, **Reno, Salinas,** San Francisco, San Diego, **Orange County,** Honolulu, and **Riverside**)[7] reported elevated concentrations in traditionally higher-risk loans and significant new bank activity. Continued tourism industry weakness could challenge earnings and credit quality among institutions in these markets.

Nevada and Hawaii, the Region's top two tourist destinations, rely heavily on air travelers. The Las Vegas MSA (where about 25 percent of employment is tourism-related) experienced a dramatic slowdown following the attacks; more than 8,000 workers were laid off in September and October 2001. Few of these workers have been rehired into tourism-related positions, and, at best, only half have been rehired in other industries in the state. Similarly, Honolulu and the rest of Hawaii reported significant weakness through December 2001; job growth declined and unemployment claims from travel-related sectors continued to rise. Salinas (Monterey County), the California MSA most reliant on tourism employment, caters to drive-in visitors. However, its proximity to Silicon Valley, where IT incomes and employment have dropped, likely contributed to the 5 percent drop in tourism-related employment in fourth-quarter 2001 compared with year-ago levels.

Along with tourism employment, RevPAR and air arrivals in some of the Region's tourism-exposed MSAs remained depressed through year-end 2001. Hotel sector revenues in the San Francisco and Oahu markets were hit particularly hard. Hotel operators reported year-over-year RevPAR declines of nearly 37 percent in San Francisco and 26 percent in Oahu as of January 2002.[8] Sustained weakness in RevPAR may slow the rehiring process, as hotel operators are not earning enough to justify adding employees.

Increased air travel to California and Hawaii since September 2001 is a positive sign for the Region's tourism sector. However, domestic and international visitor counts remained down about 15 percent during December 2001 compared with year-ago levels.

Roughly 20 percent of the Region's insured community institutions are headquartered in MSAs with relatively

[7] For each of these MSAs, the share of local employment in the tourism industry is at least 10 percent more than the national average.
[8] *Smith Travel Research* reports RevPAR data.

high dependence on tourism employment. Median holdings of CRE and commercial and industrial loans at these institutions exceeded the median for all other MSAs in the nation[9] as of year-end 2001. These concentrations could increase institutions' vulnerability to deterioration in CRE markets or depressed business activity resulting from the tourism sector slowdown. In addition, de novos (institutions chartered within the past three years) represent a disproportionately high share of institutions in these tourism-exposed markets, and they may be more prone to deterioration or failure during an economic downturn.[10]

San Francisco Region Staff

[9] This analysis excludes the eight tourism-exposed MSAs in the San Francisco Region and the five other MSAs in the nation that rely heavily on tourism (Orlando, FL; Miami, FL; Daytona Beach, FL; Santa Fe, NM; and Dover, DE), and all rural areas.

[10] See 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,* Washington, DC: 1997, for a discussion and analysis of the higher failure rate of new banks during an economic downturn.

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