Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 2000

FDIC
DALLAS
REGION

Regional Perspectives

◆ ***A growing imbalance between family incomes and escalating housing prices in the rapidly growing Denver, Boulder, Colorado Springs, and Austin metropolitan statistical areas could pressure affordability and constrain future economic growth.*** *See page 3.*

◆ ***Insured financial institutions in the Dallas Region have experienced a large relative increase in loan volume and a migration into traditionally higher-risk assets, and are facing the potential for heightened levels of credit risk.*** *See page 9.*

◆ ***The Region's insured institutions report an allowance for loan and lease losses that has lagged loan growth, particularly among institutions experiencing the most rapid growth rates.*** *See page 11.*

By the Dallas Region Staff

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion*—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** *See page 14.*

By the Division of Insurance Staff

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REVISION:

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

Regional Perspectives

- **A growing imbalance between family incomes and escalating housing prices in some of the Region's fastest-growing metropolitan statistical areas could pressure affordability and constrain future economic growth.**

- **Insured financial institutions in the Region have experienced a large relative increase in loan volume and a migration into traditionally higher-risk assets and are facing the potential for heightened levels of credit risk, particularly if the economy slows.**

- **The Region's insured institutions report an allowance for loan and lease losses (ALLL) that has lagged loan growth, particularly among institutions experiencing the most rapid growth rates.**

Are Housing Costs Getting Out of Hand?

The booming economy of the 1990s was characterized in the Dallas Region by the rapid rise of many new high-tech industries; robust growth in the financial services sector in tandem with increases in personal wealth and income; burgeoning international trade resulting from the implementation of the North American Free Trade Agreement; and an almost insatiable demand for residential, commercial, and industrial space that drove increasing levels of construction activity. Supporting this economic growth was a substantial in-migration of businesses and residents seeking to benefit from the Region's competitive advantages, including lower housing costs and strong job growth. Table 1 shows that most metropolitan statistical areas (MSAs) in the Dallas Region continued to outperform the nation in employment, personal income, and population growth. Today, however, these competitive advantages have eroded over time, caused by the same rapid growth that made the Dallas Region boom initially, and now threaten to constrain future growth in some areas. In particular, the rapid increase in housing costs in a few MSAs is creating concern among local officials and residents about housing affordability and economic growth.

Table 1

Many of the Dallas Region MSAs Outperformed the United States (Average Annual Growth Rate 1994 through 1999)

MSA	Employment Growth	Personal Income Growth	Population Growth
Albuquerque	2.97	6.02	1.28
Austin–San Marcos	5.73	9.47	3.51
Boulder–Longmont	4.07	8.40	1.94
Colorado Springs	5.27	8.17	2.39
Dallas	4.38	8.35	2.04
Denver	3.87	7.98	1.98
Fort Worth	3.80	6.85	2.15
Houston	3.35	7.17	1.91
Oklahoma City	2.90	4.97	0.87
San Antonio	3.55	6.83	1.83
Santa Fe	1.73	6.08	(11.16)
Tulsa	2.95	5.35	1.07
United States	**2.57**	**5.63**	**0.94**

Sources: RFA/Economy.com; Bureau of Labor Statistics (Employment Growth); Bureau of Economic Analysis (Personal Income Growth); Census Bureau (Population Growth)

The relationship between employment growth and home appreciation values reflects the strength of individual housing markets. We examined 12 MSAs in the Dallas Region over a five-year period (1995–2000). A strong positive correlation exists between employment growth and rising home prices[1] (see Chart 1).

The MSAs of **Austin–San Marcos, Boulder–Longmont, Colorado Springs,** and **Denver** were among the leaders in employment growth and home price appreciation and are the focus of this section as we explore whether housing costs are indeed getting out of hand. We will look first at the factors that drive housing demand and supply and determine housing prices.

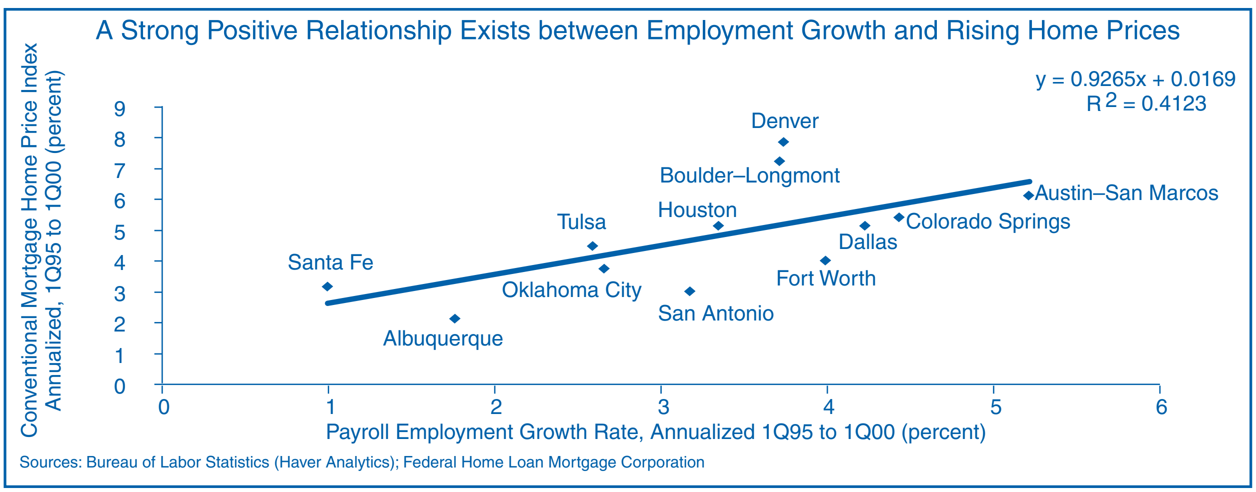
Factors Influencing Housing Demand

The demand for housing is strongly influenced by at least three factors: (1) demographic shifts (population growth, net migration, and the expansion and contraction of households); (2) rising and falling employment; and (3) wealth and income. These factors, interacting with changes in the supply of housing and economic conditions (e.g., interest rates), influence the pace of housing construction, and ultimately home prices.

New housing demand is fueled by population growth, particularly households migrating directly into the area. All four MSAs were among the fastest-growing in the United States during the 1990s. Austin–San Marcos, ranked sixth in the nation in population growth, grew at an annual rate of 3.4 percent, followed by Colorado Springs (18th) with an annual growth rate of 2.6 percent. Denver (34th) and Boulder–Longmont (38th) each posted annual growth rates of 2.2 percent. In comparison, U.S. population growth averaged 0.9 percent annually throughout the 1990s. The Austin–San Marcos MSA added nearly 300,000 new residents during the 1990s, and the combined MSAs of Denver, Boulder–Longmont, and Colorado Springs added over half a million residents.[2]

Net domestic in-migration accounted for much of this population growth (see Chart 2, next page) and represented 42 to 57 percent of the total gains in population experienced by these MSAs from 1991 through 1999.[3] Population growth generated by natural increase (births minus deaths) does not necessarily lead to immediate demands for new housing units. However, significant increases in domestic in-migration will likely strengthen demand for housing in the short term, as these households must establish new residences.

CHART 1



[1] The following linear regression model developed by the Dallas Region office was estimated:
$Y = \exists_0 + \exists_1 X_1 1_{+ ,_I}$, where Y is the dependent variable Conventional Mortgage Home Price, X_1 is the independent variable Payroll Employment Growth Rate (MSA), $\exists_0$ and $\exists_1$ are unknown parameters, and $,_I$ is the error term. This model proved to be statistically significant, with the independent variable explaining 41 percent (R^2) of the variation in the dependent variable. The model home price appreciation can be calculated by manipulating the equation Y = 0.9265x + 0.0169.

[2] Texas A&M Real Estate Center, http://recenter.tamu.edu/data/.

[3] Ibid.

CHART 2

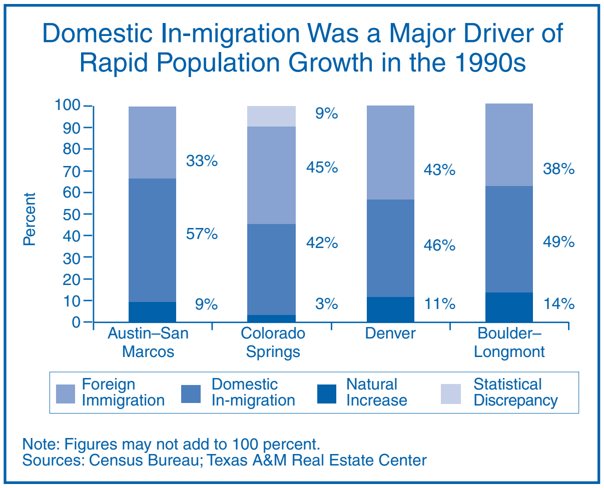
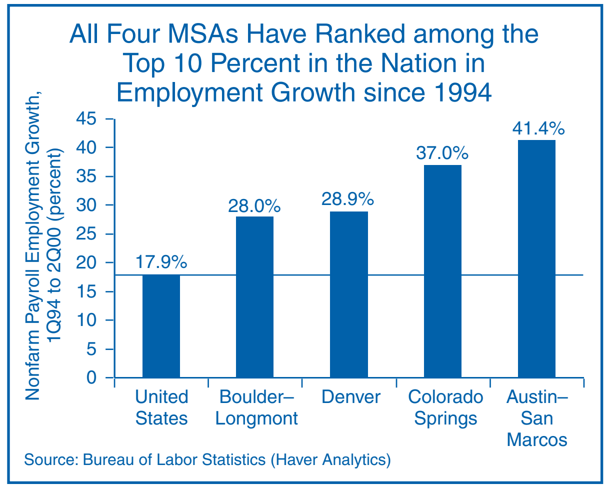


CHART 3



Attracting these new migrants were strong underlying economies characterized by rapid job growth, low unemployment rates, and high median family incomes. The four MSAs ranked among the top 10 percent of more than 300 U.S. MSAs in nonfarm employment growth since 1994 (see Chart 3). Moreover, they have experienced very low levels of unemployment—from 2.1 percent to 3.3 percent as of July 2000—compared with the U.S. unemployment rate of 4 percent.[4] Strong job growth and low unemployment are two major reasons why a large influx of new residents moved to these MSAs during the 1990s. The in-migration of new residents created an immediate demand for new housing as opposed to population growth generated by natural increase alone.

A key similarity among the four MSAs is their strong reliance on high-tech industries (see third quarter 2000 ***Dallas Regional Perspectives***). Households in these MSAs also share an above-average reliance on stock market gains (often used to finance home purchases), another reason why housing demand has performed so strongly in these markets. According to an article written by ***RFA/Economy.com's*** chief economist Mark Zandi entitled "Judging Regional Economies," differences in regional economic performance can be explained, in part, by the "new economy"; however, downside risks also exist in these MSAs, as described in the following quote:

> *Those regional economies with large and thriving high-tech industries are thus the regional economies that are reaping the largest gains in income and wealth. Colorado, California, Massachusetts, Minnesota, Texas, Utah and Washington are the prototypical new regional economies…[however] the high-flying new regional economies may ultimately price themselves out of the new economy—witness …the spiking house price gains in the Bay Area of California or in New York…* [5]

In addition, a ***U.S. Department of Housing and Urban Development*** report entitled "State of the Cities 2000" found that while the technology-driven expansion has raised wages, the resulting booming economy has also caused home prices to rise at twice the rate of inflation over the 1997–1999 period.[6]

In addition to demographic and employment trends, housing demand is also heavily influenced by household income patterns, which have implications for the quantity and quality of housing that households can afford. Two sources of data are indicative of households' ability to afford housing: per capita personal income and median family income. Once again, all four MSAs exhibited more rapid rates of per capita personal and median family income growth than the national averages (see Chart 4, next page). The demand for housing during the past decade clearly has been influenced by the strong gains in income.

[4] U.S. Bureau of Labor Statistics.

[5] Zandi, Mark. July 19, 2000. Judging Regional Economies. RFA/Economy.com, http://dismal.com/thoughts/th_mz_071900.asp.

[6] "State of the Cities 2000," p. viii, U.S. Department of Housing and Urban Development, http://www.huduser.org/publications/pdf/socrpt.pdf.

CHART 4

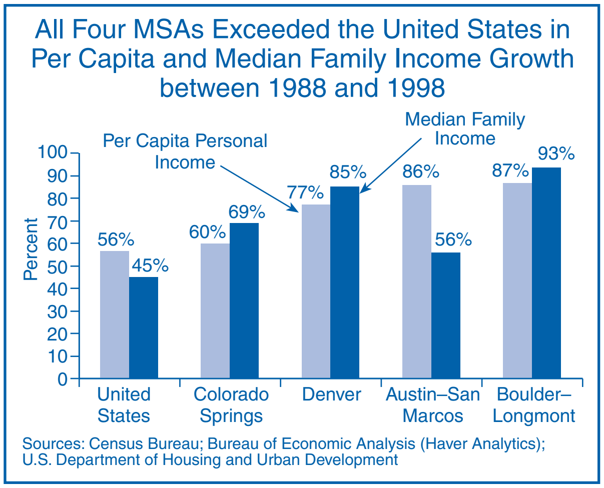
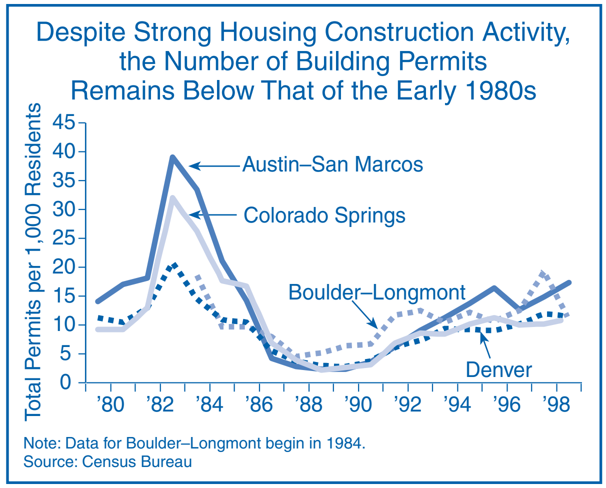


CHART 5



Factors Influencing Housing Supply

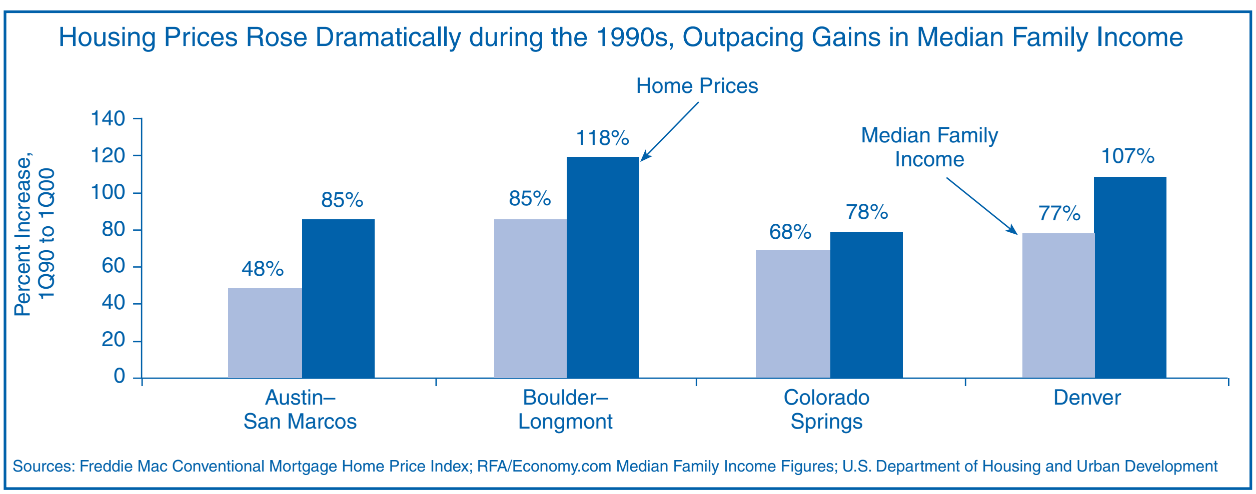
New residential construction, reflected by building permits issued, is cyclical in nature, and is generally correlated with underlying economic conditions in each MSA. Although building permits are not a perfect indicator of additions to the housing stock, they are a good indicator of changes in housing supply.

The strong expansion in residential homebuilding in the 1990s (particularly in recent years) is prompting concerns about overbuilding in these markets, drawing comparisons with the real estate crisis of the mid-1980s. However, residential building permit data do not support this argument. Chart 5 shows the trend in residential building permits per 1,000 residents for the four MSAs during the past two decades. Even though total permits at the close of the decade were above the lows of the late 1980s and early 1990s, the number remains far below the overbuilt highs of the early 1980s, which were one contributing factor to the real estate crisis of the 1990s.

Housing Affordability Decreases as Housing Costs Outpace Median Family Income

Housing costs in these four MSAs have outpaced gains in median family income (see Chart 6). Consequently, affordability has suffered in these areas, particularly in recent years. The Housing Opportunity Index compiled by the ***National Association of Homebuilders*** (see Table 2, next page) shows the four MSAs ranked between 123rd and 134th in housing affordability out of 173 MSAs[7] surveyed in second quarter 2000. Families

CHART 6



[7] The MSAs were ranked from most affordable (1) to least affordable (173).

earning the median income in these MSAs could afford only slightly more than half of all homes available for sale, well below the percentage for other U.S. families.[8]

The acceleration of housing prices in recent years has been also the result of spiraling costs for land and building materials and the growing scarcity of skilled construction workers. Complicated and lengthy development procedures (e.g., delays in the permitting process, local government regulations, zoning, inspections, etc.), in addition to rising fees and building restrictions, are also driving up construction costs. The economic boom of the 1990s, which has contributed to the high cost of housing, is pushing residents to the fringes of these four MSAs, resulting in urban sprawl and exacerbating traffic congestion.

Despite several years of strong gains in homebuilding activity, all four MSAs continue to experience strong housing demand in excess of supply, causing an increase in housing prices that has accelerated in recent years. We now examine more closely what factors have contributed to the escalation in housing prices in each of these MSAs.

Austin–San Marcos MSA

A thriving economy caused largely by an expanding high-tech industry and influx of new residents (approximately 2,000 each month) is contributing to a hot housing market. Employment growth during the 1990s helped absorb much of the excess supply of housing from the 1980s. The tremendous run-up in stock prices and the addition of many high-paying jobs in the second half of the 1990s have contributed mightily to the rapid appreciation of new and existing homes, particularly expensive homes for the *nouveau riche.*

Home prices have risen faster in the past two years. The median price of a new home in Austin–San Marcos rose 7.3 percent in 1999, to $126,500. However, by June 2000, the median price was $151,100, an increase of 18.2 percent from a year earlier. As recently as May 1997, Austin–San Marcos had more than 6,000 homes listed for sale, or a 6.8-month supply. In February 2000, however, there were slightly fewer than 3,000 active listings, or a two-month supply.[9] The average single-family home in the MSA is on the market only 30 to 35 days before it is sold.

At the same time, residential building permits in the Austin–San Marcos MSA (January through July 2000) registered double-digit gains in both single-family and multifamily permits, and are on pace to surpass last year's peak in homebuilding activity during this expansion. Yet the inventory of new and existing homes remains very low because strong job growth and rapid net in-migration have homebuilders struggling to keep up. The results are rising home prices and lengthening homebuilding schedules.

Table 2

Four Dallas Region MSAs Are Among the Least Affordable Housing Markets in the Nation

Metro Area	HOI* 2000 Q2 Share of Homes Affordable for Median Income	2000 Median Family Income (000s)	2000 Q2 Median Sales Price (000s)	2000 Q2 Affordability Rank National
Austin–San Marcos	54.0	58.9	155	123
Boulder–Longmont	50.9	74.0	216	132
Colorado Springs	50.0	51.3	152	134
Denver	51.3	62.1	180	131
United States	**58.4**	**50.2**	**147**	**NA**

* The Housing Opportunity Index (HOI) is based on the median family income, interest rates, and the price distributions of homes sold in each market in second quarter 2000. A total of 173 metropolitan areas were ranked.
Sources: National Association of Home Builders; First American Real Estate Solutions; U.S. Department of Housing and Urban Development

[8] Housing Opportunity Index: Second Quarter 2000, National Association of Home Builders, http://www.nahb.com/facts/hoi/2000_2q/regional_alpha.htm.
[9] Texas A&M Real Estate Center, http://recenter.tamu.edu/data/.

Denver MSA

Denver MSA job growth remains robust, expanding at a rate of 3.3 percent for the 12-month period ending June 2000.[10] Job and population growth is outpacing housing production, driving housing costs upward. The price of a single-family home in Denver appreciated an average of 12.1 percent in 1999. The average price of an existing single-family home in the Denver MSA rose to a record $250,000 in August 2000, up 19.3 percent from a year earlier.[11] Meanwhile, the median price—believed to be a better measure of affordability—broke the $200,000 barrier for the first time. Homes priced under $200,000 are increasingly hard to find. Resales are spending an average of 38 days on the market in 2000, compared with a 44-day average in 1999. Permits for new, single-family homes for the first seven months of 2000 dropped 13.4 percent from the same period a year ago.[12] Demand for housing is strong, and builders are unable to replenish the existing stock at a rate that is commensurate with demand.

Boulder–Longmont MSA

Employment figures for Boulder–Longmont reveal a 3 percent growth rate through the first seven months of 2000. The MSA's unemployment rate of 2.6 percent in July 2000 was well below the national rate,[13] requiring a steady influx of in-migrants to sustain its strong employment growth. However, strong employment conditions, coupled with rising land and housing costs, are eroding the cost advantage that local residents enjoyed at the beginning of the 1990s. According to the ***Federal Home Loan Mortgage Corporation's*** (FHLMC) repeat-purchase house price index, the price of existing homes in Boulder–Longmont increased more than 15 percent in second quarter 2000 from a year ago.[14]

Robust economic growth is creating a strong demand for housing. This demand, in addition to the current shortfall in supply, is causing home prices to soar. Severe growth pressures (e.g., traffic congestion, demands on the infrastructure) are mobilizing the public to demand that local governments restrict further development. Tight labor markets, the shortage of affordable housing, and mounting antigrowth sentiment may limit expansion and constrain future growth.

Colorado Springs MSA

High-tech manufacturing, national defense, tourism, and a large cadre of military retirees drive the Colorado Springs economy. This MSA is experiencing moderate job growth (3.2 percent, January through July 2000),[15] very low levels of unemployment, relatively strong in-migration, and rapid income growth. In recent years, Colorado Springs has attracted a large number of businesses because its cost of doing business is lower than the neighboring Denver and Boulder–Longmont MSAs. A study conducted by ***Coldwell Banker*** ranked it as the most affordable housing market in Colorado.[16] Nonetheless, growth pressures, such as urban sprawl and congestion, are emerging problems.

According to the ***Colorado Legislative Council,*** an advisory council to the state legislature, Colorado Springs continues to enjoy a "sustained real estate boom."[17] According to the FHLMC repeat-purchase house price index, the price of existing homes in Colorado Springs increased 7.4 percent during second quarter 2000 from a year ago.[18] However, home prices have not accelerated as rapidly in Colorado Springs as they have in neighboring Denver and Boulder–Longmont. One reason may be that although employment growth has been strong in all three MSAs, median family income has not grown as rapidly in Colorado Springs.

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[10] Colorado Department of Labor and Employment, http://lmi.cdle.state.co.us/ali/00dnvrws.htm.

[11] Denver Board of REALTORS and Denver Metropolitan Commercial Association of REALTORS.

[12] U.S. Census Bureau, http://www.census.gov/const/C40/Table3/t3yu0007.txt.

[13] Colorado Department of Labor and Employment, http://lmi.cdle.state.co.us/ali/00bldrws.htm.

[14] Federal Home Loan Mortgage Corporation, http://www.freddiemac.com/finance/cmhpi/current/excel/msas.xls.

[15] Colorado Department of Labor and Employment, http://lmi.cdle.state.co.us/ali/00spgsws.htm.

[16] The 2000 Coldwell Banker Home Price Comparison Index is based on a single-family dwelling model with approximately 2,200 sq. ft., 4 bedrooms, 2 1/2 baths, family room (or equivalent), and 2-car garage. Surveyed homes and neighborhoods are typical for corporate middle-management transferees. http://www.coldwellbanker.com/FRAMES/TopFrame.asp?Item=hpci.

[17] Colorado Legislative Council. "Colorado Economic Chronicle" August 2000, p. 4, http://www.state.co.us/gov_dir/leg_dir/lcs/chronicle/2000/Aug00/cr0800.PDF.

[18] Federal Home Loan Mortgage Corporation, http://www.freddiemac.com/finance/cmhpi/current/excel/msas.xls.

Summary

Housing construction activity in the Dallas Region likely will remain strong into 2001, although off slightly from its 1999 peak. The decline since 1999 can be attributed to a softening in demand for homes, albeit from already high levels; comparatively higher mortgage rates; and weaker growth in capital gains. One of the most significant downsides to the Region's booming economy is that, at this stage of the cycle, incomes are failing to keep up with escalating housing prices.

Several supply constraints have contributed to this growing gap between income and housing prices. Lack of skilled construction labor, a shortage of developable lots, and increasing antigrowth sentiment are major impediments to new home construction. The tight housing market is putting a squeeze on potential homebuyers and renters as they face rising home prices and rents resulting from the limited supply of housing. This trend is making it more difficult for employers to attract entry- and mid-level workers. Housing availability is a key factor in the continued economic strength of these MSAs.

Throughout the 1990s, housing production in these MSAs has played catch-up, with demand for housing stimulated largely by strong job growth. Economic theory suggests that when housing grows scarce and less affordable, households will respond by deferring homeownership, by "doubling and tripling up" occupancy, or by commuting longer distances from where housing may be more affordable. Short of an economic slowdown in these areas, demand for housing is likely to remain strong, with home prices continuing to rise rapidly. Unless mortgage interest rates, which have come down 50 basis points since peaking at 8.52 percent in May 2000 (monthly average),[19] start to climb again, healthy employment conditions and favorable consumer attitudes will continue to generate robust housing demand. In the long term, the Austin–San Marcos, Boulder–Longmont, Colorado Springs, and Denver MSAs must try to balance continued strong economic growth with intensifying antigrowth sentiment.

[19] FHLMC, Federal Reserve Board (Haver Analytics).

Dallas Region Insured Institutions Continue to "Loan Up"

Insured financial institutions in the Dallas Region have increased their relative lending volume to the highest level in the past 14 years. This loan growth has risen rapidly over the most recent 2½-year period. The Region's insured institutions reported a loan-to-asset (LTA) ratio as low as 43.1 percent for year-end 1990,[20] compared with 60.2 percent as of June 30, 2000. This section examines what factors have contributed to the increase in loan levels, looks at insured institutions experiencing the most rapid rate of loan growth, and considers the implications for banks and thrifts from these shifts in asset composition. Emerging risks include the potential for increasing levels of credit risk, expanding loan exposure at a time when the economy could be slowing, and an allowance for loan and lease losses (ALLL) that has lagged the Region's rapid level of loan growth and that is already the lowest among all FDIC Regions.

Factors contributing to why Dallas Region banks and thrifts have increased loan levels include relatively low LTA levels and a strong demand for loans generated by the robust Dallas Region economy. A discussion of the recent trend in loan growth is not complete, however, without a look back at why the Region's insured institutions have held a greater proportion of securities than loans since the late 1980s.

Background

Dallas Region insured institutions have placed greater emphasis on securities than have banks and thrifts elsewhere in the country since the banking crisis of the late 1980s and early 1990s. Reasons may stem from the memories of large credit losses of the 1980s,[21] favorable funding sources,[22] or both. In any case, Dallas Region insured institutions have performed well compared with banks and thrifts elsewhere in the country despite this difference in asset allocation.

[20] Excludes NationsBank—Texas, which consolidated with NationsBank in June 1998.

[21] See *Regional Outlook,* fourth quarter 1999, pp. 24–25.

[22] See *Regional Outlook,* second quarter 2000, p. 9.

The Dallas Region's ability to hold a high percentage of securities and maintain profitability was helped by a favorable interest rate environment. However, the shape of the yield curve from 1997 through 1998 provided incentives for insured institutions to extend maturity distributions in order to attain higher yields. For example, mortgage-backed securities (MBS) with maturities in excess of 15 years held by the Region's insured institutions stood at 63 percent of total MBS as of year-end 1999, up from 40 percent two years prior. In comparison, 48 percent of MBS portfolios nationwide were held in long-term securities, up from 33 percent over the same period. This strategy was successful while interest rates were steady; however, the extended maturity distribution also elevated the potential for greater interest rate and market risk.

In fact, beginning June 30, 1999, the Federal Reserve began raising short-term interest rates at the same time the U.S. Treasury was buying back longer-term bonds.[23] The net effect was generally rising interest rates and a yield curve that inverted at the three-month mark. Banks holding large MBS portfolios with extended maturities saw the value of these securities begin to fall, and the overall yield was sub par, particularly compared with loans.[24]

The Region's Banks and Thrifts Have Increased Loan Levels

In an environment in which loan demand was strong and a strategy of holding a large share of securities was less effective because of rising interest rates, many insured institutions began increasing loan levels to maintain profitability. Historically, loans have returned higher yields than securities. As shown in Table 3, assets held by Dallas Region insured institutions[25] grew 22 percent between year-end 1997 and June 30, 2000, a slightly higher rate than for the nation. At the same time, loan volume increased 33 percent for the Region, compared with 23 percent for the nation. While the percentage of assets dedicated to loans increased for both the Region and the nation, the Region's loan portfolio has grown more rapidly.

Moreover, the types of loans showing the greatest increases include real estate construction (95 percent), commercial real estate (54 percent), and commercial and industrial (33 percent), all of which historically exhibit higher levels of risk than many other loan categories.

In addition to the shift into traditionally higher-risk assets, Table 3 shows the difference between insured institutions headquartered in metropolitan and rural areas. In general, insured institutions' loan portfolios in metro areas grew more rapidly than did portfolios of

TABLE 3

LOAN GROWTH SHOWS RAPID SHIFT TO HISTORICALLY MORE RISKY LOANS AMONG INSURED INSTITUTIONS (YEAR-END 1997 TO JUNE 30, 2000)

	UNITED STATES	DALLAS REGION		
	ALL INSTITUTIONS (%)	ALL INSTITUTIONS (%)	METRO (%)	RURAL (%)
TOTAL ASSETS	18.6	22.4	25.0	10.8
TOTAL LOANS	22.6	33.4	35.6	22.6
RE CONSTRUCTION	68.2	94.7	97.4	73.3
COMMERCIAL RE	29.4	53.5	56.1	42.0
CONSUMER	3.6	17.6	19.3	8.0
C&I	31.4	32.9	34.0	25.2
SINGLE-FAMILY AND 1 TO 4 RESIDENTIAL	19.4	23.1	23.0	23.4

RE = REAL ESTATE; C&I = COMMERCIAL AND INDUSTRIAL
SOURCE: BANK AND THRIFT CALL REPORTS

[23] Ibid.
[24] Ibid. Chart 7 shows how a rising interest rate environment affected securities available for sale.
[25] For insured institutions in the Dallas Region as of June 30, 2000, merger adjusted.

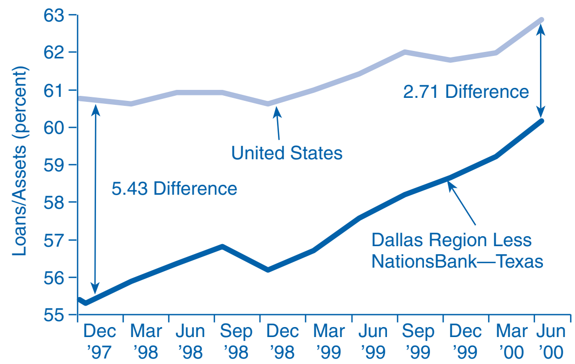
rural-based institutions for all types of loans except single-family and 1- to 4-family residential loans. Particularly noteworthy is the fact that insured institutions in metropolitan areas grew real estate construction loans 24 percentage points faster than did those in rural areas. Metro-based institutions also increased commercial real estate and consumer loans more rapidly than did rural-based institutions.

Dallas Region insured institutions were able to increase loan levels in part because they were less "loaned up" than institutions elsewhere in the country. They were therefore able to grow loan portfolios without the heavy use of noncore funds experienced elsewhere. In fact, deposits fell slightly for the four quarters ending June 30, 2000, and other borrowed funds increased by only 2 percentage points (as a percentage of total assets).

The net result is that the LTA ratio for the Region's insured institutions is increasing faster than that of the nation, and the historical gap between the LTA ratio for the Region and the nation is narrowing (see Chart 7).

CHART 7

Dallas Region Institutions Continue to "Loan Up"



Source: Bank and Thrift Call Reports

Dallas Region's Robust Economic Expansion Fuels Loan Growth

A strong regional economy also contributed to the increased loan volume among the Region's banks and thrifts. The Region has outpaced the nation in gross output, employment, and population growth. The gross regional product growth from 1997 through 1999 averaged 6.1 percent,[26] compared with the nation's 4.3 percent gross domestic product growth. The Region's average employment growth rate was 3.4 percent, outpacing the U.S. average of 2.5 percent. The Region reported a 1.6 percent population growth, compared with the U.S. average of 0.9 percent. These indicators illustrate the Region's economic vibrancy, which likely translates into an increased demand for loans.

Institutions with High Levels of Loan Growth Show Distinct Trends

To compare their vulnerability with that of other institutions, we analyzed banks and thrifts with assets less than $1 billion that experienced the greatest increases in loan volume from December 31, 1997, through June 30, 2000. Interest rates began to rise during this period, and the securities component of the asset portfolio continued to decline to a level closer to the U.S. average. After adjusting for mergers and acquisitions and removing de novo institutions,[27] we ranked the institutions by loan growth rate. We then examined the insured institutions in the top 25 percent and compared their characteristics with those of other banks and thrifts in the Region and the nation.

The 324 banks and thrifts[28] in the top 25 percent exhibit very distinct trends. Changes after June 30, 1999—when short-term interest rates began their 175-basis-point climb—are particularly enlightening. This group's loan volume grew much faster (31.9 percent for the four quarters ending June 30, 2000, compared with 10.6 percent for other institutions in the Dallas Region[29] and 11.2 percent for institutions nationwide). Of particular interest is the increase in real estate construction loans (46 percent), commercial real estate loans (39 percent), and commercial and industrial loans (32 percent), categories that have been historically more risky. The shift into loans and traditionally higher-risk loan categories has contributed to an increase in the group's net interest margin. In contrast, insured institutions in the nation have experienced margin compression (see Table 4, next page). However, the ALLL-to-total-loans ratio declined to 1.11 percent for the institutions exhibiting the most

[26] Average growth rate is an average of growth rates for 1997, 1998, and 1999.

[27] Banks established after December 31, 1997, are not included for two reasons. First, de novo institutions tend to exhibit rapid loan growth, which may distort the analysis. Second, these institutions did not report loans or assets prior to year-end 1997.

[28] Combined assets of $48 billion.

[29] Less than $1 billion in assets.

rapid loan growth rates, significantly lower than the ratio for either the Region or the nation.

The results of our analysis reflect the trends relating to institutions doing business in metro and rural areas. Banks and thrifts in the high-loan-growth group tended to be in the Region's metro areas, and these institutions increased lending significantly faster than did institutions in rural areas—35 percent for metro versus 26 percent for rural. As shown in Table 4, the metro high-loan-growth group also holds a higher percentage of loans and the highest net interest margin of all institutions in the Region or nation as of June 30, 2000. Banks and thrifts with a significant allocation[30] of commercial and industrial loans were by far the largest subgroup within this high-loan-growth group, representing almost 60 percent of all insured institutions in the analysis.

Implications of a Significant Shift in Asset Composition

Previously, banks and thrifts were willing to accept interest rate and market rate risk because the interest rate environment was stable and funding costs were low. As interest rates increased and (realized and unrealized) securities losses mounted, insured institutions began shifting asset composition away from securities and into loans, a shift that could increase the level of credit risk. As a result, the loan review and credit administration functions have become increasingly important.

Expanding Loan Volumes May Become Risky if the Economy Slows

The Dallas Region has benefited from extraordinary economic growth. The demand for lending also has increased, providing an incentive for banks and thrifts to make loans despite intense competition from bank and nonbank sources. Should the economy slow, however, competition for the best credits may increase as demand falls overall. David Stumpf, an analyst with ***A.G. Edwards,*** wrote, "A sluggish economy not only would diminish loan demand, but also could put additional pressure on credit quality."[31] In addition, the Region's rising share of loans has implications for the ALLL.

The ALLL Has Not Kept Pace with Loan Levels

Charge-offs and past-due rates are at historically low levels for the nation and the Region. However, a lesson from past economic downturns is that today's loans could become tomorrow's problems.

Table 4

Institutions Experiencing High Loan Growth Maintain Net Interest Margin and Return on Assets

	Loan-to-Asset Ratio		Net Interest Margin[1]		Return on Asset[1]		ALLL-to-Total Loans	
	Jun-99	Jun-00	Jun-99	Jun-00	Jun-99	Jun-00	Jun-99	Jun-00
High-Loan-Growth Group	59	64	4.68	4.85	1.17	1.18	1.13	1.11
High Loan—Metro	60	65	4.79	4.94	1.16	1.19	1.15	1.14
High Loan—Rural	58	62	4.48	4.68	1.18	1.15	1.10	1.07
Dallas Region[2]	52	55	4.46	4.66	1.24	1.32	1.35	1.31
United States	61	63	3.88	3.82	1.24	1.14	1.60	1.53

[1]Income statement ratios are for the six-month periods ending June 30, 1999, and June 30, 2000, annualized.
[2]Includes all Dallas Region institutions except (a) those with more than $1 billion in assets and (b) those in the high-loan-growth group.
ALLL = allowance for loan and lease losses
Source: Bank and Thrift Call Reports

[30] Significant allocation is defined as institutions with more than 25 percent of total loans in the following categories: commercial and industrial, real estate construction, multifamily, and commercial real estate lending.
[31] Stumpf, David. September 11, 2000. Credit Concerns Succeed Rate Fears on Wall Street. *American Banker,* p. 32.

The Dallas Region is indeed "loaning up." The 324 banks and thrifts in our analysis are increasing loan exposure at twice the rate of other institutions in the Region and the nation. However, insured institutions in the Dallas Region continue to report the lowest ALLL-to-total-loans ratio of any FDIC Region. Moreover, the Region's fastest-growing banks and thrifts report an ALLL ratio that has been declining and is lower than that of other insured institutions in the Region. Should the economy weaken and loans begin to deteriorate, many institutions may find themselves without adequate buffers against future losses.

Dallas Region Staff

Emerging Risks in an Aging Economic Expansion

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

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

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

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

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

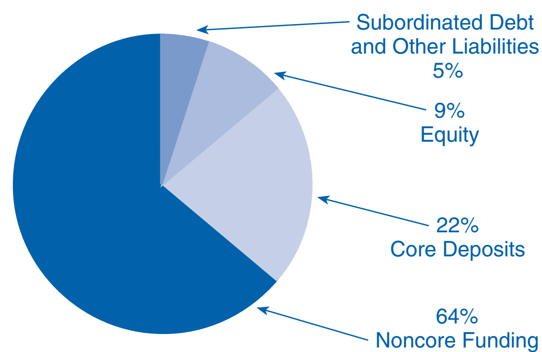
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting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

Funding Patterns Heighten Liquidity Concerns

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

Chart 1

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



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

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

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

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

Increasing Levels of Interest Rate Risk Challenge Some Institutions

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

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

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

Chart 2

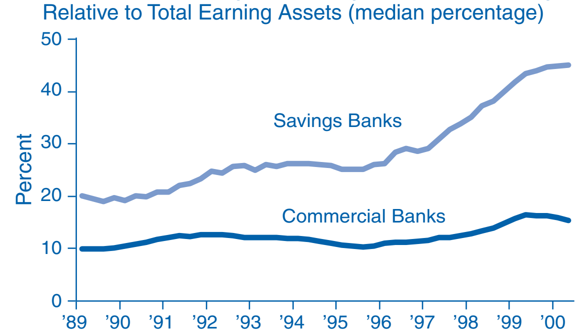
Subprime Lenders' Growing Dependence on Noncore Funding Strains Liquidity

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

Chart 3

Growing Concentration in Long-Term Assets Elevates Interest Rate Risk

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



Source: Bank Call Reports, excluding Thrift Financial Report filers

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

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

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

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

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

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

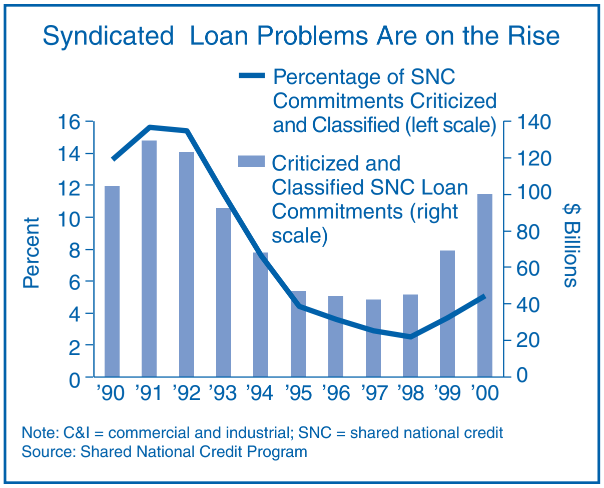
The Rising Level of Problem Business Loans Is Centered in Large Banks

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

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

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

CHART 4



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

Industry Sector Weaknesses

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

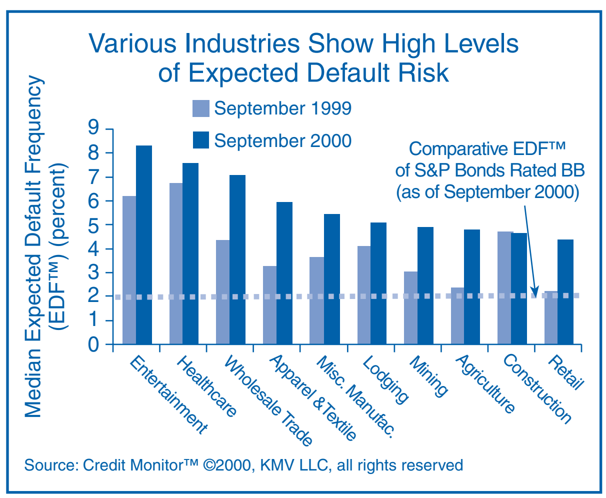
KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

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

Rising Corporate Debt Burdens

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

CHART 5



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

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

Seasoning of 1997–1998 Vintage Loans

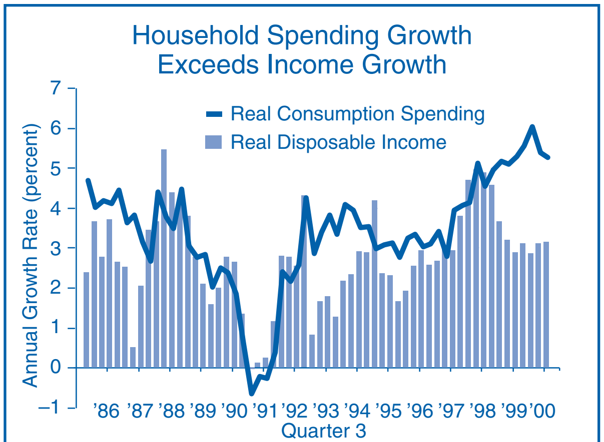
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4]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

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

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

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

CHART 6



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

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

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

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

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

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

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

Construction and Development Loan Growth Is Accelerating

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

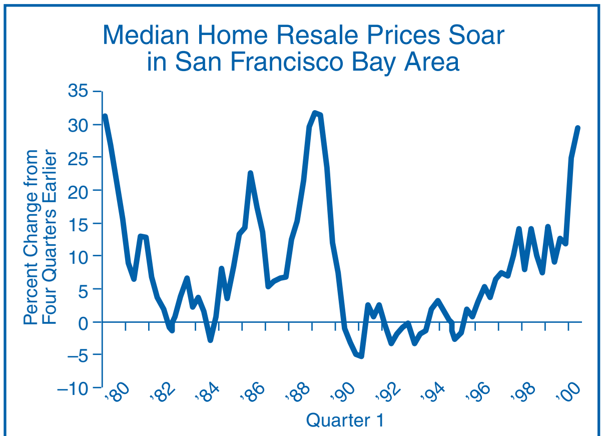
Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

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

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

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

CHART 7



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

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

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

TABLE 1

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

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

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

Farm Sector Challenges Continue

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

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

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

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

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

Summary

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

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

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