

An Update on Emerging Issues in Banking

Housing Market Strengths and Risks

March 28, 2002

A report released today in the FDIC's Regional Outlook evaluates changes in mortgage underwriting during the last expansion, and the likelihood that weakening home price growth could adversely affect home borrowers and lenders. The authors do not expect adverse mortgage performance trends to threaten the capital or earnings of the vast majority of FDIC-insured institutions. The report concludes, however, that looser lending standards during the 1990s may have heightened lenders' overall risk compared to previous business cycles, and that a few previously booming locations, such as the San Francisco Bay Area¹, are exhibiting heightened home price risk.

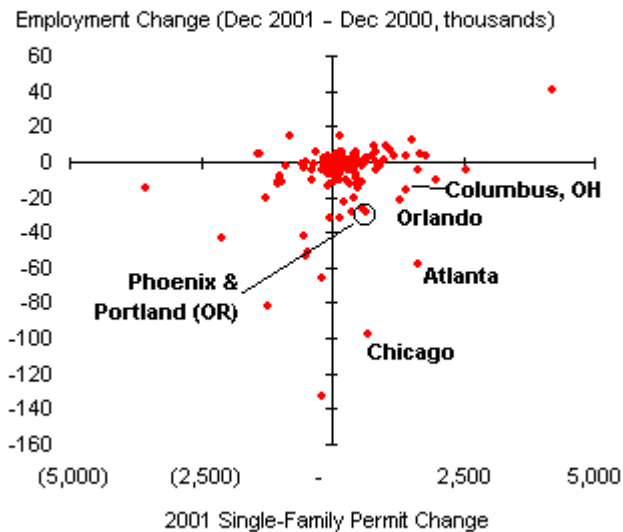
Nonconstruction residential mortgages historically have been one of the lowest credit-risk loan types for FDIC-insured institutions. Past experience probably understates credit risks during this cycle because the mortgage lending business has changed since the last recession. Chief among the changes are robust mortgage market competition, which has contributed to narrower collateral margins (higher initial leverage); increased reliance on non-recession-tested automated underwriting; and expanded involvement in the subprime mortgage market (discussed in a prior FYI). Credit quality indicators for insured institution mortgage loan portfolios have shown only preliminary signs of weakness thus far, although continued strong mortgage origination activity in 2001 may have masked (in the aggregate) developing credit problems for more seasoned mortgage loans.

Construction and Development Lending Risks May Be Elevated in Some MSAs

Historically, lending to finance housing construction is riskier than mortgage lending on existing structures. If markets with an oversupply of housing experience weaker economic performance, insured institutions with significant lending exposures to residential real estate development may be vulnerable to weakening credit quality. Last year, some large markets displayed signs that residential construction activity was accelerating as local economic conditions were deteriorating, especially **Atlanta** (see Chart 1).

Chart 1

**Residential Construction Activity Accelerated in 2001
Despite Declining Employment in Some MSAs**



Source: Bureau of Labor Statistics, U.S. Census Bureau (Haver Analytics)

Adverse Home Price Trends Remain Isolated

The risk of significant downward corrections in home prices does not appear geographically widespread. However, a handful of MSAs that have seen several years of rapid home price appreciation and declining affordability are now experiencing a softening in economic conditions (see table 1). Home prices and insured institutions lending in these markets may be adversely affected should these weaker conditions persist.

Problems likely would be more pronounced for households that rely on multiple incomes to meet mortgage payments or those with limited financial resources. In addition, increased underwriting of high loan-to-value and subprime mortgages during the past decade could aggravate any rise in delinquencies. Foreclosure risks would be amplified in any markets that see outright declines in home prices during 2002.

As of year-end 2001, the San Francisco Bay Area appeared to demonstrate the greatest likelihood of a significant overall decline in home prices. The area's fourth-quarter, year-ago change in median home prices turned negative for the first time in more than six years, highlighting this risk. Further, a recent analysis from the UC-Berkeley Haas School of Business forecasts that prices in the Bay Area housing market will decline 15 percent overall (30 percent for luxury homes) by year-end, when, according to this analysis, the recession in the local economy is expected to end.²

¹ As considered here, this includes the following MSAs: San Jose, Santa Cruz-Watsonville, San Francisco, Santa Rosa, Oakland,

Salinas, and Vallejo-Fairfield-Napa.

²"Bay Area Housing Market Will Remain Slow," David Goll, East Bay Business Times, January 23, 2002.

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Chart 1

The title of this chart is "Residential Construction Activity Accelerated in 2001 Despite Declining Employment in Some MSAs". It is a scatter plot of dots where the vertical position measures the absolute year-ago change in an MSA's nonfarm employment (in thousands) as of December, 2001, and the horizontal position indicates that MSA's absolute year-ago change in December 2001 year-to-date single-family residential permits. MSAs in the lower right-hand quadrant are those where employment was declining last year, but marginal housing supply was increasing, suggesting a potentially growing imbalance in housing supply. Atlanta is the MSA where this condition was most significant, followed by markets like Phoenix, Portland (OR), and Orlando.

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Table 1

As Recession Evolved, Home Price Appreciation Waned Through 2001 ...Further Deceleration in Growth (or Declines) May Be Possible in 2002

MSAs Ranked by Deceleration in Home Price Index between first quarter and fourth quarter 2001	Annual Percent Changes, OFHEO Home Price Index		
	1998-2000, Average	2001, First Quarter	2001, Fourth Quarter
United States	6.3	9.6	6.9
San Jose CA PMSA	17.7	24.4	0.6
Santa Cruz-Watsonville CA PMSA	16.8	25.7	5.9
San Francisco CA PMSA	16.5	19.4	3.5
Salinas CA MSA	13.7	24.3	9.4
Santa Rosa CA PMSA	14.8	22.7	8.6
Oakland CA PMSA	14.7	22.3	8.2
Austin-San Marcos TX MSA	9.4	15.2	5.0
Merced CA MSA	6.4	24.6	15.7
Jamestown NY MSA	4.9	9.9	1.6
Stockton-Lodi CA MSA	9.0	22.8	14.9
Wheeling WV-OH MSA	4.1	10.8	3.7
Goldsboro NC MSA	4.0	7.9	0.9
Cumberland MD-WV MSA	2.7	8.6	1.8
Lewiston-Auburn ME NECMA	4.2	14.0	7.1
Bangor ME NECMA	3.7	13.2	6.5
Fargo-Moorhead ND-MN MSA	4.0	11.1	4.6
Barnstable-Yarmouth MA NECMA	12.8	17.6	12.5
Pine Bluff AR MSA	2.2	6.6	0.3
Dubuque IA MSA	3.9	8.8	2.5
Boulder-Longmont CO PMSA	10.9	14.6	8.3
Denver CO PMSA	11.1	13.7	7.9
Utica-Rome NY MSA	3.5	14.6	9.1
Vallejo-Fairfield-Napa CA PMSA	11.8	20.0	14.7
Bryan-College Station TX MSA	4.8	11.1	5.8
San Diego CA MSA	11.8	15.6	10.4
San Luis Obispo-Atascadero-Paso Robles CA MSA	11.4	19.2	14.2
Tucson AZ MSA	3.3	8.6	3.6
Jersey City NJ PMSA	8.0	11.1	6.2
Clarksville-Hopkinsville TN-KY MSA	3.3	9.1	4.2
Rapid City SD MSA	6.2	8.9	4.1
La Crosse WI-MN MSA	5.7	7.4	2.6
St. Cloud MN MSA	6.9	10.4	5.7