FYI - An Update on Emerging Issues in Banking

Economic Conditions and Emerging Risks in Banking

November 4, 2003

This paper was provided to the FDIC Board of Directors today as part of "The FDIC Insurance Funds Outlook and Premium Rate Recommendations for the First Semiannual Period of 2004."

With Improving Economy, Concerns Shift to Interest Rates

The two main economic concerns of the past two years, a lack of new jobs and lackluster business investment, finally appear poised to subside. Improved job prospects and more evenly distributed economic growth should further reduce credit risk, while possibly lifting demand in the moribund commercial and industrial loan market. As overall loss rates subside, particularly in the C&I and credit card segments, risks related to rising interest rates may move to the forefront of concern for insured institutions.

A stronger economy will benefit credit quality. However, the higher interest rates that usually accompany an expanding economy could elevate some banks' interest rate risk and cause problems in both the consumer and commercial real estate sectors. For example, rising rates will lead to greater asset extension risks, especially for institutions holding large amounts of mortgage-related assets. Also, some borrowers with limited financial wherewithal, such as subprime customers, or those with adjustable rate mortgages, may see cash flows squeezed by rising debt service payments. In combination with the potential for some weakness in home prices, and thus reduced housing wealth, this exposure to rising interest rates could increase consumer credit risk in select local markets or for certain classes of borrowers. Finally, commercial real estate (CRE) loans, which have thus far performed well despite high vacancy rates and otherwise weak market conditions, may show increased credit risk as interest rates rise.

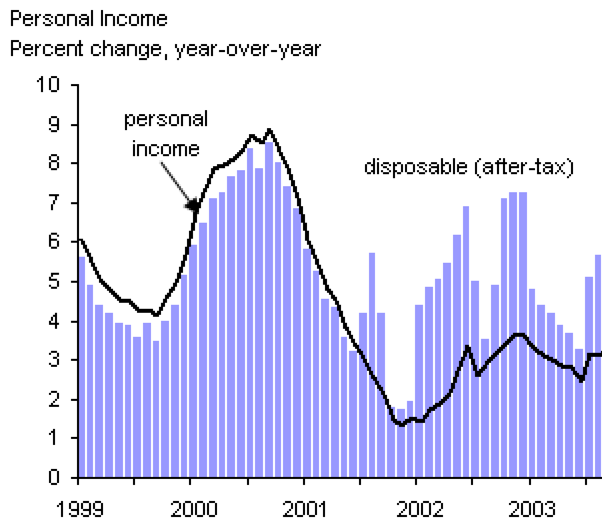
Slow Business Spending and Hiring Set to Improve

The US economy has been expanding since the recession officially ended in November 2001; however, due to rapid labor productivity growth, the overall economy must grow at a faster pace than it had through mid-2003 in order to generate new jobs. This lack of job growth, the so-called "jobless recovery," was the predominant risk facing the economy and insured institutions as of October 2003. Fortunately, following a 7 percent jump in real GDP growth in third quarter 2003, economic growth is anticipated by most professional forecasters to run at an average annual rate of 4 percent through year-end 2004. This pace should be sufficient to finally generate the new jobs thus far missing from the economic expansion.

Absent job growth in recent years, overall economic activity has been supported by proactive and aggressive fiscal and monetary stimulus. Fiscal stimulus has taken the form of direct government expenditures, including transfer payments made under the unemployment insurance program, as well as indirect stimulus through lower tax rates and child tax rebates in 2001 and 2003. Monetary policy stimulus, evident in a negative real federal funds rate in recent quarters, has also helped to support household cash flows by keeping down consumer and mortgage interest payments. Both of these factors have bolstered personal income growth (see Chart 1). Absent additional tax cuts, it is likely that the income-bolstering effects of fiscal stimulus will wane after the tax refund season in 2004. Also, with the eventual increase in overall interest rates, debt service burdens may also rise for some households. Sustained household income and spending growth will depend on the economy's ability to generate solid job growth beyond mid-2004.

Chart 1

Tax Cuts Are Boosting Income Growth For Now, But Sustained Job Gains Are Needed To Support Personal Income Over The Long Haul



Source: BEA

In addition to an imminent turn in the labor market, business investment also appears poised for stronger growth through 2004. Spending on technology gear and software, accounting for roughly half of non-real estate business investment, has been growing since mid-2002. Orders for non-technology manufactured goods have generally been improving since mid-year 2003. Further, the initial estimate of third quarter GDP showed that real non-technology business investment increased in all three major categories—transportation, industrial, and other—even as real technology investment posted its seventh consecutive quarterly advance.

U.S. Reliance on Foreign Capital Could Push Interest Rates Higher

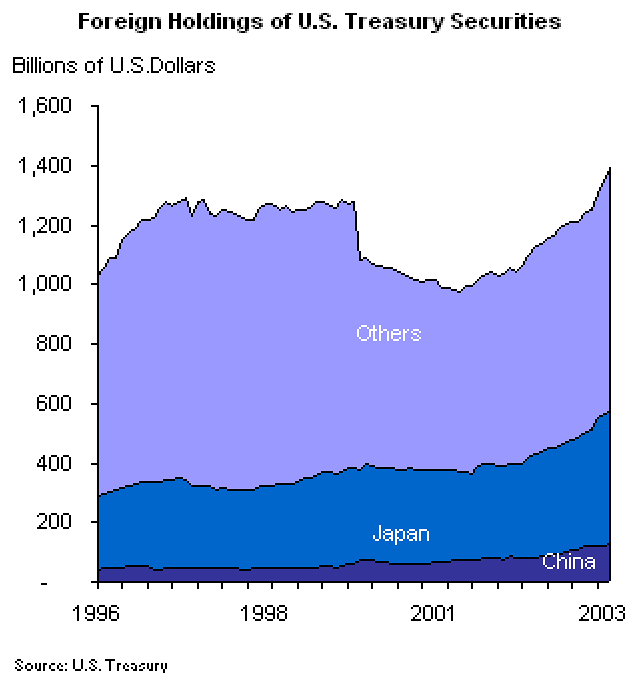
The two business cycle risks that have hampered the economy since recession's end, the jobless recovery and lackluster business investment, appear set to finally fade away. This leaves one primary economic risk for 2004—the threat of higher interest rates. Interest rates could move higher next year due to several factors which might cut into demand for US Treasury debt. Chief among these are concerns that foreign investors may reduce their demand for US financial assets. This could arise either from improving domestic investment opportunities in those nations, which would siphon off some demand from US alternatives, or because of a reduced need to recycle US dollars attained through massive currency interventions. In addition, as the need to fund a growing federal budget gap results in greater issuance of US Treasury debt, interest rates may also move higher.

As of this writing, signs of renewed growth were beginning to solidify in Japan, while the major European economies also were showing preliminary indications of stronger economic growth for 2004. Renewed growth abroad may encourage foreign investors to place more of their money in-country, reducing marginal demand for US government securities and other financial assets. That said, one offset will be continued growth in US imports. As the US economy begins to show stronger growth, import demand is likely to increase even further. As a result, exporters to the US are likely to continue to recycle significant dollar amounts earned through trade into US Treasury debt and other financial assets.

Given recent pressure on China and Japan to cease their currency intervention activities, these nations

may reduce their net purchases of US Treasury debt, pushing up interest rates at the margin. Japan has sold yen and bought dollar denominated assets, such as US Treasuries, in order to weaken the yen and keep their exports competitive. From January through July this year alone, Japan sold about 9.03 trillion yen ($80.5 billion) and purchased US Treasuries. Japan is the largest foreign holder of US treasury notes and bonds, with $444 billion out of the $1.39 trillion held abroad as of July 2003. The total amount of treasury securities outstanding is about $3.5 trillion, so foreign holdings account for about 40 percent of all Treasury debt outstanding.

China is also a large purchaser of US treasuries, as it recycles its current account surplus with the U.S. and also maintains a currency exchange rate peg of 8.3 yuan per dollar. China needs large dollar reserves in order to maintain the yuan's dollar peg against speculative attacks. According to the US Treasury, China is the third largest owner of U.S. treasury bonds, and these holdings surged 23 percent to $126 billion through the fall of 2003. About one third of China's $365 billion of foreign exchange reserves are denominated in dollars (see Chart 2).



Government Will Compete With Private Borrowers in Credit Markets

The widening federal government deficit, and the increased demand for funding it entails, raises concerns about crowding out of private investment. As the overall demand for credit rises, upward pressure may be applied to interest rates. Although increases in expected deficits will likely push long term interest rates higher, the immediacy of the need for fiscal stimulus to support economic growth in the past two years has outweighed this concern in the minds of many policymakers and economists.

The Congressional Budget Office forecasts the budget deficit will widen to $500 billion in fiscal year 2004, after closing the 2003 fiscal year at $374 billion, or 3.5 percent of GDP—a ten year high. Although this was far from the 6 percent of GDP peak reached in 1983, the market may expect that the vast supply of Treasury securities needed to fund the US deficit going forward will necessitate higher yields. It is clear that there is a relationship between larger budget deficits and higher long-term interest rates. What is not clear is how much of the full impact of future expected deficits is reflected in long-term interest rates at the

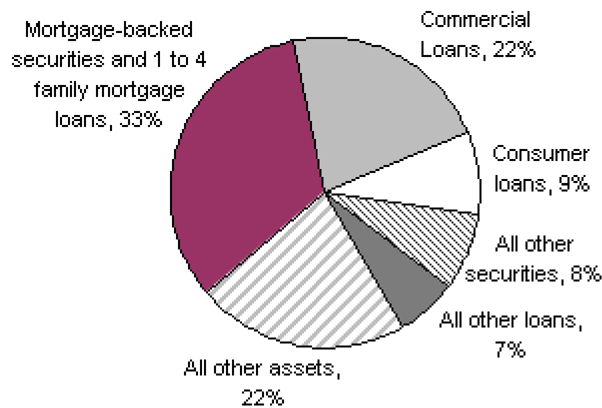
moment. It seems possible given the present accommodative monetary policy and weak global demand for capital, the full impact of the larger budget deficits are not yet reflected in long-term interest rates. As a synchronized global recovery takes hold and G-3 government deficits start to crowd out private sector investment, long-term interest rates may rise.

Exposure to Rising Interest Rates Has Grown

The exposure of FDIC-insured institutions to highly interest-sensitive assets is large and growing. As of June 30, fully one-third of industry assets were mortgage loans or mortgage-backed securities (see Chart 3). An additional 8 percent of industry assets were other fixed-income securities. Holdings of mortgage-related assets have grown rapidly at FDIC-insured institutions—making up 75 percent of industry loan growth in the first half of 2003—while commercial loans outstanding had declined for 10 consecutive quarters through June. According to Loan Performance Corporation, more than three-quarters of currently outstanding single-family mortgage debt was underwritten between early 2001 and mid-2003.

Chart 3

One Third Of Commercial Bank and Thrift Assets Were Mortgage-Related As Of June 30, 2003



Source: Bank and Thrift Reports

Mortgage-related assets and income streams are highly sensitive to movements in interest rates. Since 2000, successive declines in interest rates have led to market value gains in securities and fixed-rate loan portfolios as well as recurring waves of mortgage refinancing, which has boosted the fees earned from mortgage origination while lowering the market value of mortgage servicing portfolios—both important sources of fee income for the industry.

On net, lower interest rates have been a boon for the earnings of mortgage lenders and the industry as a whole. However, the fact that interest rates in June had reached their lowest levels in 45 years is characteristic of a unique—and potentially very challenging—interest rate cycle.

Even as lower rates and mortgage refinancing have been boosting the overall earnings of mortgage lenders, the low absolute level of short-term rates has made it difficult for many institutions to pass interest rate reductions along to their depositors, thereby squeezing their net interest margins (NIMS). In fact, the pervasiveness of declining NIMs is a persistent weakness in otherwise strong industry operating results.

The fact that millions of homeowners have refinanced mortgages at the lowest fixed rates in more than a

generation will result in dramatically lower refinancing activity as interest rates rise. The significant increase in long-term Treasury yields that has taken place since mid-June of this year has already sharply slowed the rate of applications for mortgage refinancing. As a result, the effective maturity of mortgage portfolios has extended, amplifying price sensitivity to rising rates.

For example, the more than one percentage point increase in 10-year Treasury that occurred between early June and late August turned more than $14 billion in unrealized gains to $2.5 billion in unrealized losses in large bank available-for-sale securities portfolios. Lower originations can be expected to reduce the high levels of fee income mortgage lenders have earned in recent years. Moreover, the volume of low-yielding mortgage-related assets in the banking industry will weigh on earnings, either through NIM pressure or losses on sale of assets, as interest rates rise.

Highly Leveraged Households Pose Mortgage, Consumer Credit Risks

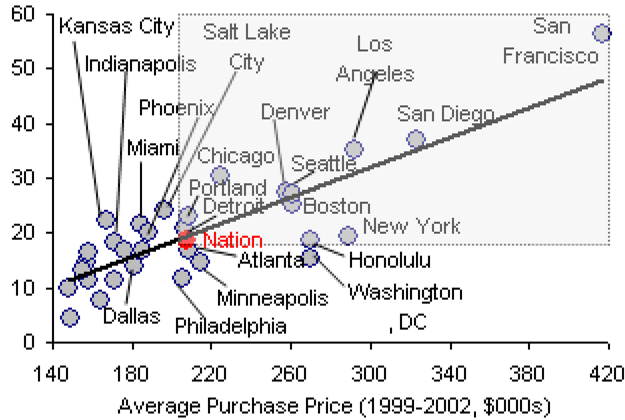
Persistently low interest rates prompted households to add consumer debt, rather than de-leverage during the last recession and subsequent “jobless recovery.” Because household sector debt growth outpaced disposable personal income increases, aggregate debt service burdens remain near historic highs. Despite elevated consumer leverage, mortgage and consumer loan delinquencies among insured institutions remain relatively low, thanks in part to low interest rates; however, to the extent households are exposed to variable rate debt, the magnitude and speed of future interest rate increases could influence consumer and mortgage loan performance prospectively.

Household cash flows may be squeezed by rising interest rates, in particular among consumers that rely on variable rate loans such as credit cards, home equity lines of credit, or adjustable-rate closed-end mortgages (ARMs). If any of these households also have taken on a significant amount of debt, such that a large portion of their monthly cash flows are already committed to debt service at current interest rates, this risk could be amplified. For instance, subprime mortgages are more often variable rate than prime loans, and subprime borrowers typically have less available resources to weather cash flow shocks. In addition, lender surveys by the Federal Housing Finance Board suggest that ARMs are more popular in the nation’s pricier housing markets such as San Francisco, San Diego, Los Angeles, New York, Boston, Seattle, and Denver (see Chart 4). Home equity lines of credit, which have increased dramatically in popularity, are also typically variable rate. Thus, rising interest rates could affect household debt service requirements among subprime borrowers and homeowners in certain markets disproportionately.

Chart 4

Home Purchasers In Higher-Priced Markets Opt For Adjustable-Rate Mortgages More Frequently

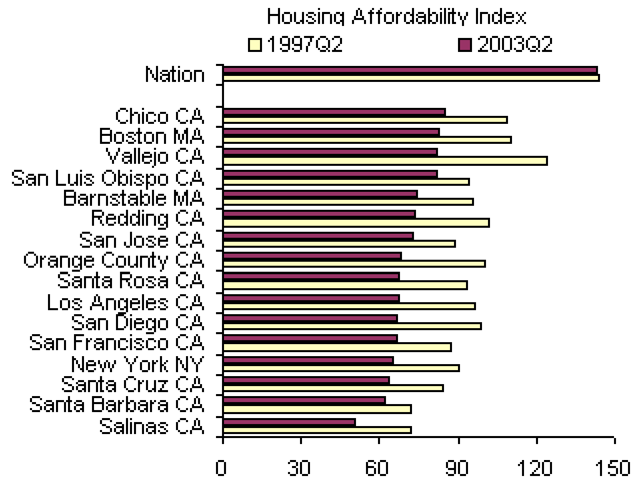
Average Annual Share of Home Purchase Mortgages With Adjustable Rates (1999-2002, %)



Note: Data include mortgages originated for home purchases only; excludes refinancings.

Source: Federal Housing Finance Board

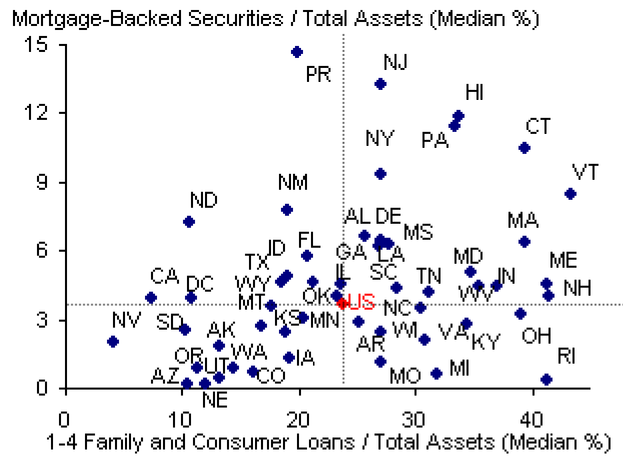
Although low interest rates have boosted home purchase and refinancing activity and buoyed home prices, future interest rate increases could exert downward pressure on home purchase demand and thus home price appreciation rates in some markets. Importantly, the majority of outstanding mortgage debt was underwritten using recent collateral values, so declines from current highs could elevate mortgage default activity and losses among some mortgage lenders. Home prices in less-affordable housing markets could be particularly vulnerable, since median family incomes in these areas are already straining to finance median priced homes (see Chart 5). There is, of course, a theoretical limit in how long, and by how much, house price growth can diverge from income growth. The important question for financial stability is whether any correction that occurs is gradual or abrupt, localized or geographically widespread. While a nationwide housing bubble appears unlikely, many analysts concede that some markets may be prone to slower home price appreciation or home value declines in a rising interest rate environment given surrounding economic conditions, demographic shifts, or affordability constraints. Lenders specializing in highly-leveraged mortgages could also be affected disproportionately because of a weaker borrower equity position at origination. Historically, mortgages with higher loan-to-value ratios have been associated with higher default rates.



The effects of higher interest rates on homeowner cash flows and collateral values could pose the greatest risk to insured institutions with elevated mortgage loan exposures. Although the popularity of ARMs combined with low and deteriorating affordability within many markets in the West could be cause for concern, insured community institutions based in many of these markets do not hold high, direct exposures to single family mortgages or consumer loans.[1] In addition, past-due mortgage and consumer loan ratios among lenders in most Western states were low as of mid-2003. In contrast, median exposures to residential mortgages, consumer loans, and mortgage-backed securities tend to be higher among insured institutions in the eastern United States, particularly the Northeast (see Chart 6).

Chart 6

Insured Institution Exposures To Housing and Consumer Credit Tend To Be Highest East Of the Mississippi



Note: Includes insured institutions holding less than $5 billion in total assets that are not specialty lenders.
Source: Bank and Thrift Call Reports (June 30, 2003)

Mortgage underwriting developments over the past decade could also influence mortgage credit quality prospectively. For instance, most “conforming” mortgages are sold in the secondary market; thus, mortgages retained in bank loan portfolios may be weighted towards junior lien positions, jumbo mortgages, or credits to less creditworthy borrowers. Some underwriters have featured progressively less reliance on borrower equity, as evidenced by the rapid rise in “piggyback” financing arrangements, where portions of the traditional 20 percent downpayment are borrowed in the form of a home equity loan (e.g., “80-10-10” loans). Similarly, home equity lending programs featuring loan-to-value ratios in excess of 100 percent have become more common. These lending developments have opened the door to homeownership for many, but they may also pose increased credit risks to mortgage lenders.

Construction and Commercial Real Estate Lenders Again a Concern

Commercial real estate lending was at the heart of the banking problems of the 1980s and early 1990s. Aggressive underwriting and rampant overbuilding led to billions in losses to the industry and the deposit insurance funds. Construction activity and CRE lending fell off for a number of years in the 1990s before a late-decade resurgence that was centered in certain fast-growing metro areas in the FDIC’s Atlanta and San Francisco regions. Community banks in those metro areas built up significant concentrations in construction and CRE lending during the late 1990s as the housing markets boomed, commercial rents rose, and vacancy rates fell to historically low levels. Currently, some 778 FDIC-insured institutions show concentrations of construction and commercial real estate loans exceeding 500 percent of Tier 1 capital. In measuring these concentrations, however, it is important to emphasize that much of the exposure consists of residential construction loans, where credit risk is historically lower and fundamentals to date have been strong. A recent FDIC supervisory initiative showed that one-half of construction and development loan exposures at institutions reviewed in its Atlanta Region were residential projects.

Residential Construction Lending

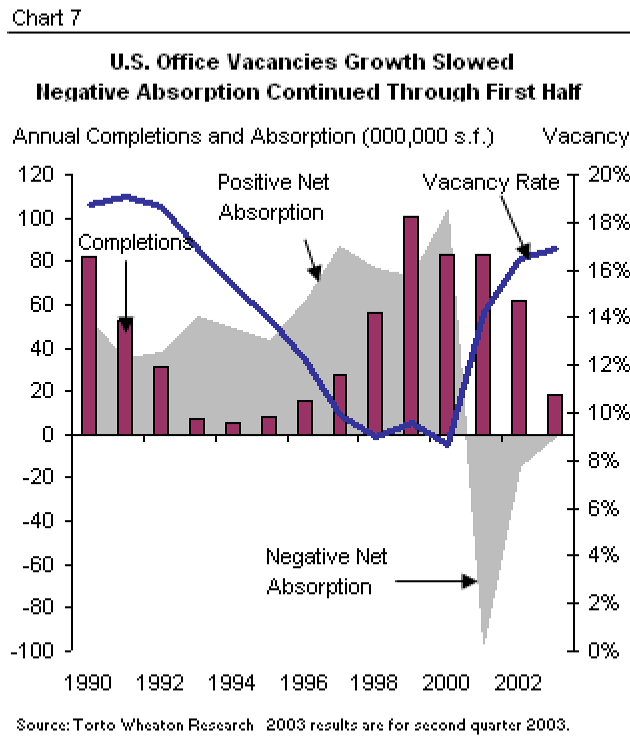
Higher interest rates, lackluster employment growth, and slowing rates of home price appreciation may become particularly challenging for certain community banks. Many community banks have found a niche

as residential real estate acquisition and development lenders. This lending activity is exposed to the fortunes of the residential housing and mortgage markets, which could suffer from higher mortgage rates and stagnant or falling home values in certain markets. While reports are that many residential builders are strong enough to weather potential slowing in housing demand, institutions that have pursued loan growth by lending to relatively thinly capitalized builders may find these builders struggling to make debt service payments. Some young institutions in formally fast growing metro areas have reportedly relaxed lending standards in their residential construction and development lending programs to meet growth and market share targets.

Commercial Real Estate Lending

Since late 2000 market fundamentals in commercial offices, industrial facilities, and lodging properties have fallen off considerably. Office vacancy rates doubled between mid-2000 and mid-2003, to 17 percent of available space (see Chart 7). As rents negotiated in long-term lease continue to dilute current trends, in-place rents have fallen only gradually. More starkly, asking rents have declined by as much as 50 percent in some markets during that time, suggesting further downward pressure for property cash flows until job growth picks up significantly.

Chart 7



Source: Torto Wheaton Research 2003 results are for second quarter 2003.

Despite these weak fundamentals, CRE loan performance at FDIC-insured institutions remains strong by historical standards. As of June 30, nonperforming CRE loans measured only 0.89 percent of outstanding balances. Several trends may have helped insulate banks' CRE portfolios from the effects of the deteriorating market fundamentals in this cycle, including: low interest rates; more stringent CRE lending standards; the availability of alternate, publicly-held funding sources such as REITs; and, the relative attractiveness of real estate as an investment class.

Lower interest rates have reduced debt service burdens and allowed property owners to meet loan payments despite reduced occupancy and rental rates. Regulatory reforms enacted after the last real estate down cycle significantly enhanced supervisory guidelines for underwriting, real estate appraisal, and other risk management practices. Publicly-available funding sources have improved market

transparency and the current popularity of real estate investments has sustained property values despite weaker fundamentals.

At the same time, analysts are warning that the disconnect between the weak fundamentals of CRE markets and the strong performance of CRE loans will not persist indefinitely. In this regard, the single factor that could do the most harm to CRE loan performance would be rising interest rates.

Because most CRE loans are financed at variable interest rates, higher interest rates could quickly push up debt service costs and strain push borrowers into a money-losing situation. Rising interest rates could also raise the rates of return demanded by property investors. Absent a concurrent turnaround in net operating incomes, real estate values and thus collateral prices could come under pressure.

History shows that commercial real estate lending is an area where credit losses can accumulate quickly. In the face of high loan concentrations, weak market fundamentals, and borrowers hanging on by virtue of low interest rates, the potential for higher losses represents a clear and significant risk.

Emerging Risks in Perspective

The risks discussed above should caution FDIC-insured institutions to guard against complacency in managing their own risks. However, the industry in the aggregate is well-positioned to withstand the present risks. Net income for the banking and thrift industries set another record of nearly $60 billion in the first half of 2003. This followed a banner year in 2002 when industry earnings topped $100 billion for the first time. Moreover, the industry appears poised to report another record quarter for the period ended September 30, 2003. Eleven consecutive years of returns exceeding one percent of industry assets have contributed to an industry aggregate capital ratio that is near record-high levels. Finally, the percent of unprofitable institutions is near record lows. Overall concern should be moderated by these performance statistics.

---

[1] For purposes of this analysis, insured community institutions include insured institutions holding less than $5 billion in total assets that are not specialty lenders or industrial loan companies.

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

Disclaimer

The views expressed in *FYI* are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Some of the information used in the preparation of this publication was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

Last Updated 11/4/2003

Chart 1
Tax Cuts Are Boosting Income Growth For Now, But Sustained Job Gains Are Needed To Support Personal Income Over The Long Haul

Date	Personal Income Percent change, year-over-year	Disposable (after-tax)
1999	6.08	5.62
1999	5.51	4.92
1999	5.01	4.39
1999	4.78	4.20
1999	4.55	3.94
1999	4.47	3.85
1999	4.25	3.55
1999	4.30	3.91
1999	4.15	3.47
1999	4.63	3.99
1999	4.93	4.37
1999	5.67	5.14
2000	6.71	5.91
2000	7.22	6.50
2000	7.84	7.11
2000	7.94	7.22
2000	8.14	7.63
2000	8.32	7.81
2000	8.73	8.35
2000	8.52	7.86
2000	8.88	8.53
2000	8.34	7.99
2000	7.76	7.42
2000	7.13	6.86
2001	6.07	5.82
2001	5.45	5.25
2001	4.81	4.57
2001	4.53	4.36
2001	3.82	3.58
2001	3.37	3.21
2001	3.05	4.17
2001	2.54	5.69
2001	2.13	4.16
2001	1.50	1.76

2001	1.33	1.74
2001	1.52	1.92
2002	1.42	4.38
2002	1.75	4.86
2002	1.87	5.07
2002	2.15	5.46
2002	2.73	6.15
2002	3.35	6.87
2002	2.58	4.98
2002	2.96	3.50
2002	3.17	4.92
2002	3.43	7.07
2002	3.69	7.27
2002	3.63	7.23
2003	3.33	4.77
2003	3.10	4.36
2003	3.01	4.17
2003	2.87	3.86
2003	2.81	3.70
2003	2.47	3.27
2003	3.16	5.09
2003	3.13	5.67
2003	3.36	4.68
Source: BEA		

Chart 2
Foreign Holdings of U.S. Treasury Securities

Date	China	Japan	Others
199609	40.6	246.3	-286.9
199610	43.8	254.0	-297.8
199611	46.1	256.5	-302.6
199612	47.2	263.3	-310.5
199701	48.1	266.2	-314.3
199702	52.3	273.0	-325.3
199703	53.2	274.4	-327.6
199704	52.6	281.8	-334.4
199705	51.5	287.0	-338.5
199706	41.5	293.7	-335.2
199707	40.4	298.8	-339.2

199708	43.7	297.9	-341.6
199709	45.1	294.6	-339.7
199710	46.2	300.2	-346.4
199711	46.4	295.2	-341.6
199712	47.9	277.6	-325.5
199801	49.6	270.0	-319.6
199802	48.3	273.7	-322.0
199803	48.1	274.1	-322.2
199804	47.3	264.2	-311.5
199805	46.4	266.7	-313.1
199806	45.2	264.1	-309.3
199807	44.3	264.4	-308.7
199808	43.2	264.5	-307.7
199809	43.6	264.5	-308.1
199810	45.2	265.1	-310.3
199811	47.1	272.7	-319.8
199812	46.4	276.1	-322.5
199901	47.3	278.7	-326.0
199902	47.4	280.0	-327.4
199903	46.6	280.9	-327.5
199904	45.0	284.9	-329.9
199905	47.2	286.5	-333.7
199906	49.4	299.5	-348.9
199907	50.0	302.9	-352.9
199908	50.1	305.4	-355.5
199909	51.0	316.1	-367.1
199910	52.1	318.4	-370.5
199911	50.1	313.9	-364.0
199912	51.8	320.0	-371.8
200001	57.3	323.1	-380.4
200002	60.1	321.2	-381.3
200003	71.4	307.6	-379.0
200004	71.7	322.4	-394.1
200005	72.5	319.4	-391.9
200006	67.5	318.8	-386.3
200007	66.4	319.6	-386.0
200008	62.6	317.8	-380.4
200009	62.1	317.3	-379.4
200010	59.5	317.7	-377.2
200011	58.9	321.7	-380.6

200012	60.3	317.7	-378.0
200101	61.5	312.3	-373.8
200102	63.7	312.5	-376.2
200103	69.8	307.1	-376.9
200104	69.2	305.9	-375.1
200105	69.2	306.7	-375.9
200106	72.7	300.8	-373.5
200107	74.2	295.3	-369.5
200108	73.4	293.1	-366.5
200109	72.0	292.9	-364.9
200110	72.3	314.5	-386.8
200111	77.9	315.4	-393.3
200112	78.6	317.9	-396.5
200201	77.5	310.6	-388.1
200202	76.5	311.9	-388.4
200203	84.5	312.6	-397.1
200204	82.4	314.6	-397.0
200205	81.3	317.8	-399.1
200206	81.0	335.7	-416.7
200207	81.4	348.2	-429.6
200208	86.8	350.9	-437.7
200209	89.2	360.5	-449.7
200210	91.0	359.5	-450.5
200211	96.9	361.5	-458.4
200212	102.9	364.7	-467.6
200301	105.2	371.8	-477.0
200302	106.2	377.6	-483.8
200303	117.7	386.6	-504.3
200304	119.4	389.2	-508.6
200305	121.7	429.7	-551.4
200306	122.5	441.6	-564.1
200307	126.1	443.8	-569.9
Source: U.S. Treasury			

Chart 3
One Third Of Commercial Bank and Thrift Assets Were Mortgage-Related As Of June 30, 2003

Asset Category	Percent of Total Assets
Mortgage-backed securities and 1 to 4	33%

family mortgage loans	
Commercial loans	22%
Consumer loans	9%
All other securities	8%
All other loans	7%
All other assets	22%

Source: Bank and Thrift Reports

Chart 4
Home Purchasers In Higher-Priced Markets Opt For Adjustable-Rate Mortgages More Frequently

City	Average Purchase Price (1999-2002, $000s)	Average Annual Share of Home Purchase Mortgages With Adjustable Rates (1999-2002, %)
Atlanta	208	16.75
Boston	261	25.25
Chicago	224	30.50
Cleveland	171	11.50
Columbus	185	16.75
Dallas	181	14.00
Denver	258	27.50
Detroit	207	21.00
Greensboro	157	14.50
Honolulu	270	18.75
Houston	165	7.75
Indianapolis	172	18.25
Kansas City	167	22.25
Los Angeles	292	35.25
Louisville	158	11.25
Miami	184	21.50
Milwaukee	176	16.75
Minneapolis	214	14.50
New York	289	19.25
Philadelphia	206	11.75
Phoenix	189	20.00
Pittsburgh	148	10.00
Portland	208	23.00
Rochester	149	4.25
Salt Lake	196	24.00

City		
San Diego	323	37.00
San Francisco	417	56.25
Seattle	261	27.25
St. Louis	158	16.50
Tampa	155	13.25
Washington, DC	270	15.50
Nation	207	18.50

Note: Data include mortgages originated for home purchases only; excludes refinancings.

Source: Federal Housing Finance Board

Chart 5
Affordability Has Continued To Weaken In Many California and Northeast Markets

Location	1997Q2	2000Q2	2003Q2
Salinas CA	71.58	48.60	50.42
Santa Barbara CA	71.88	65.48	61.86
Santa Cruz CA	84.47	72.00	63.49
New York NY	90.37	79.00	65.42
San Francisco CA	87.22	69.36	66.53
San Diego CA	98.70	76.50	66.76
Los Angeles CA	96.30	80.71	67.37
Santa Rosa CA	93.51	75.92	67.56
Orange County CA	100.56	76.81	68.02
San Jose CA	88.84	67.35	72.96
Redding CA	101.64	85.04	73.48
Barnstable MA	95.39	70.75	74.37
San Luis Obispo CA	94.36	85.19	81.55
Vallejo CA	123.96	90.57	82.01
Boston MA	110.51	76.48	82.94
Chico CA	108.44	90.61	84.74
Nation	143.55	132.51	143.24

Note: For each market, the index shows the share of a median priced home's mortgage that is affordable to households earning a median income. A lower number indicates less affordability.

Source: Economy.com

Chart 6
Insured Institution Exposures To Housing and Consumer Credit Tend To Be Highest East Of the Mississippi

State	1-4 Family and Consumer Loans / Total Assets (Median %)	Mortgage-Backed Securities / Total Assets (Median %)
NH	41.37	4.02
WV	35.36	4.42
FL	20.78	5.72
NV	4.10	2.00
VT	43.24	8.46
OH	39.07	3.26
KY	34.45	2.75
HI	33.73	11.85
IN	36.93	4.43
MO	27.07	1.16
CA	7.29	3.92
MA	39.38	6.35
RI	41.18	0.38
DE	27.10	6.46
NC	30.42	3.53
CT	39.31	10.48

WA	14.45	0.83
ME	41.25	4.54
TN	31.15	4.21
VA	30.84	2.13
AZ	10.44	0.15
WY	17.68	3.57
CO	16.10	0.67
KS	18.89	2.40
OK	21.30	4.59
UT	13.15	0.48
PA	33.34	11.44
OR	11.27	0.84
MD	34.76	5.04
NY	26.98	9.37
NJ	27.00	13.23
DC	10.81	3.93
SC	28.32	4.34
AL	25.68	6.59
MT	16.76	2.70
AK	13.21	1.81
MI	31.77	0.60
TX	18.53	4.59
MS	27.71	6.24
GA	23.63	4.56
ID	18.94	4.87
IL	23.32	4.03
WI	26.97	2.42
LA	26.91	6.23
IA	19.16	1.31
NM	19.02	7.78
AR	25.21	2.88
NE	11.97	0.14
MN	20.33	3.08
PR	19.83	14.66
ND	10.59	7.24
SD	10.27	2.54
US	23.81	3.67

Note: Includes insured institutions holding less than $5 billion in total assets that are not specialty lenders.

Source: Economy.com

Chart 7
U.S. Office Vacancies Growth Slowed
Negative Absorption Continued Through First Half

000,000 s.f.			
Date	**Completions**	**Net Absorption**	**Vacancy Rate**
12/31/90	82	52.70	18.72%
12/31/91	53	34.90	19.04%
12/31/92	32	37.30	18.68%
12/31/93	7	54.10	16.91%
12/31/94	6	48.50	15.30%
12/31/95	8	43.10	13.92%
12/31/96	16	61.60	12.20%
12/31/97	28	86.90	9.93%
12/31/98	56	77.00	8.97%
12/31/99	101	72.50	9.61%
12/31/00	83	103.10	8.65%
12/31/01	83	-96.50	14.20%
12/31/02	61	-14.70	16.50%
12/31/03	18	-1.10	16.90%

Source: Torto Wheaton Research 2003 results are for second quarter 2003.