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# ◆ Regional Outlook ◆

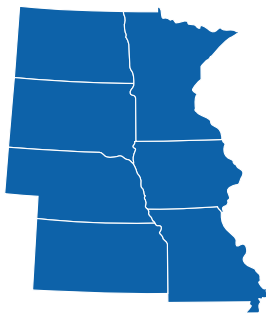
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FEDERAL DEPOSIT INSURANCE CORPORATION

THIRD QUARTER 2000

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## FDIC KANSAS CITY REGION



### DIVISION OF INSURANCE

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## Regional Perspectives

◆ *The Region's Economic Conditions*—While the authors of the Federal Agriculture Improvement and Reform Act of 1996 intended to take U.S. farm policy in a new direction, reducing farmers' reliance on governmental aid, the Region's farmers have continued to benefit significantly from federal aid payments. Changes in the structure of the agricultural industry and international trade considerations will affect the future direction of U.S. farm policy. The farm bill of 2002 could mark a crossroads in the development of U.S. farm policy, with far-reaching implications for farmers and the bankers who lend to them. *See page 3.*

*By Jeffrey W. Walser, Regional Economist*

## In Focus This Quarter

◆ *Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding*—Commercial real estate construction has boomed in a number of U.S. metropolitan markets during recent years amid falling vacancy rates and growing demand for new space. Insured depository institutions have reasserted their role as primary sources of capital for this construction boom, particularly in the wake of the 1998 financial markets crisis that left some important market-based lenders on the sidelines. Recent data for some metropolitan areas show that on-balance-sheet exposures of FDIC-insured institutions are by some measures higher now than at the peak of the last commercial real estate cycle during the late 1980s. This article reassesses major U.S. metropolitan real estate markets in search of possible signs of overbuilding that could drive up vacancy rates and drive down rents in the near term. This review points to an underlying trend of markets experiencing more vigorous construction activity across multiple property types. *See page 11.*

*By Thomas A. Murray, Senior Financial Analyst*

◆ *Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate*—Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios. *See page 19.*

*By Alan Deaton, Financial Economist*

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## *Regional Perspectives*

- Although the authors of the Federal Agriculture Improvement and Reform Act of 1996 intended this legislation to take U.S. farm policy in a new direction, reducing farmers' reliance on governmental aid, the Region's farmers have continued to benefit significantly from federal aid payments.
- Changes in the structure of the agricultural industry and international trade considerations will affect the direction of U.S. farm policy.
- The farm bill of 2002 could mark a crossroads in the development of U.S. farm policy, with far-reaching implications for farmers and the bankers who lend to them.

### *U.S. Farm Policy: Which Direction After 2002?*

During the first half of 2000, the Federal Deposit Insurance Corporation (FDIC) hosted five Agricultural Bankers' Roundtables throughout the United States. The initial meeting was held on March 28, 2000, in **Omaha, Nebraska**, to discuss the state of the agricultural economy. Fourteen bankers from **Iowa** and **Nebraska** spoke with FDIC officials about farming conditions in these states and their experiences with banking clients. These bankers, who operate in an area where corn, soybeans, hogs, and cattle are the most important agricultural commodities, agreed that their borrowers have been adversely affected by the low commodity prices that have persisted since 1997. The bankers unanimously thought that federal government supplemental payments to farmers and federal crop insurance were crucial to maintaining the financial health of farm borrowers in 1998 and 1999. In fact, farm banks in the Kansas City Region as a whole have yet to reflect the poor farm economy in reported results. See Chart 1.

The experience of the bankers at the Omaha meeting was consistent with information reported by the United States Department of Agriculture (USDA). Table 1

shows price trends for the major farm commodities in the Kansas City Region.

Average corn and wheat prices have declined each year since 1996, and the price of soybeans has fallen each year since 1997. For each of these crops, favorable yields and large planted acreages have resulted in significant accumulations of inventories, both in the United States and abroad. Given these large stocks of commodities and normal weather conditions, the USDA forecasts that prices will remain low in 2000 and 2001. Hog prices reached historic lows in late 1998 and early 1999, but they have recovered partially in 2000 as supplies have declined. Cattle prices continue to improve in 2000 after four years of low price levels.

The effect of continued low crop prices and the importance of government payments is apparent in Chart 1 (next page), which depicts U.S. net farm income in the 1990s, both the portion earned by farmers and that provided by the federal government. The income earned by farmers from their operations has declined each year since 1996, but significant government payments have supported the level of net farm income.

**TABLE 1**

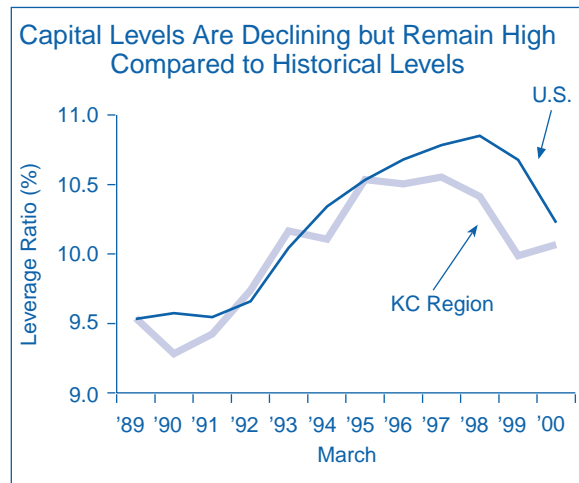
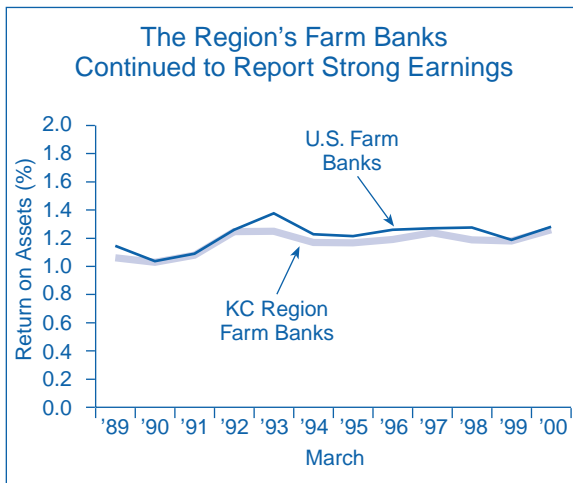
<b>COMMODITY PRICES ARE EXPECTED TO REMAIN DEPRESSED THROUGH 2001</b>						
	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>PROJ. 2000</b>	<b>PROJ. 2001</b>
CORN	3.24	2.71	2.43	1.94	1.90	1.70
SOYBEANS	6.72	7.35	6.47	4.93	4.70	4.40
WHEAT	4.55	4.30	3.38	2.65	2.50	2.50
HOGS	53.39	51.36	34.72	33.55	44.50	45.50
CATTLE	65.06	66.32	61.48	65.52	69.00	74.50

NOTES: GRAIN PRICES ARE FOR MARKETING YEAR OF EACH CROP.  
CROP QUANTITIES ARE PER BUSHEL; LIVESTOCK ARE PER HUNDREDWEIGHT.  
SOURCE: USDA, JULY 12, 2000

CHART 1

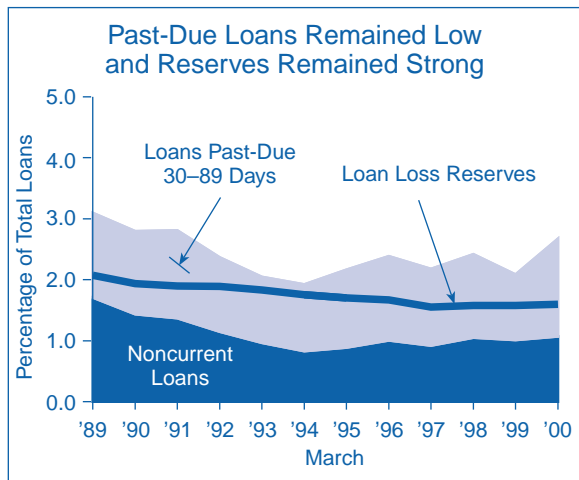
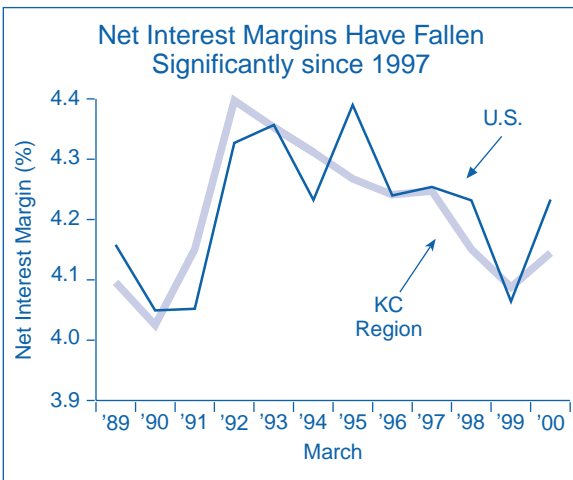
## Banking Scorecard

In the aggregate, as of March 31, 2000, the Region's 1,259 farm banks<sup>1</sup> continued to report sound conditions. Earnings remained strong during 1999 and through the first quarter of 2000. However, higher interest costs and increasing competition for loans and deposits caused net interest margins to fall in 1999. Reported capital levels are high compared to historical levels, but have declined since 1998 because of increasing unrealized losses on available-for-sale securities. These unrealized losses, which affect capital but have not yet affected earnings, totaled \$287 million, and reduced farm banks' aggregate capital ratio from 10.50 percent to 10.07 percent as of March 31, 2000.



Despite continued low commodity prices, problem loans remained manageable, and reserve levels provided a cushion against potential loan problems. Record government payments to farmers helped maintain farm banks' relatively low levels of problem loans in 1999, and support payments in 2000 are likely to exceed previous levels.

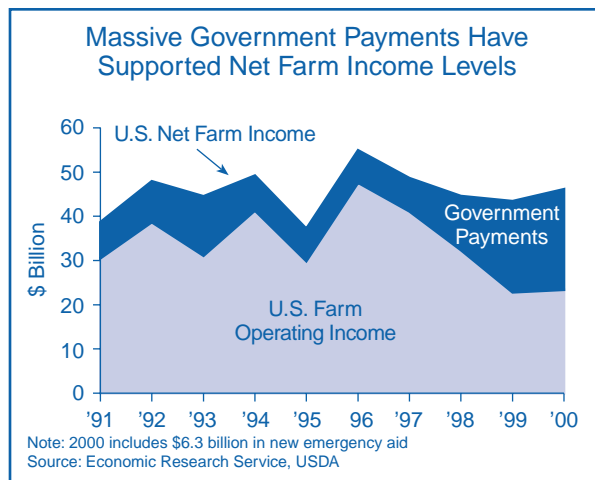
Funding is a concern as farm banks' loan-to-asset ratios continue to rise. Farm banks are finding it difficult to increase core deposits and, as a result, are turning to noncore funds, such as large time deposits, Federal Home Loan Bank borrowings, and brokered deposits, to support asset growth.



Source: Bank Call Reports

<sup>1</sup>Farm banks are defined by the FDIC as FDIC-insured financial institutions with agricultural operating loans and real estate loans secured by real estate making up at least 25 percent of total loans.

CHART 2



The USDA's forecast for 2000 projects farm operating income to be \$23.4 billion, the second lowest level for the 1990s, but government payments to be \$22.7 billion, the highest level ever. If this forecast is realized, government payments will account for nearly half of net farm income in the nation.

While the bankers who participated in the roundtable discussion acknowledged that the supplemental aid packages approved by Congress in 1998 and 1999 were critical to the financial health of many of their borrowers, they were uncertain about the future direction of U.S. farm policy. Subsequent to the Omaha meeting in March, Congress again approved a substantial aid package for agriculture for 2000. However, longer-term uncertainty about the direction of farm policy remains a substantial risk to the financial health of the Region's farmers and the bankers who lend to them.

The 1996 Farm Bill, also known as the Federal Agriculture Improvement and Reform (FAIR) Act, established the framework for current farm policy. In 2002, the current legislation will expire, and Congress must write a new farm bill. This article discusses the issues that likely will be addressed as part of the creation of the 2002 bill and examines possible directions the new legislation could take.

### **Background—The FAIR Act of 1996**

Since the Agricultural Adjustment Act of 1933, the federal government has tried to boost farm income with price supports and supply restriction. Before the 1996 FAIR Act, the farm program included a system of defi-

ciency payments for major crops. Commodities covered by the program were corn, sorghum, barley, wheat, oats, rice, and cotton. Under this system, the U.S. Secretary of Agriculture announced a target price at the beginning of the year, and farmers were paid the difference between it and the market price at the end of the year. The deficiency payments served as a risk-reducing mechanism, offsetting fluctuations in commodity prices.

In the 1980s, the system of deficiency payments was increasingly criticized. Federal agricultural programs were no longer perceived as an efficient and equitable means of providing income support for farmers. By 1995, a consensus had grown in Congress in favor of substantial reform of U.S. farm policy, resulting in the passage of the FAIR Act of 1996. The FAIR Act introduced a number of fundamental changes in farm policy, including the following:

- Decoupling program payments from most production decisions and thus ending the practice of paying farmers deficiency payments when prices of commodities fell below target prices. During the early 1990s, more than 90 percent of the crops grown in the Kansas City Region, measured by value, qualified for the deficiency payment program. Following the passage of the FAIR Act, farmers began to receive aid that is less tied to fluctuations in commodity prices.
- Eliminating federal authority to control the supply of program commodities by limiting planted acreage. Under previous farm bills, farmers were required to "set aside" a portion of their production acreage to qualify for deficiency payments.
- Establishing a schedule of fixed income support payments known as "production flexibility payments," based on farmers' historical pattern of production. Farmers receive these payments regardless of their present production decisions. These payments are declining over the life of the FAIR Act until its expiration in 2002.

Proponents of the FAIR Act saw the 1996 legislation as a historic shift in the direction of farm policy. The new program was to minimize many of the distorting effects of the existing support programs. The decoupling of payments from production decisions and the elimination of supply controls allowed farmers to respond to market signals and reduce the opportunity costs of idling productive land. The legislation also sought to achieve a

level of budgetary certainty with its schedule of fixed and declining payments. In contrast, the previous system of deficiency payments created an open-ended obligation that led to high levels of support in the 1980s.

While the 1996 Farm Bill was widely seen as eliminating traditional farm policy instruments, its reform was only partial. Although payments to growers of the program crops were no longer tied to yearly production, these payments were not eliminated. Even as the bill was being debated, the total cost of farm benefits was not expected to be less than that under the traditional legislation. Many observers saw the FAIR Act as compensation for ending the government's future obligation to farmers.

However, contrary to the intentions of the original authors of the bill, it did not repeal the 1933 legislation of price supports and acreage controls. Therefore, a return to high price supports and production controls will occur in 2002 if Congress does not act. Some observers view the FAIR Act as a "policy experiment" rather than a permanent change in practices.<sup>1</sup>

The FAIR Act also has not changed farmers' traditional acceptance of government support. Previously, farmers were required to accept acreage restrictions in exchange for deficiency payments, but the FAIR Act removed this requirement. The transition payments under the new legislation were free of such restrictions, so nearly all eligible farmers participated, and the proportion of farmers receiving payments from the federal government and thereby the constituency associated with government payments actually increased.

The law also retained the controversial "three-entity" rule that allows some large farmers to circumvent program payment limitations by establishing eligibility through legally separate operations. The retention of this rule suggests that the FAIR Act did not address equity concerns, as benefits continued to be based on past levels of output, effectively concentrating program benefits in the hands of large-scale producers.

Finally, the bill renewed long-term diversions of land under the Conservation Reserve Program (CRP), under which farmers can voluntarily idle their land for ten-year periods. The bill authorized CRP contracts for 35.4 million acres. While the ostensible goal of the CRP is to

preserve environmentally sensitive land, it also has had the effect of controlling supply.

Whether or not the FAIR Act was originally intended as a phase-out of the government's support of agriculture, events since 1996 have worked against that reduced support. Responding to declining farm incomes, Congress has passed emergency supplemental legislation in each of the past three years. In 1998, Congress passed an Agriculture Relief Package, including disaster relief and market loss assistance, totaling \$5.975 billion. This package provided relief to farmers who had suffered crop losses because of poor weather and disease and to farmers who had suffered "loss due to circumstances beyond their control. These circumstances include economic dislocation, unilateral trade sanctions and a failure to pursue trade opportunities aggressively."<sup>2</sup> In effect, the market-loss assistance portion of the package consisted of almost a 50 percent "bonus" transition payment to farmers who had qualified in 1998. In 1999, Congress approved an \$8.7 billion emergency spending bill that provided a combination of disaster and farm income assistance.<sup>3</sup> Most recently, in late May 2000, Congress approved an emergency agriculture spending bill, which includes \$7.1 billion in direct assistance for 2000, and \$8.2 billion of subsidies delivered through crop insurance programs over the next five years.<sup>4</sup>

The emergency legislation enacted over the past three years has increased farmers' dependence on government assistance and reflects a growing dissatisfaction with the strategy of the FAIR Act. At the USDA's annual Agricultural Outlook Forum, on February 24, 2000, Secretary Dan Glickman represented the current administration's position:

*During the last two years, Congress and the Administration were compelled to act....This certainly helped many farmers. Plenty of them would not have made it without that assistance. Nevertheless, I believe it...applied a very expensive tourniquet, when the situation actually called for a blood transfusion. Scrambling at the last minute to throw together ad hoc assistance is not the best way to help our farmers. Why can't we have all the assistance mechanisms in*

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<sup>1</sup>Agricultural Policy Analysis Center, University of Tennessee. Spring 2000. *Policy Matters*, p. 18.

<sup>2</sup> Disaster and Tax Relief for American Farmers (<http://agriculture.house.gov/105/disaster.htm>).

<sup>3</sup> RL30201: Appropriations for FY2000: U.S. Department of Agriculture and Related Agencies. December 6, 1999. Congressional Research Service Issue Brief, p. 2.

<sup>4</sup> The Agricultural Risk Protection Act of 2000 (<http://agriculture.house.gov/2559conf.htm>).

place, ready to kick in when the farm economy heads south? Why can't we fix the leaky roof before it starts raining?<sup>5</sup>

As we approach 2002, competing philosophies will shape the debate about the future of U.S. farm policy. Will policymakers modify the 1996 Act, or revert to previous policies? The apparent alternatives are well summarized by a past USDA chief economist:

*There are two schools of thought on this issue. One says, at great cost, we bought our way out of these programs and we will stay on schedule and will be free of them when the FAIR Act expires. If this occurs, advocates say, the FAIR Act will be worth all that it cost. The other school of thinking says that if agriculture experiences a substantial decline in income (which it did in 1998), we will be right back into price supports and supply controls as we were before.<sup>6</sup>*

While the FAIR Act was a significant departure from the usual path of U.S. farm policy, the important economic issues that have driven past debates will continue to be part of the discussion when a new farm bill is created in 2002. It is useful, then, to consider the salient issues that will frame this debate.

### Determinants of Future U.S. Farm Policy

Before any discussion of agricultural policy begins, this question must be asked: "Do U.S. farmers still require a safety net?" When the Agricultural Adjustment Act of 1933 was passed during the height of the Great Depression, federal aid to farmers was justified as a strategy to keep farmers on the land and to improve the incomes of farm families relative to urban families.

The validity of the goal of keeping farmers on their land is sometimes disputed on at least two grounds. First, in a larger context, the decline in the importance of agriculture is a natural result of economic growth, which many observers see as both inevitable and desirable.<sup>7</sup> At least since the Industrial Revolution, agriculture employment has declined. As the U.S. economy has grown, opportunities for employment off the farm have increased and

<sup>5</sup> Glickman, Dan. February 24, 2000, Remarks at the USDA Agricultural Outlook Forum (<http://www.usda.gov/oc/waob/oc2000/speeches/glickman.txt>).

<sup>6</sup> Paarlberg, Don. First quarter, 1999. "Obituary for a Farm Program." *Choices*, p. 36.

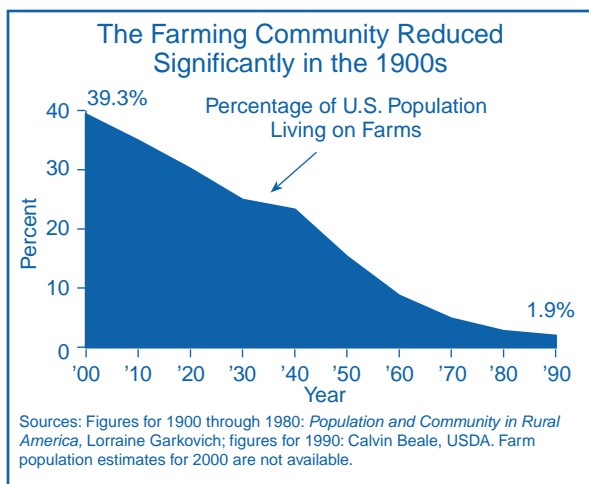
<sup>7</sup> Johnson, D. Gale. 1991. *World Agriculture in Disarray*. New York: St. Martin's Press, p. 16.

attracted more workers. The trend has been particularly pronounced in the twentieth century as the development and adoption of new technologies have reduced the demand for agricultural labor. Second, experience suggests that federal aid to farmers has not kept workers on the farm. This trend is apparent in Chart 3; the data show that the share of the U.S. population living on farms has declined steadily throughout the past century.

The continuing significant decline in the farm population suggests that federal farm policy has had little long-term effect on the continuing out-migration from farms.

The goal of improving farm incomes relative to urban incomes may no longer be as relevant as it was in the 1930s. As advances in technology have reduced the costs of agricultural production, commodity prices have slowly declined in real terms. As a result, farm operations have consolidated into larger and larger enterprises, as farmers have had to make larger capital investments to maintain and increase their incomes. In the 1920s, farm incomes averaged about one-quarter of nonfarm incomes, and the standard of living of farm people was significantly below that of urbanites. Today, however, incomes per farm household generally equal or exceed those of nonfarm households, and the wealth of farm households averages several times that of all households. However, these averages mask significant variations in the populations discussed. For example, as *USDA* data indicate, half a million farm households in the United States reported annual incomes below \$20,000 in 1997.<sup>8</sup>

CHART 3



<sup>8</sup> Harwood, Joy, and Craig Jagger. Fourth quarter, 1999. "Agriculture's Safety Net. Looking Back to Look Ahead." *Choices*, p. 59.

If federal aid to farmers is likely to continue in some form, the more immediate question to consider may be, "Which farmers should be assisted?" Traditionally, most federal aid to agriculture has been targeted to producers of the seven "program" crops: wheat, corn, sorghum, barley, oats, rice, and cotton. The deficiency payments were based on the volume of production, not on a farmer's income. As a result, the largest farms received the largest payments. The continuing consolidation of agriculture has concentrated agricultural aid in the hands of the largest producers. Typically, livestock producers and producers of nonprogram crops such as soybeans have benefited much less from federal aid programs. While the FAIR Act decoupled payments from actual production decisions during the seven-year life of the current farm bill, the payments were based on historical production levels of the program crops. If an important goal of farm policy is to improve farmers' incomes, the traditional deficiency payments and the FAIR Act's transition payments are, according to some critics, an inefficient means of accomplishing that end.

### ***International Trade Issues Will Continue to Constrain the Direction of U.S. Farm Policy***

Beyond domestic considerations, questions of international trade will continue to constrain the options of U.S. policymakers. But certainly, U.S. farm policy is not produced in a vacuum. Future directions in farm policy must be framed in the context of global economic and political realities. Consider the place of U.S. policy within the framework of GATT (General Agreement on Tariffs and Trade) and its successor, the World Trade Organization (WTO). Agricultural policy was not a serious part of the GATT/WTO agenda until 1994, when the first guidelines were produced under the Uruguay Round of negotiations.

Since 1994, the United States has been under pressure from the European Union (EU) and other exporters of agricultural commodities who have significant interest in removing barriers to trade from the United States. But beyond tariffs, these exporters also have an interest in the explicit and implicit subsidies provided by governments to farm producers because it places their farmers at a competitive disadvantage. In the United States, the FAIR Act and the popular CRP program have been criticized for a variety of reasons. The FAIR Act was widely hailed by U.S. trading partners and competitors for decoupling aid from production deci-

sions, thus moving toward a system of aid that was less likely to distort decision making by individual farmers. But policy moves over the past three years have not won the support of our trading partners, as "emergency" legislation in 1998, 1999, and 2000 provided continued assistance for U.S. farmers and slowed downward adjustments in production, which worldwide commodity prices would otherwise dictate. The regime of international trade, including WTO rules, certainly constrains the direction of U.S. farm policy.

The other major issue affecting the future of U.S. farm policy is the evolving relationship between rural development and agricultural policy. Farmers now make up only a small minority of the population of rural areas, so some analysts see the need for a rural development policy separate from agricultural policy. As agriculture continues to consolidate, the economic viability of many rural communities will be at risk. Towns and smaller cities that existed primarily to support agricultural activities must find new sources of economic sustenance. Smaller communities will face a number of challenges, including maintaining access to financial markets, improving access to telecommunications, maintaining infrastructure, and developing strategies for business assistance. As noted by one observer of the rural economy, "it is clear that consolidation in agriculture brings into focus a wide range of policy issues in rural America. Most of these lie far afield of the traditional purview of Congressional agriculture committees."<sup>9</sup> The future direction of agricultural policy will be shaped by a growing realization that rural development issues need to be addressed as well.

### ***Possible Directions of U.S. Farm Policy***

What direction could the 2002 farm bill take? According to analysts, three different scenarios are possible. Under one scenario, the market-oriented features of the FAIR Act would be retained, and a schedule would be set for ending any remaining payments to export crop producers. Permanent farm program legislation would be repealed, and the Freedom to Farm Act would be acknowledged as a successful buyout of New Deal-era farm policies.<sup>10</sup> Strong market prices, while not predict-

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<sup>9</sup> Drabenstott, Mark. First quarter, 1999. "Consolidation in U.S. Agriculture: The New Rural Landscape and Public Policy." *Economic Review*. Federal Reserve Bank of Kansas City.

<sup>10</sup> Orden, David, Robert Paarlberg, and Terry Roe. 1999. *Policy Reform in American Agriculture*. Chicago: The University of Chicago Press, p. 218.



ed in the near term, would be vitally important to realizing this outcome, as many observers argue that the high commodity prices of 1996 were instrumental in helping the passage of the FAIR Act. In addition, substantial progress would need to be made in international trade negotiations. Supporters of U.S. agriculture likely would demand rapid progress by the European Union in reforming its Common Agriculture Policy to ensure some semblance of parity in international markets. However, if commodity prices are low during the period 2000 to 2002, a significant retreat from the framework of the 1996 Farm Bill is possible. A retreat could restore past techniques of intervention, including target prices, increased use of export subsidies, and resurrection of supply control authority.

A third scenario would retain the core reforms of the FAIR Act, including the end of deficiency payments and supply controls, but extend or enhance a variety of strategies of intervention. Likely strategies would include increased reliance on crop insurance, following the policies instituted in the Agricultural Risk Protection Act of 2000, which increased premium subsidies. In a sense, crop insurance programs, with subsidized premiums, serve as a substitute for the ad hoc supplemental aid offered to farmers in 1998, 1999, and 2000. Consequently, Congress's tendency to provide supplemental aid has had adverse incentive effects on the crop insurance program. Some academic studies have concluded that crop insurance programs cannot be justified on the basis of economic efficiency, but serve as a politically palatable means of transferring income to an effective interest group.<sup>11</sup> Nonetheless, increased participation in crop insurance likely will decrease political pressure for more supplemental aid.

CRP may be expanded, with eligibility requirements loosened. The program has been popular, as it combines supply control, income support, and environmental goals with minimal administration costs. Under CRP, qualified farmers withdraw their land from production for ten years in return for fixed annual payments from the government. This program provides fixed annual cash flow to the participating farmers with no input expenditures required. The usefulness of CRP has been mixed in the Kansas City Region, as CRP likely is more profitable than cultivating less productive farmland. Nonetheless, this policy tool likely will continue to be an important part of future strategies.

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<sup>11</sup> Goodwin, Barry K., and Vincent H. Smith. 1995. *The Economics of Crop Insurance and Disaster Aid*. Washington, D.C.: AEI Press, p. 29.

As part of a discussion on continuing income support goals, a consensus for income/need-based assistance for farmers is likely to materialize. Proposals will emerge to provide assistance that will be delivered in broader, non-commodity-specific ways.<sup>12</sup> For example, some have suggested that federal aid be provided to farmers based on annual incomes, rather than on the crops they produce. If a goal of federal aid is to support farm incomes, programs that are focused on those farmers most in need could become attractive in the future.

Finally, broader programs of rural development assistance likely will attract increased attention. At the Agricultural Outlook Forum, Secretary Dan Glickman spoke of the need for increased attention to rural issues outside the farmstead:

*[another] principle involves integrating rural development into farm policy. In today's world, most people in rural America cannot make a decent living in production agriculture alone....A new farm policy must go beyond the wheat program, the rice program, the cotton program, and so on to address the more fundamental question: how can we help preserve the nation's agrarian tradition by providing more rural economic opportunity....Over the last 60 years, agriculture has been dramatically transformed, and yet farm policy has remained relatively stagnant. People generally do not and cannot farm the way they did in the 1930s and 1940s, so government's role in helping them has to change accordingly.<sup>13</sup>*

While the specific characteristics of the 2002 farm bill cannot be predicted precisely, the low commodity prices that have persisted since 1997, and Congress's willingness to provide supplemental legislation, suggest that a total dismantling of the traditional farm policy instruments is unlikely. Even though the Farm Bill of 1996 has attracted considerable criticism in the past three years, a consensus still exists that a return to traditional farm policy instruments may not be entirely appropriate in the modern agricultural economy.

Changes in agricultural policy are typically slow and incremental. The reforms attempted in 1996 significantly departed from traditional policy. While Congress has cushioned the farm economy from the effects of the

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<sup>12</sup> Harwood and Jagger, p. 59.

<sup>13</sup> Glickman, Dan. February 24, 2000, Remarks at the USDA Agricultural Outlook Forum (<http://www.usda.gov/oce/waob/oc2000/speeches/glickman.txt>).

## *Regional Perspectives*

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new system, change is still in the air. The 2002 farm bill likely will address a number of new issues with some novel policy initiatives.

As was evident during the FDIC's Agricultural Bankers' Roundtable, bankers historically have benefited from the traditional federal government aid programs for farmers. Deficiency payments to crop producers have allowed farmers to repay their loans, even during periods of low commodity prices. However, the passage of

the 1996 Farm Bill marked a departure from "business as usual" in the farm policy arena and set the stage for possibly more significant changes when the 2002 farm bill is debated. The uncertainty expressed by bankers during the FDIC meetings is understandable, as farmers and the bankers who lend to them could be operating in a new environment after 2002.

*Jeffrey W. Walser, Regional Economist*

## *Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding*

- In analyses conducted in 1998 and 1999, nine metropolitan areas were identified as at risk for overbuilding; this analysis notes more vigorous building occurring across multiple property types and identifies 13 markets, including eight of the previous nine, as at risk for overbuilding.
- Construction activity has accelerated during the current economic expansion with cyclically high levels of supply and demand.
- Capital markets scaled back their investments in commercial real estate in 1998 and 1999, while FDIC-insured institutions increased their construction and development lending by more than 20 percent each year.

The banking industry and the FDIC learned during the late 1980s that once commercial real estate (CRE) markets become overbuilt, losses can mount quickly. During the 1980s and early 1990s, losses on CRE loans were responsible for hundreds of bank and thrift failures and billions of dollars in insurance losses for the FDIC. Since then, commercial vacancy rates have improved dramatically in a number of major U.S. metropolitan markets. In turn, CRE charge-offs reported by FDIC-insured institutions have fallen to very low levels—less than 0.05 percent of average loans in both 1998 and 1999.

Two recent studies published by the FDIC evaluate the risk of overbuilding in major U.S. metropolitan areas.<sup>1</sup> These studies identified nine cities—**Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland** (Oregon), and **Salt Lake City**—as markets at risk for rising commercial vacancy rates. This article revisits the FDIC’s previous analysis of CRE markets. Using a more restrictive definition of at-risk markets, we find that eight of the previously identified nine markets remain on the list, joined by five additional markets: **Denver, Fort Worth, Jacksonville, Sacramento, and Seattle.**<sup>2</sup> In general, more

markets are experiencing increased levels of construction activity across multiple CRE property sectors than was the case just two years ago.

Like the two earlier studies, this analysis does not predict an imminent rise in vacancies and losses in the at-risk markets. Instead, as before, the goal is to raise awareness about substantial growth in real estate development and the corresponding increases in risk exposure to financial institutions.

### *Previous Real Estate Cycles Are Well Documented*

Many analysts view the late 1980s U.S. experience as the very definition of adverse conditions in CRE markets. The factors that brought about these adverse conditions are well documented.<sup>3</sup> During the early and mid-1980s, CRE construction boomed. Total office space completed in 54 major U.S. markets tracked by *Torto Wheaton Research* exceeded 100 million square feet per year every year from 1982 through 1987. Insured banks and thrifts were prime sources of credit for this building boom. Total outstanding construction and development (C&D) loans on the balance sheets of insured institutions grew by 52 percent, or \$52.5 billion dollars, in 1985 alone, followed by three successive years of growth in outstanding C&D loans. A key factor behind this surge in lending was intense competition among lenders. In response to the heightened competition, many lenders loosened their underwriting standards, often extending credit on speculative projects on terms that did not protect them from downside risk. Examples of aggressive lending practices from this period included more collateral-based lending, higher loan-to-value limits, reliance on overly optimistic appraisals, and inattention to secondary repayment sources.

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<sup>1</sup> See “Ranking the Risk of Overbuilding in Commercial Real Estate Markets,” *Bank Trends*, October 1998, and “Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead,” *Regional Outlook*, first quarter 1999.

<sup>2</sup> The one metropolitan area identified in the prior analyses as at risk for overbuilding that did not fall into the same category using the stricter criteria in this analysis is Nashville. Nevertheless, Nashville still ranks high in terms of construction activity at fifth highest in the U.S. for retail and twelfth highest for office construction activity.

<sup>3</sup> See, for example, Freund et al. 1997. *History of the Eighties: Lessons for the Future*, Chapters 9 and 10. FDIC.

Poorly underwritten credit and massive increases in construction resulted in overbuilding in a number of large U.S. metropolitan markets. Nationwide, the office vacancy rate for competitively leased space peaked at over 19 percent in 1991.<sup>4</sup> In the Southwest and New England, where the cycle of overlending and overbuilding was most pronounced, metro real estate markets were in even worse shape. Office vacancies in Dallas peaked at over 27 percent in 1988, while office vacancies in Boston reached over 17 percent in 1990. As vacancies rose and rents fell, lenders in the Southwest, Northeast, and elsewhere increasingly found themselves in possession of nonperforming loans and impaired real estate assets. The result was a sharp increase in the number of failed banks in the Southwest and Northeast.<sup>5</sup>

Following the CRE debacle of the late 1980s and early 1990s, commercial construction and lending volumes slowed. C&D loan growth at FDIC-insured institutions declined every year from 1989 through 1994, while a similar drop in private construction expenditures lasted through 1993.



### ***Factors Contributing to Cycle of Overbuilding in CRE***

One reason that CRE markets are prone to periodic bouts of overbuilding is the business cycle itself, which saps demand for new space when business activity turns downward. But another important contributing factor is the lag time in the development process as new construction moves from inception to completion. Heavy demand at the start of a project may wane or vanish before completion occurs. In general, the time lag associated with CRE development is longest for hotel and office projects and becomes shorter for retail, multifamily, and industrial properties, respectively. The associated degrees of lending risk mostly follow the same pattern. In general, less risk is associated with industrial buildings and multifamily projects, which typically take less than one year to build.

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<sup>4</sup> The U.S. vacancy rate is calculated as an aggregate of selected major markets tracked by Torto Wheaton Research.

<sup>5</sup> As further detailed in the *History of the Eighties*, combined assets of failed banks in the Northeast and Southwest comprised over 70 percent of assets of all banks failing between 1980 and 1994.

To the extent that commercial construction projects involve a lag between inception and completion, net additions to supply can be anticipated in advance. Much progress has been made during this real estate cycle toward increased availability of information on CRE markets, particularly in regard to supply characteristics. Market transparency has been promoted in part by a heightened level of public ownership of CRE properties and the corresponding higher degree of disclosure by the owned entities, such as real estate investment trusts (REITs) and commercial mortgage-backed securities (CMBSS).

Changes in demand are harder to predict. A current example may be the high level of demand generated by Internet start-up companies that rely heavily on financing provided by venture capital funds and initial public stock offerings. Because many of these start-ups depend so heavily on cash inflows from investors as opposed to operating revenues, their viability as tenants and their continued demand for high volumes of office space may depend more on capital market conditions than on their own business performance. While demand may appear strong under robust business conditions, it is prone to decline rather suddenly in the event of an economic downturn. Given these attributes of CRE markets, the process of gauging the success for lease-up of a proposed project involves not only looking at new supplies of competitive space coming onto the market, but also evaluating how vulnerable the market is to a downturn in demand for space.

### ***Recent Developments***

Following a lull in commercial construction activity that resulted from adverse market conditions in the early 1990s, construction activity has gradually accelerated during the current economic expansion. The increased pace of construction occurred first in industrial and retail markets, where growth in net new completions of space picked up starting in 1993. The pace of multifamily construction accelerated in 1995, followed by increasing levels of office and hotel construction in 1997. Regionally, commercial construction activity recovered first in the Southeast and Northwest, where the effects of the previous overbuilding had been the least pronounced. Only later did the pace of construction increase in California, the Southwest, and the Northeast. As the U.S. economic expansion endures into its tenth year, construction activity continues to pick up steam across most property types. In the 54 major met-

ropolitan areas tracked by *Torto Wheaton Research*, total annual office space completions rose from just over 3 million square feet in 1994 to 78.7 million square feet in 1999.

National private expenditures on hotel and retail construction for 1999 exceeded all prior years on both a current-dollar and an inflation-adjusted dollar basis. Similarly, national private construction expenditures on office space in 1999 were at an all-time high on a current-dollar basis. On an inflation-adjusted dollar basis, office construction expenditures in 1999 were still not as high as they were during the mid-1980s.

A new characteristic of the CRE industry in the current expansion has been the marked increase in capital availability through the financial markets. Annual issuance of CMBSs has grown from negligible amounts in 1990 to over \$67 billion in 1999. Financing made available through REITs has been the other link to the capital markets. REIT market capitalization increased from approximately \$10 billion in 1994 to nearly \$145 billion in 1999.

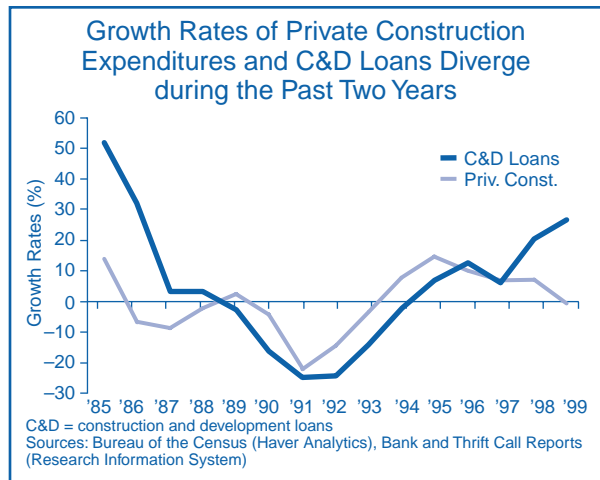
While the availability of market-based sources of capital has helped to facilitate growth in construction during this expansion, the financial market turmoil of late 1998 cast a cloud over the CMBS market that has yet to lift fully. Significant events in the global capital markets in 1997 and 1998, including the Asian economic crisis and the Russian government bond default, significantly curtailed the ability of major CMBS issuers to go to the market for financing. Significant liquidity problems resulted for a number of commercial mortgage firms. Nomura, Lehman Brothers, CS First Boston, and others incurred losses, while Criimi Mae, Inc., was forced to declare bankruptcy.

As the capital markets pulled back from CRE investments, insured banks and thrifts stepped in to fill the void. Chart 1 shows that the total volume of C&D loans on the balance sheets of FDIC-insured institutions rose by more than 20 percent per year in both 1998 and 1999, even as growth in U.S. private construction expenditures slowed to a crawl.<sup>6</sup>

In terms of overall construction market activity, the current situation appears to be one of cyclically high

<sup>6</sup> U.S. private construction expenditures, as calculated by the Bureau of the Census, include multifamily (two or more units), industrial, office, hotel, and retail space.

CHART 1



levels of supply and demand. Because significant growth in net new space is forecast for many markets and property types during 2000 and 2001, a drop in demand for space could impair absorption rates and lead to higher vacancies and lower rents. Most analysts feel that future trends in real estate demand will be closely linked to national and regional economic conditions.

### Identification of Markets at Risk for Overbuilding

Previous FDIC studies have identified CRE markets at risk for broad-based overbuilding on the basis of comparative rankings in the rates of growth in commercial space. In a 1998 study, U.S. metropolitan areas were ranked according to 1997 new construction activity as a percentage of existing stock for the five main property types: office, industrial, retail, multifamily, and hotel.<sup>7,8</sup> In that study, any metro area that appeared in the top 15 for *any two* of the commercial property types was labeled “at risk.” Nine cities were identified as being at risk for overbuilding: **Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland (Oregon), and Salt Lake City.**

<sup>7</sup> Federal Deposit Insurance Corporation. October 1998. Ranking the Risk of Overbuilding in Commercial Real Estate Markets, *Bank Trends*.

<sup>8</sup> Construction activity is measured in square feet and includes projects completed during the year, plus projects still under construction as of year-end. This figure is then divided by the total stock of space to obtain a construction activity percentage for use in comparative rankings.

## In Focus This Quarter

This study updates the previous results using year-end 1999 data.<sup>9</sup> In doing so, it applies more restrictive criteria to identify at-risk metropolitan real estate markets. As before, the metro areas are ranked according to new construction as a percentage of existing stock in each of the five main commercial property types. However, in this analysis, to be considered at risk, a metro area must rank in the *top ten* for any two of the property types. Despite the fact that it was harder for individual markets to qualify as being at risk, all but one of the previously identified nine markets remain on the at-risk list. Moreover, they are joined by five additional metropolitan areas: **Denver, Fort Worth, Jacksonville, Sacramento, and Seattle**. It is evident that more metropolitan areas are emerging with vigorous CRE construction and development across multiple property sectors.

### Most Active Construction Markets

Charts 2 through 6 represent the property sectors of office, industrial, retail, multifamily, and hotel. They also list, for each property sector, the metropolitan areas having the highest levels of construction activity, relative to existing stock, for the year ending December 31, 1999. The overall national construction activity rate is also shown for comparative purposes for each of the property sectors. Each metropolitan area is ranked from the highest to lowest for levels of construction activity.

As shown in these charts, **Las Vegas, Orlando, and Phoenix** are standouts, with each placing among the top ten metropolitan areas in the country for construction activity in at least four of the five different property sectors. **Las Vegas** is among the top ten in construction activity for all five property sectors except for hotel construction, where it ranks twenty-sixth.<sup>10</sup> **Las Vegas** ranks first in retail construction and second in industrial construction. **Orlando** is first in both office and multifamily construction. **Phoenix** is among the top ten for each of the five property sectors except hotel construction, where it ranks sixteenth.

<sup>9</sup> For the five property sectors reviewed in this report, data sources were **Torto Wheaton Research** for office and industrial and **F.W. Dodge** for retail, multifamily, and hotel. Torto Wheaton Research's data for office and industrial encompass 54 and 53 metropolitan statistical areas (MSAs), respectively. F.W. Dodge's data for retail, multifamily, and hotel encompass 58 MSAs.

<sup>10</sup> Las Vegas has the most hotel rooms in the country, with slightly fewer than 124,000 rooms as of year-end 1999. During 1999, Las Vegas experienced the greatest addition of rooms (in absolute numbers) of any market. With over 13,000 new rooms added during 1999, Las Vegas had nearly twice the level of the next highest metropolitan area, which was Orlando, with an additional 7,000 rooms.

CHART 2

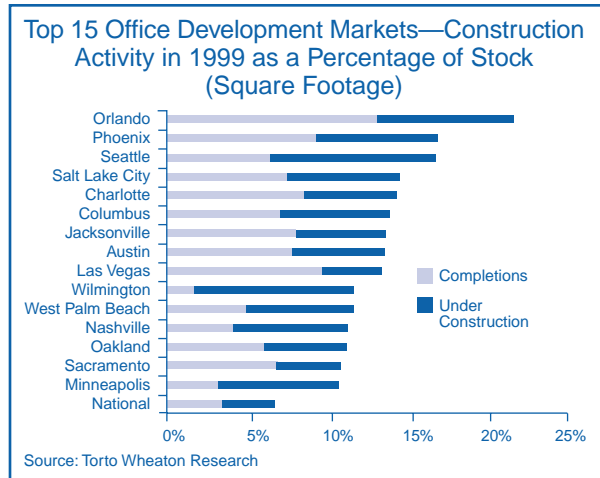


CHART 3

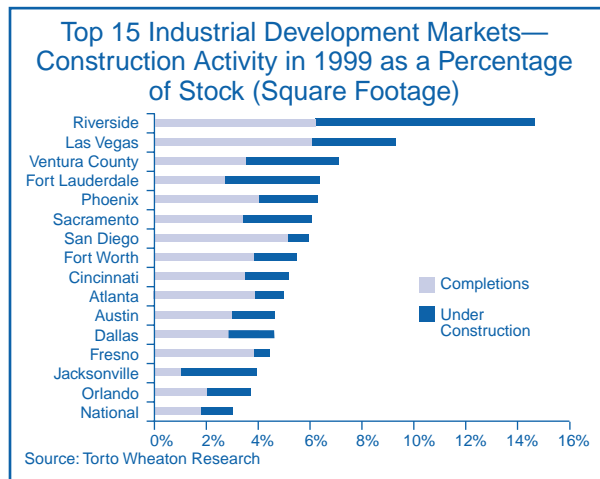
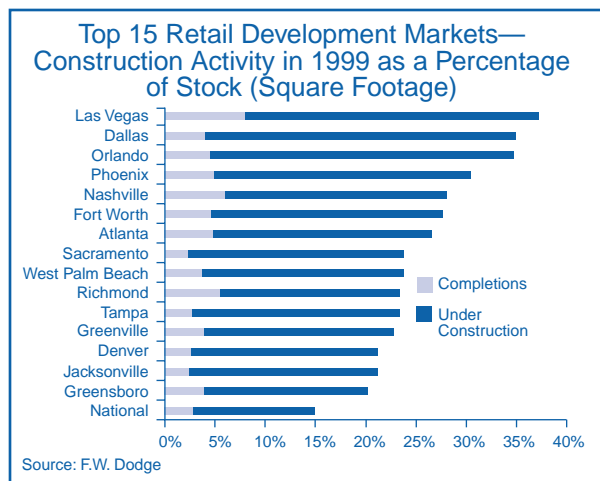


CHART 4



## In Focus This Quarter

Other markets deserve notice for their high or moderately high levels of construction activity in one or more property sectors. **Columbus, Ohio**, ranks sixth in the nation for its high level of office construction and twelfth for both multifamily and hotel construction. **Greenville** is tenth in the nation for hotel construction and twelfth for retail. **West Palm Beach** is ninth for retail and eleventh for office. **Austin** is eighth for office, eleventh for both multifamily and industrial, and thirteenth for hotel.

### C&D Loan Concentrations

Concentrations of C&D loans at community banks in the at-risk markets are generally higher now than they were at the peak of the last cycle in the 1980s.<sup>11</sup> As shown in Chart 7, the median ratio of C&D loans to total assets as of March 31, 2000, was higher than the median ratio as of December 31, 1988, in ten of the thirteen at-risk markets.<sup>12</sup> The median C&D loan concentration is currently higher than the national average in all 13 at-risk markets.<sup>13</sup>

At present, overall loan performance remains very good for the C&D portfolios of insured institutions. Reported delinquent and nonaccrual C&D loans remain at nominal levels as a percentage of total loans, although the ratio for both measures increased marginally during the first quarter of 2000.

### Construction Employment Concentrations

The percentage of a metropolitan area's workforce employed in construction is an indicator of the sensitivity of the local economy to construction. Six of the 13 metropolitan areas at risk for overbuilding are found among the top 12 most concentrated construction employment markets (see Chart 8, next page).<sup>14</sup> In addition, all of the 13 have construction concentration levels exceeding the national average. With slightly under 10 percent of its nonfarm workforce employed in construction, **Las Vegas** has the highest construction-

<sup>11</sup> Community banks are FDIC-insured institutions with assets less than \$1 billion.

<sup>12</sup> For community banks that have C&D loans.

<sup>13</sup> Since 1992, the aggregate C&D-to-asset ratio for the nation's community banks has been higher than the C&D-to-asset ratio for institutions larger than \$1 billion. This is a reversal of the condition from 1984 through 1991 when the aggregate C&D-to-asset ratio for institutions larger than \$1 billion exceeded the C&D-to-asset ratio for community banks.

<sup>14</sup> Construction concentrations are the percentage of construction employees relative to the nonfarm workforce.

CHART 5

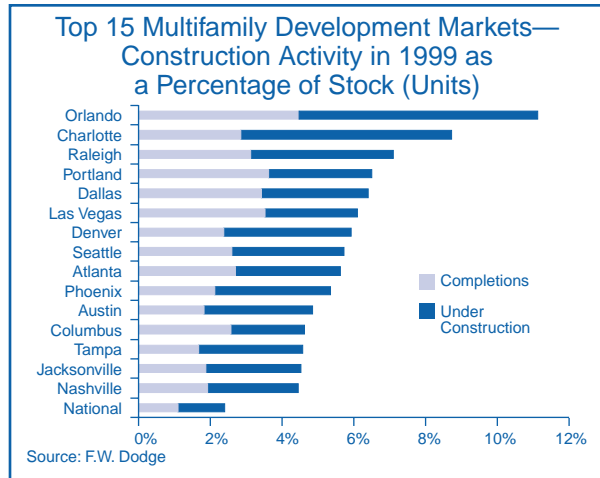


CHART 6

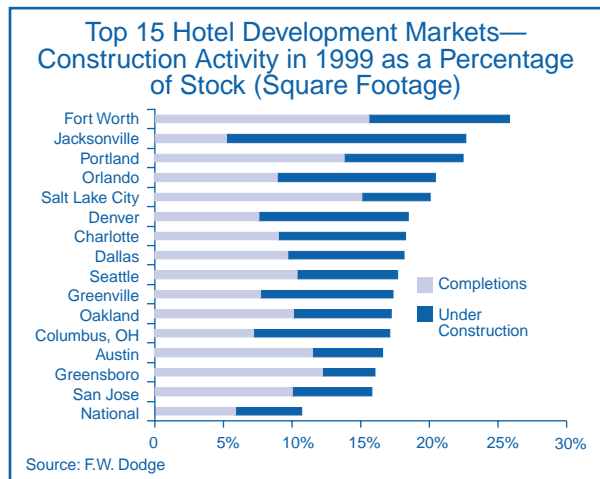
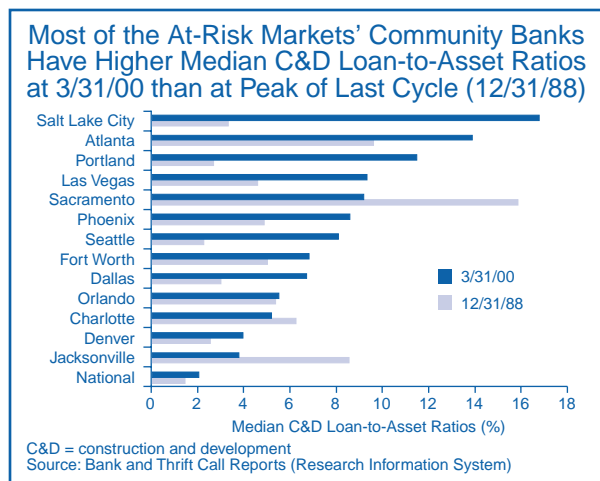


CHART 7



# In Focus This Quarter

concentrated workforce of all metropolitan areas in the United States and is slightly over twice the national rate of 4.8 percent.

## High Construction Activity and High Vacancy Levels

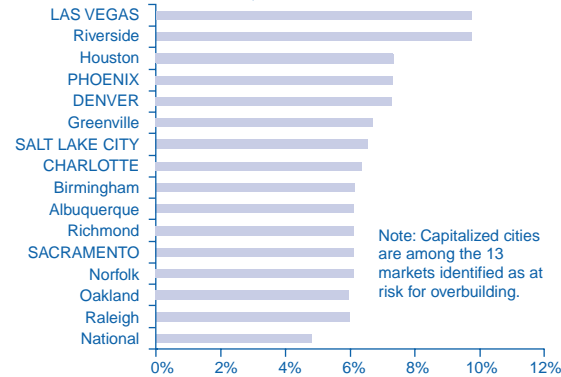
Newly constructed, speculative space competes directly for tenants against already-built and vacant space. To assess at-risk markets fully, it is useful to compare the levels of construction activity for each metropolitan area's property sector against its associated vacancy levels.<sup>15</sup>

Charts 9 through 13 show, by property sector, each city's level of construction activity plotted against the corresponding vacancy rate. It is axiomatic that a metropolitan area with high vacancies and high construction is cause for concern for builders and lenders alike.

It follows for metropolitan areas with high construction and high vacancy that newly arriving CRE projects will face significant competitive pressures in obtaining tenants. Consequentially, barring any preleasing or any fundamental upward shifts in demand, rental concessions may be needed to obtain tenants, and property values may be depressed.

**CHART 8**

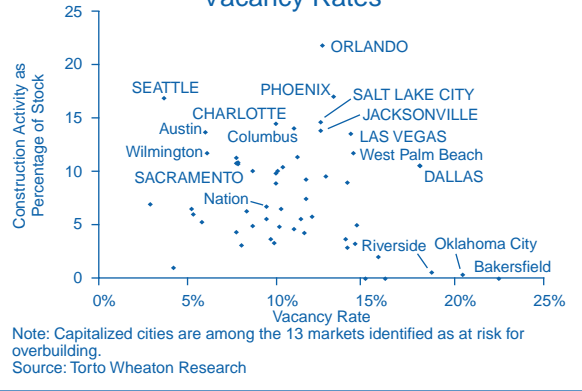
Many of the 13 At-Risk Markets Are among the Nation's Metropolitan Statistical Areas Having the Highest Construction Employment Levels as of First Quarter 2000



<sup>15</sup> The data vendors do not provide category breakdowns for construction activity into speculative versus nonspeculative (preleased) properties.

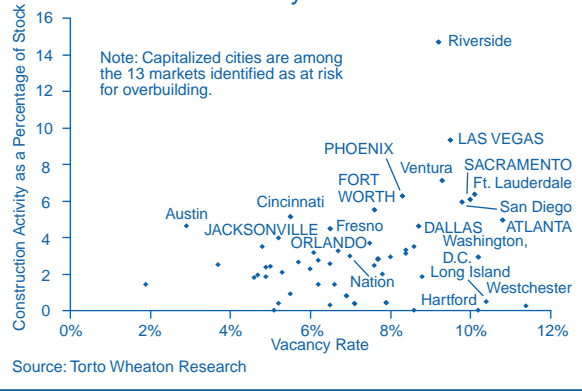
**CHART 9**

Many of the 13 At-Risk Markets Report High Office Construction Activity and High Office Vacancy Rates



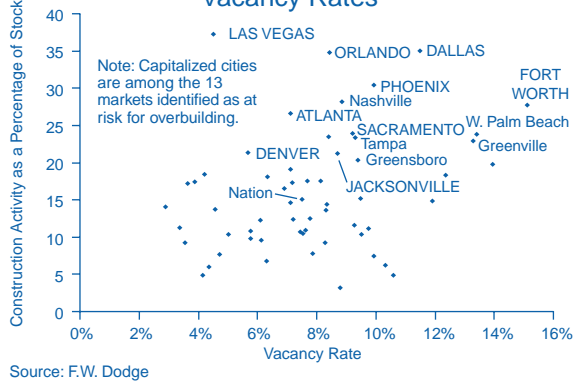
**CHART 10**

Many of the 13 At-Risk Markets Report High Industrial Construction Activity and High Industrial Vacancy Rates



**CHART 11**

Many of the 13 At-Risk Markets Report High Retail Construction Activity and High Retail Vacancy Rates





### What Market Analysts Are Saying

Views of industry analysts provide additional perspective on the risks pertaining to each of the five property sectors and the individual metropolitan areas.

#### Office

Newly constructed nationwide office supply will outpace demand in 2000 and beyond, according to **Torto Wheaton Research**.<sup>16</sup> Some 65 million square feet of space is scheduled for completion in 2000. However, net absorption is projected to be only 58 million square feet in 2000, resulting in an excess supply of 7 million square feet. Torto Wheaton Research predicts that office completions will outpace absorptions for all projected year-ends through 2005, and corresponding vacancy rates will climb to slightly more than 14 percent at year-end 2005.

Overall office fundamentals are in equilibrium, according to **Donaldson Lufkin & Jenrette (DLJ)**, thanks to preleasing and sufficient demand.<sup>17</sup> Still, DLJ identifies a number of markets as being at greater risk for excess new supply. DLJ's markets to watch for possible overbuilding are Charlotte, Fort Lauderdale, Minneapolis, and Sacramento. More than 9 percent in new supply is projected for Sacramento over the next 18 months, with only a 3 percent increase in demand. DLJ identifies the Sacramento suburbs as the major center of construction activity and notes with concern the existing 13 percent suburban vacancy rate for this metropolitan area.

Overall office construction levels will peak this year, according to the **Urban Land Institute (ULI)**.<sup>18</sup> Increases in suburban office vacancy rates to nearly 11 percent by the end of 2000 are projected, with downtown rates falling to slightly over 8 percent. ULI notes the possibility of a rash of space returns by Internet companies and others in the technology sector as a significant going-forward risk.

Many analysts caution about the ability of new office construction to be absorbed in certain markets where labor supplies remain tight. In recent **Wall Street Journal** articles, Dallas and Seattle are reported to be actively recruiting high-tech engineers through immigrants from India and China to fill in the gaps in their tight labor-market pool for high-technology jobs.<sup>19, 20</sup>

<sup>16</sup> Torto Wheaton Research. Spring 2000. *Office Outlook*.

<sup>17</sup> Thierry Perrein, Donaldson, Lufkin & Jenrette. April 2000. *DLJ REIT Corporate Handbook*, "Cautious Optimism."

<sup>18</sup> Urban Land Institute. *ULI 2000 Real Estate Forecast*.

<sup>19</sup> Templin, Neal. June 7, 2000. Economic Focus: Houston, Dallas Are Draw for Immigrants. *The Wall Street Journal*.

<sup>20</sup> Barnes, Brooks. June 7, 2000. Economic Focus: Seattle Enjoys Influx of Foreign Workers. *The Wall Street Journal*.

In a recent office market report by **Moody's Investors Service**, three metropolitan areas (Jacksonville, Nashville, and Phoenix) are coded as "red"—indicating danger for high supply and declining demand factors.<sup>21</sup> Charlotte is coded as "yellow," and its office demand is projected to grow by only 5 percent this year, while supply will increase by over 11 percent.

#### Multifamily

Recent mortgage rate increases will slow purchases of single-family homes, thereby increasing the demand for multifamily properties, according to a recent article by **PaineWebber**.<sup>22</sup> Nevertheless, concerns are raised for oversupply conditions for multifamily construction in Atlanta, Dallas, Houston, and Las Vegas—cities characterized as "low barrier-to-entry markets."

Markets appearing weak to **DLJ** for the multifamily property sector include Charlotte, Denver, Jacksonville, Orlando, Portland, Raleigh, Salt Lake City, and Seattle.<sup>23</sup>

#### Industrial

Atlanta and Dallas are weaker for the industrial property sector, according to **DLJ**, because of significant new supply levels.<sup>24</sup> A 7 percent supply growth is projected for Phoenix in 2000, with only a 4 percent increase in demand.

#### Retail

For retail properties, **DLJ** believes a number of markets have excess supply; the standouts are Austin, Las Vegas, Orlando, Phoenix, and Sacramento.<sup>25</sup>

#### Hotel

Analysts point to specific concerns for a "glut" of limited-service hotels in certain markets and note many hotel developers taking advantage of low barriers to entry for hotel construction. In response, many developers argue that "product differentiation" within different hotel sectors justifies further development.

Growth in expenditures on hotel construction has been above 7 percent for each of the past several years, while room revenues grew at a more moderate pace, according to **PaineWebber**.<sup>26</sup> The poor growth in room revenue is attributed to supply exceeding demand.

<sup>21</sup> Gordon, Sally. June 2, 2000. Moody's Investors Service, *Special Report—CMBS: Red-Yellow-Green Update, Second Quarter 2000, Quarterly Assessment of U.S. Property Markets*.

<sup>22</sup> PaineWebber. June 6, 2000. *Real Estate Investment Trust—Initiating Coverage on the REIT Industry*.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> PaineWebber. June 1, 2000. *Industry Outlook Lodging, U.S. Hotel Construction Update—First Quarter 2000*.

CHART 12

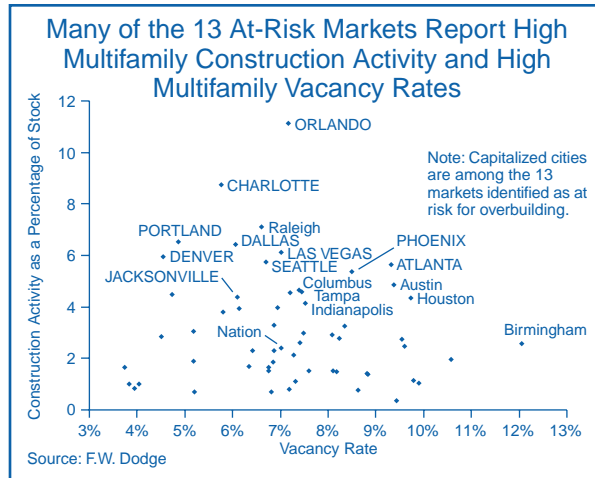
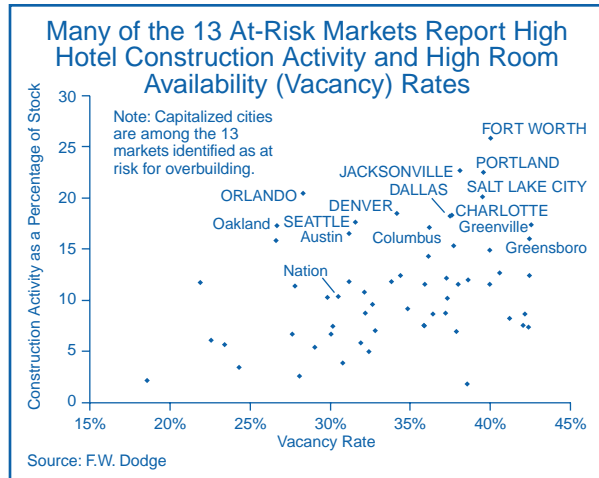


CHART 13



As shown in the referenced charts, multiple cities are experiencing high volumes of construction activity concurrent with high vacancy rates. Seven of the 13 at-risk cities show up in the upper-right quadrants, exhibiting both high rates of construction and vacancy: **Atlanta** for industrial and multifamily; **Dallas** for office and retail; **Fort Worth** for retail and hotel; **Jacksonville** for office and hotel; **Las Vegas** for office and industrial; **Orlando** for office and multifamily; and **Salt Lake City** for office and hotel.

Other metropolitan areas beyond these 13 are precariously situated at the furthestmost positions on the charts for high vacancy and high construction levels: **Austin** and **Houston** for multifamily; **Greensboro** for hotel; **Greenville** for retail and hotel; and **West Palm Beach** for office and retail.

**Conclusion**

Since 1997, responding to a void left by the departure of other capital market lenders, community banks have stepped up their CRE lending activity. At the same time, more metropolitan areas are emerging with vigorous CRE construction and development across multiple property sectors. In the 1998 and 1999 FDIC analyses, nine metropolitan areas were identified as being at risk for overbuilding across multiple property types. In the present analysis, 13 metropolitan areas, including eight of the nine from the prior analyses, receive this designation. Given strong levels of CRE completions, these metropolitan areas are particularly sensitive to any decline in real estate demand that could result from a slowdown in the national or regional economy.

*Thomas A. Murray, Senior Financial Analyst*

## *Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate*

- **Home prices have risen rapidly in several major U.S. metropolitan areas.**
- **The credit quality of residential real estate loan portfolios traditionally has been solid.**
- **New lending programs such as subprime and high loan-to-value lending could change the historical loss experience associated with residential real estate.**

### **Introduction**

The median price of an existing single-family home has been rising rapidly in several U.S. metropolitan areas. After a prolonged period of stagnant or slowly rising resale prices in many of these markets throughout most of the 1990s, prices have rebounded strongly, reaching double-digit rates of growth in some areas. Not surprisingly, these markets have also experienced relatively robust job growth, particularly in high-tech sectors that have been the catalyst for growth in the New Economy.<sup>1</sup>

However, as existing home prices in some markets have been rising rapidly, new building activity has recently begun to slow because of rising interest rates. After reaching a 19 percent year-over-year growth rate in the fourth quarter of 1998, single-family housing starts declined by 2.8 percent in the second quarter of 2000. Similarly, year-over-year growth in single-family housing permits declined by 8.4 percent in the second quarter of 2000. Higher home mortgage rates, along with the prospect for more moderate job growth, have dampened market activity.

Single-family mortgages have traditionally been associated with low loss rates compared with other, higher-risk lending lines at insured institutions. However, the real estate market is still susceptible to boom and bust cycles, which could pose a risk to institutions with exposures to residential real estate. This risk would be heightened by the formation of asset price bubbles in local markets. Furthermore, as the competition among

<sup>1</sup> For a discussion on what is meant by the term “New Economy,” see “Banking Risk in the New Economy,” *Regional Outlook*, second quarter 2000; <http://www.fdic.gov/bank/analytical/regional/ro20002q/na/t2q2000.pdf>.

mortgage lenders becomes more intense, insured institutions are increasingly participating in new, higher-risk types of mortgage lending, such as high loan-to-value (LTV) lending and subprime lending. These new lending practices—still largely untested in a recession—raise some concerns about the future credit quality of residential loan portfolios.

### **Home Prices in Some Local Markets Are Soaring**

Home prices have been soaring recently in a number of large U.S. metropolitan markets. Rapid price increases in some of these areas have come on the heels of a period of slow or stagnant growth (see Chart 1). Table 1 (next page) identifies the top 20 metropolitan markets based on the median price of an existing single-family home. Many of the areas identified in the table are also places where home prices are increasing most rapidly. Healthy job growth, tight labor market conditions, and a tight supply of available homes have contributed to price increases in these areas.

Some of the same metropolitan areas that are experiencing significant home price appreciation are also highly dependent on the high-tech sector. The shaded areas in Table 1 highlight the metro markets that not only have the highest median home prices in the nation but also have a concentration of high-tech employees in the workforce greater than 5 percent. Explosive growth

**CHART 1**

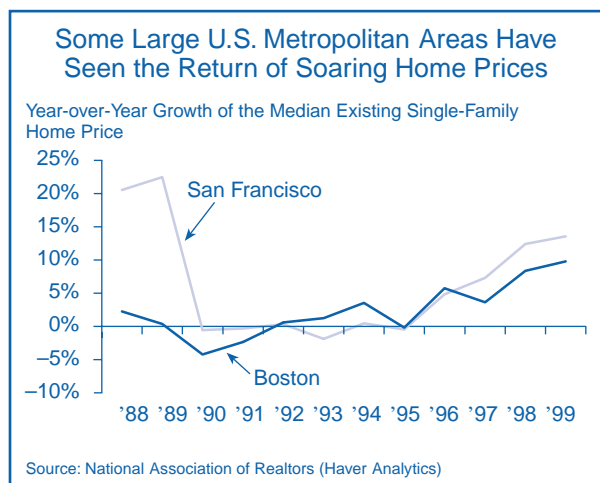


TABLE 1

OF THE 20 U.S. CITIES WITH THE MOST EXPENSIVE HOUSING, MORE THAN HALF HAVE A CONCENTRATION IN HIGH-TECH EMPLOYMENT		
THE SHADED AREAS INDICATE MARKETS WHERE HIGH-TECH EMPLOYEES CONSTITUTE AT LEAST 5 PERCENT OF THE TOTAL PAYROLL EMPLOYMENT (SEE NOTE).		
METROPOLITAN STATISTICAL AREA RANKING BY MEDIAN HOME PRICE	MEDIAN PRICE OF AN EXISTING SINGLE-FAMILY HOME MARCH 2000	PERCENT CHANGE FROM ONE YEAR AGO
1 SAN FRANCISCO, CA	\$418,600	25.0%
2 ORANGE COUNTY, CA	\$300,800	10.3%
3 HONOLULU, HI	\$289,000	-2.0%
4 BOSTON, MA*	\$255,000	8.4%
5 SAN DIEGO, CA	\$251,400	16.1%
6 BERGEN-PASSAIC, NJ	\$250,200	9.8%
7 NEWARK, NJ	\$229,500	18.8%
8 SEATTLE, WA	\$226,100	8.3%
9 NEW YORK, NY	\$221,500	14.3%
10 NASSAU-SUFFOLK, NY	\$209,200	12.8%
11 LOS ANGELES, CA	\$202,900	5.6%
12 MIDDLESEX, NJ	\$198,500	8.6%
13 MONMOUTH-OCEAN, NJ	\$186,200	19.4%
14 DENVER, CO	\$181,500	12.9%
15 WASHINGTON, DC-MD-VA	\$177,500	5.6%
16 PORTLAND, OR	\$166,700	0.8%
17 CHICAGO, IL	\$166,700	0.4%
18 LAKE COUNTY, IL	\$162,600	-2.2%
19 AURORA-ELGIN, IL	\$158,200	7.5%
20 RALEIGH-DURHAM, NC	\$156,300	-4.2%
<b>NATION</b>	<b>\$133,533</b>	<b>2.7%</b>

\* RANKING BASED ON THE LATEST DATA AVAILABLE (THIRD QUARTER 1999).  
 NOTE: HIGH-TECH, AS DEFINED BY DISMAL SCIENCES, INC., INCLUDES INDUSTRIES SUCH AS PHARMACEUTICALS, COMPUTERS,  
 ELECTRONIC COMPONENTS, COMMUNICATIONS EQUIPMENT, AND COMMUNICATIONS SERVICES.  
 SOURCES: NATIONAL ASSOCIATION OF REALTORS (HAVER ANALYTICS); DISMAL SCIENCES, INC.

in technology industries during this expansion has created new job opportunities in many metropolitan areas where high-tech companies and employment tend to be concentrated. The influx of highly skilled, and often highly compensated, high-tech workers into these areas has boosted the demand for both new and existing homes, pushing up home prices. For example, in San Francisco, where high-tech employees now comprise 7.1 percent of the total workforce, home prices rose by 22 percent in calendar year 1999 and are expected to rise another 14 percent in 2000.<sup>2</sup>

<sup>2</sup> July 21, 2000. Your Money Matters: Turning Down the Heat on Home Prices—Forecasters Find More Evidence That the Market Is Cooling; San Francisco Still Rocks. *The Wall Street Journal*.

Soaring home prices in these metro areas have created the possibility of speculative price bubbles that could cause problems for mortgage lenders. If a decline in high-tech employment or company earnings were to cause a deterioration in home values in these markets, the credit quality of mortgage portfolios at insured institutions could be jeopardized.

### *Favorable Economic Conditions Have Sustained Consumer Spending Patterns*

As the current U.S. expansion entered its 113th month in July 2000, consumer spending continued along a path of rapid growth. In the second quarter of 2000, person-

al consumption expenditures increased by 8 percent over the previous year. Nearly ideal conditions for consumers have contributed to high levels of spending. The unemployment rate remains near the record low of 3.9 percent set in April 2000, and consumer confidence remains near the record high set in January 2000. Moreover, consumer buying power has been boosted by real wage gains, generally low interest rates, and stock market earnings.

One of the only negative aspects for consumers has been the recent rise in interest rates, which has increased the cost of borrowing. From the end of 1998 to June 2000, both the bank prime lending rate and the average mortgage contract rate for purchase of a previously occupied home rose by more than 100 basis points. However, the flexibility offered by adjustable-rate mortgages (ARMs) has helped consumers shield themselves from the full effects of interest rate increases. As of the second quarter of 2000, the share of ARMs as a percentage of all loans closed had risen from 10 percent in the fourth quarter of 1998 to 30 percent (see Chart 2).

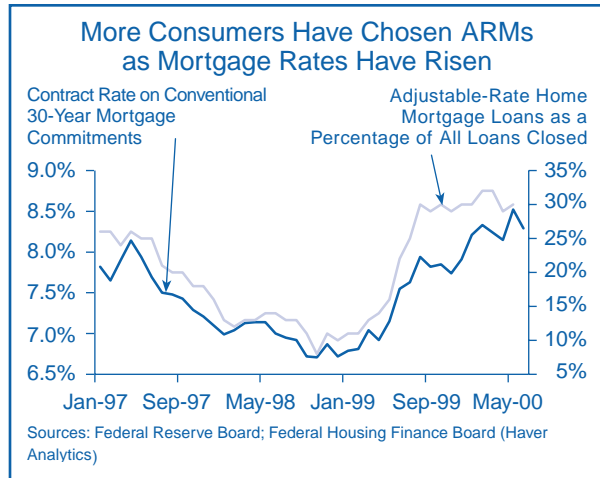
Nonetheless, as interest rates have risen, overall activity in the single-family housing market has slowed noticeably. After reaching an annualized rate of 1.4 million units in December 1999, monthly starts of single-family homes have declined by more than 15 percent to 1.2 million units in June 2000. Similarly, the annualized rate of single-family permits issued in June 2000 was down 14 percent from January 2000 levels. The *National Association of Realtors (NAR)* reports that, despite current high levels of activity, deteriorating affordability conditions are expected to slow the resale housing market over the course of the year.<sup>3</sup> In June 2000, NAR's composite Housing Affordability Index fell to its lowest point since September 1996. To the extent that any decline in economic conditions would produce a less favorable environment for consumers, the housing market would likely slow even further.

### **Overall Credit Quality of Residential Mortgages Has Been Solid**

Historical losses from residential real estate exposures at insured institutions are well documented. In the 1980s, areas such as Texas, California, and New Eng-

<sup>3</sup> National Association of Realtors Press Release. August 1, 2000. Housing Affordability Drops to Eight-Year Low, NAR Reports.

CHART 2



land experienced strong economic growth, rapid residential development, and sharp home price appreciation that created asset price inflation. Coastal California markets, in particular, experienced double-digit growth rates that propelled the median home price in California to more than double the national average.<sup>4</sup>

Regional recessions in many of these areas took a toll on residential real estate markets. Home values either stagnated or declined precipitously, and the foreclosure rate on residential real estate began to rise rapidly. Nevertheless, very few bank failures can be attributed solely to losses on residential mortgages. Loss rates on residential loans have traditionally been low compared with other loan categories.

The credit quality of conventional single-family mortgage portfolios has generally been good throughout this economic expansion. The percentage of conventional loans past due during this expansion has averaged 2.8 percent, compared with 3.5 percent during the last expansion from 1982 to 1990.<sup>5</sup> Moreover, past-due conventional loans fell for the sixth consecutive quarter in the first quarter of 2000 to 2.3 percent (see Chart 3, next page). Foreclosures started, while slightly higher on average than the previous expansion, remain at a healthy level well below 1 percent of loans (see Chart 4, next page).

<sup>4</sup> Federal Deposit Insurance Corporation, Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future. Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s.* <http://www.fdic.gov/bank/historical/history/contents.html>.

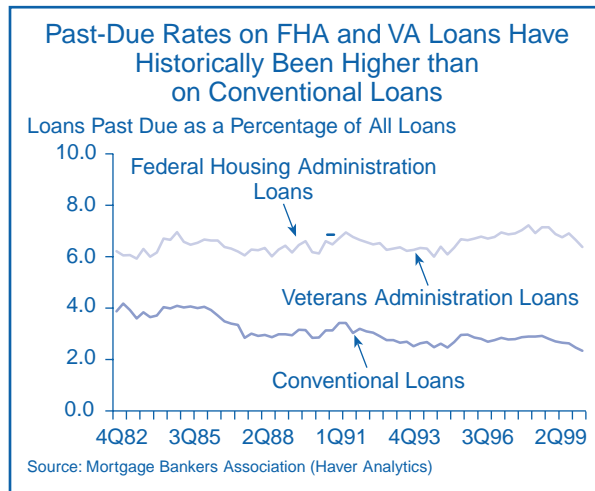
<sup>5</sup> "Past due" refers to loans that are 30 or more days past due.

## In Focus This Quarter

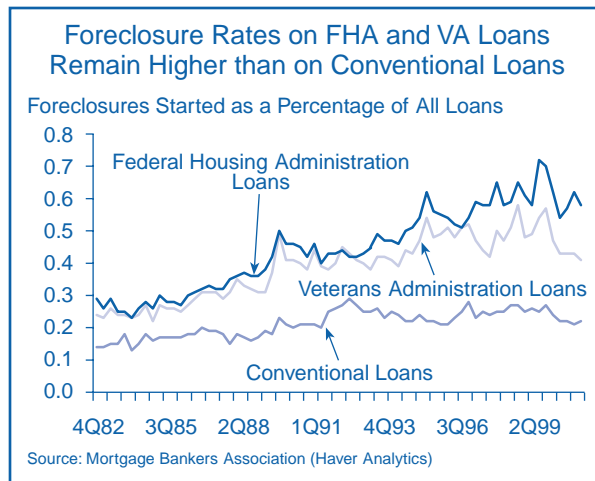
By contrast, Veterans Administration (VA) and Federal Housing Administration (FHA) loans have performed less well during this expansion. These loan types are both designed to aid less creditworthy borrowers in securing a home loan. VA and FHA loans, which include a portion of the higher-risk high-LTV and sub-prime loans, have historically experienced higher past-due and foreclosure rates than other classes of mortgage loans (see Charts 3 and 4).

The overall performance of 1–4 family residential mortgages at insured institutions has been solid. As of March 2000, delinquent 1–4 family loans remained well under 1 percent of total 1–4 family loans, and the percentage of charge-offs was nearly zero. Charge-offs may have reached the bottom of the credit cycle in 1998, however, after peaking at a record high in 1993 (see Chart 5).

**CHART 3**



**CHART 4**

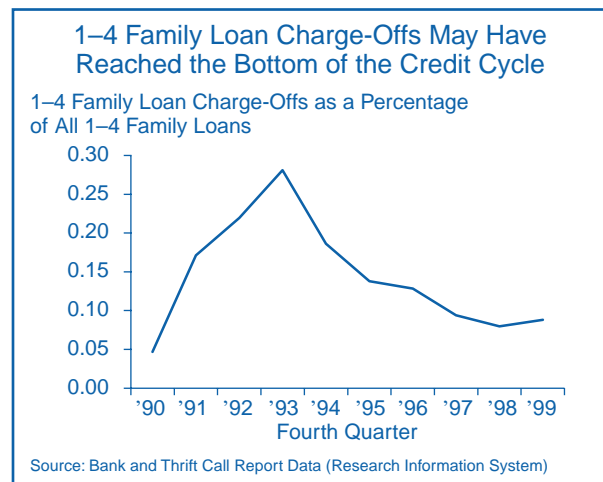


A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving sub-market residential real estate problems associated with local economic and business conditions or new, higher-risk lending lines of business.

Concerns have arisen recently about the future of residential loan credit quality and consumer credit quality in general. The *Board of Governors of the Federal Reserve System* warned that, although the consumer sector seems healthy by most measurable standards, “[consumer] delinquency rates may be held down, to some extent, by the surge in new loan originations in recent quarters because newly originated loans are less likely to be delinquent than seasoned ones.”<sup>6</sup> Consumer credit outstanding grew by nearly 8 percent in the second quarter of 2000, the highest growth rate in the past three years. At the same time, 1–4 family loans at insured institutions expanded by 11 percent from March 1999 to March 2000, the highest year-over-year growth rate since 1997.

High growth rates are not the only concern regarding the future credit quality of residential loan portfolios. Rising interest rates have raised the cost of borrowing for consumers at a time when consumer credit has been expanding rapidly. Mortgage debt service payments as a percentage of disposable personal income rose to nearly 6 percent in the first quarter of 2000, continuing an

**CHART 5**



<sup>6</sup> Board of Governors of the Federal Reserve System. July 20, 2000. Monetary Policy Report to the Congress, p. 7.

upward trend since mid-1994. This level was last reached in 1991, when the economy was emerging from an economic recession and some local residential markets were in turmoil. Further increases in interest rates would push mortgage debt service payments higher, which could impair the ability of mortgage holders to service both mortgage debt and other consumer debt. Moreover, other consumer loans would likely enter delinquency before mortgage loans, as consumers are more likely to pay their mortgages before other consumer debt.

***New Residential Lending Programs May Heighten the Risk Exposure of Insured Institutions***

Recent trends in high-LTV and subprime lending have heightened the risk exposure of insured institutions. Intense competitive pressure in the banking industry has narrowed the margins of traditional lending lines, inducing banks to seek more profitable lines of business. Both high-LTV and subprime lending offer wider margins, but at the price of increased risk to the lender.

High-LTV loans represent greater risk to lending institutions when collateral values decline. If a home loan is underwritten on the basis of an inflated home value, there is a greater possibility of default if the value of the home declines. Furthermore, a decline in the value of the home could reduce the possibility of recovering the loan in the event of default and foreclosure.

The share of high-LTV loan originations is growing.<sup>7</sup> The percentage of loans with an LTV ratio greater than 90 percent has risen from around 5 percent to more than 20 percent over the past ten years.<sup>8</sup> Table 2 identifies the metropolitan areas where more than 30 percent of the conventional home loans underwritten in 1999 carried an LTV ratio greater than 90 percent. Given that the historical cycles of boom and bust in residential real estate have often been geographically isolated, both regional and national trends in high-LTV lending should be carefully monitored.

Subprime lending is a term commonly used to refer to loans that are extended to borrowers who are perceived as less creditworthy.<sup>9</sup> As insured institutions have increased their involvement, the subprime lending market has presented banks with new growth opportunities and new risks. Subprime loans represent a small but growing share of total mortgage originations (see Chart 6, next page). To be sure, higher pricing on subprime loans promises wider margins and higher revenues for lenders, but the credit risk associated with less-than-prime borrowers requires ongoing oversight and management to prevent credit losses from eroding margins. Some financial institutions that have either grown subprime portfolios or acquired subprime affiliates are now scaling back their involvement in subprime

**TABLE 2**

<b>POCKETS OF RISK MAY BE FORMING WHERE THE LTV IS HIGHEST</b>	
<b>METROPOLITAN STATISTICAL AREA (MSA) OR CONSOLIDATED MSA RANKED BY PERCENTAGE OF LOANS WITH LTV GREATER THAN 90 PERCENT</b>	<b>PERCENTAGE OF LOANS WITH LTV OVER 90 PERCENT 1999</b>
1 GREENVILLE-SPARTANBURG-ANDERSON, SC	50%
2 HONOLULU, HI	42%
3 MEMPHIS, TN	38%
4 CHARLOTTE-GASTONIA-ROCK HILL, NC-SC	37%
5 BIRMINGHAM, AL	35%
6 HOUSTON-GALVESTON-BRAZORIA, TX	35%
7 ATLANTA, GA	32%
8 JACKSONVILLE, FL	32%
9 NASHVILLE, TN	32%
10 OKLAHOMA CITY, OK	32%
11 TULSA, OK	32%
12 GREENSBORO-WINSTON-SALEM-HIGH POINT, NC	31%
13 KANSAS CITY, MO-KS	30%
14 LAS VEGAS, NV-AZ	30%

LTV = LOAN-TO-VALUE  
SOURCE: FEDERAL HOUSING FINANCE BOARD

<sup>7</sup> See also Diane Ellis. "High Loan-to-Value Lending: A New Frontier in Home Equity Lending." *Regional Outlook*, first quarter 1999; <http://www.fdic.gov/bank/analytical/regional/ro19991q/na/t1q1999.pdf>.

<sup>8</sup> Federal Housing Finance Board.

<sup>9</sup> See also Kathy R. Kalser and Debra L. Novak. "Subprime Lending: A Time for Caution." *Regional Outlook*, third quarter 1997; <http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf>.

lending activities to limit projected losses.<sup>10</sup> In some cases, excessive losses related to the business of underwriting subprime loans have contributed to the failure of insured institutions.

A recent report from *Inside Mortgage Finance* states that subprime portfolios are showing evidence of weakness.<sup>11</sup> According to this report, the serious delinquency rate in the overall subprime market rose from 6.5 percent in 1998 to 6.9 percent in 1999.<sup>12</sup> Furthermore, the percentage of A-rated borrowers in the subprime market fell from 59 percent to 53 percent during the same period. The implication is that both subprime and prime mortgages originated this year could likely underperform relative to prior years, adversely affecting credit quality at insured institutions.

The potential for higher future losses related to subprime lending is of particular concern. The delinquency rate on subprime mortgages has traditionally been much higher than that of prime mortgages. As of December 1999, seriously delinquent prime mortgage loans comprised only 0.5 percent of total mortgage loans, compared with 3.2 percent of the best-rated subprime loans. Subprime mortgage loan seasoning analysis shows that 1999 vintage subprime loans have so far outperformed both 1997 and 1998 vintage loans (see Chart 7). However, there is a concern that adverse

changes in economic conditions and the health of the consumer sector could cause the foreclosure rate on subprime mortgage loans to increase more steeply than in prior years.

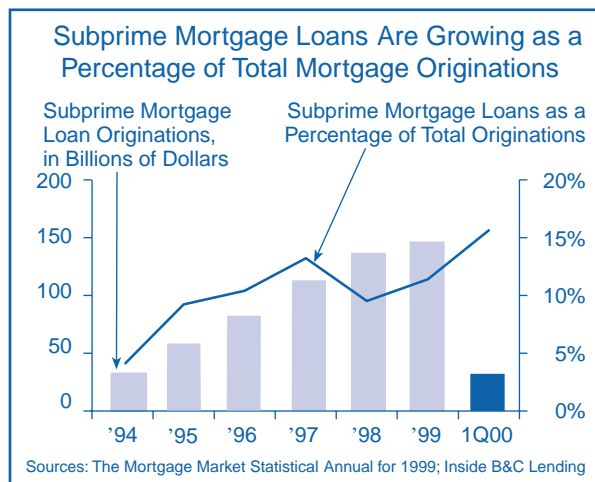
### Conclusion

Rising home prices in some U.S. metropolitan areas may be a warning sign that asset price bubbles may be forming in some areas. A number of these areas also contain concentrations of employment in the high-tech sector, placing them at higher risk in the event of a downturn in that sector. Mortgage lenders in these areas should carefully monitor developments that could adversely affect home prices and collateral values. Nationally, single-family housing market activity appears to be slowing after a period of rapid growth supported by a long economic expansion and generally favorable interest rates.

Historically, mortgage loans at insured institutions have been one of the best-performing asset classes. As 1–4 family loan charge-offs have approached zero, it appears as if the credit cycle may have bottomed out, implying that loss rates may be rising. Moreover, as insured institutions increase involvement with subprime and high-LTV lending, the potential for higher future losses on residential real estate also increases. It will be important to keep an eye on developments in the economy and the consumer sector that could affect the future credit quality of residential real estate at insured institutions.

*Alan Deaton, Financial Economist*

**CHART 6**

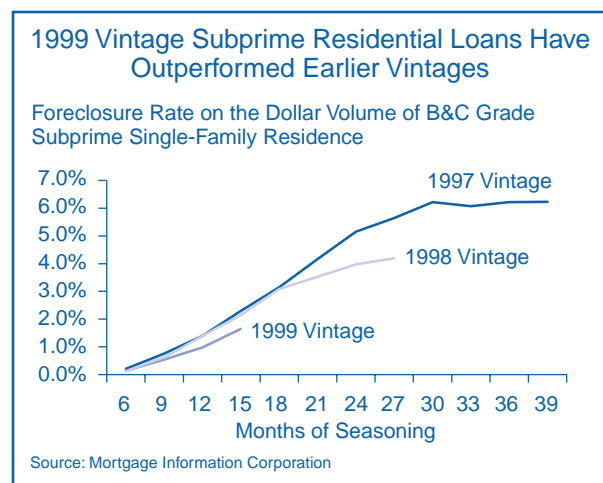


<sup>10</sup> Subprime Mortgage Market Faces More Challenges in Second Half of Turbulent 2000. *Inside Mortgage Finance*. July 7, 2000.

<sup>11</sup> Mortgage Delinquency Rates Decline in Early 2000 But Industry Braces for Shift in the Wind. *Inside Mortgage Finance*. July 14, 2000.

<sup>12</sup> Seriously delinquent loans are defined as loans at least 90 days delinquent or in foreclosure.

**CHART 7**





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