MAY, 2002 NUMBER 02-04

DIVISION OF INSURANCE

Bank Trends

Analysis of Emerging Risks In Banking

NEW YORK, NY

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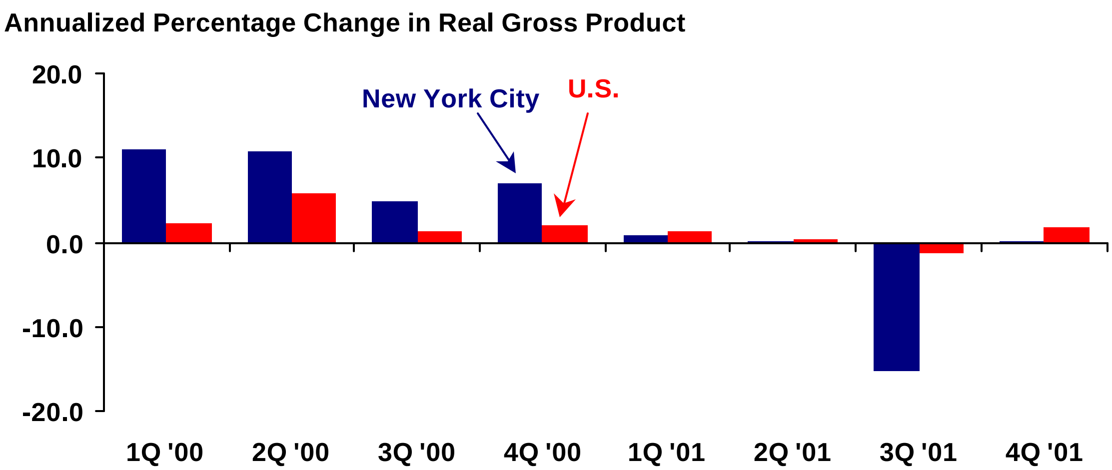
The New York City Economy: Post 9/11

In 2000, the New York City economy was significantly outperforming the nation primarily because of a robust financial services sector. By mid-2000, however, the nation's and the City's economies began to slow. The slowing in the New York City economy primarily was attributed to declining capital markets activity that was, in part, a response to failures in the dot-com and telecommunication industries as well as the general slowdown in the nation's economy. After declining to near-zero growth in second quarter 2001, the New York City metropolitan area economy contracted sharply following 9/11. In third quarter 2001, the gross metro product of the City decreased at an annual rate of approximately 15 percent, compared with a 1.3 percent annual rate of decline in the nation's Gross Domestic Product (see Chart 1)

Chart 1

After a Strong 2000, 9/11 Shocked NYC's Economic Growth in Third Quarter 2001



Source: National Income and Product Accounts, Economy.com. Note: NYC data are Economy.com's May 2002 estimates for the PMSA, which includes the Bronx, Kings (Brooklyn), Manhattan, Queens, Richmond (Staten Island), Putnam, Rockland and Westchester Counties.

The New York City Economy: Post 9/11

Background

In 2000, the New York City economy was significantly outperforming the nation primarily because of a robust financial services sector.[1] By mid-2000, however, the economies of the nation and the City both began to slow. The slowing in the New York City economy primarily was attributed to declining capital markets activity that was, in part, a response to failures in the dot-com and telecommunication industries, as well as the general slowdown in the U.S. economy. After declining to near-zero growth in second quarter 2001, the New York City metropolitan area economy contracted sharply following 9/11. In third quarter 2001, the gross metro product of the City decreased at an annual rate of approximately 15 percent, compared with a 1.3 percent annualized rate of decline in U.S. Gross Domestic Product (GDP).

The attack destroyed or significantly damaged many businesses in Downtown Manhattan. Business confidence, already shaken by the nation's slowing economy, was temporarily shattered as the stock market closed for four days and uncertainty reigned. Advertising, travel, tourism, and retailing suffered immediate declines. Airline traffic came to a standstill, and New York City's hotels suffered significant declines in revenues per room, which declined 34 percent from fourth quarter 2000 to fourth quarter 2001 due to sharply lower occupancy and room rates.[2] Many Manhattan companies returned large tracts of office space to the market in anticipation of leaner times ahead. Local income and business tax collections were disrupted. The City's fiscal situation also deteriorated significantly such that the local government currently faces the largest budget deficit in decades.

[1] Source: Economy.com, April 2002 estimate. Changes in the City's economy are tracked by Economy.com's gross metro product for the New York City PMSA, which includes the five boroughs plus Putnam, Rockland, and Westchester Counties.

[2] Source: Smith Travel Research. Numbers quoted in Merrill Lynch Research, "Top 25 Lodging Markets," May 8, 2002.

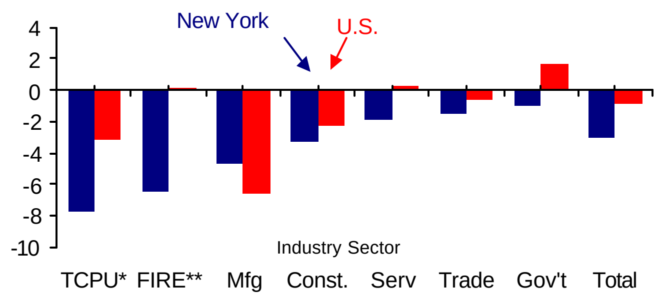
Employment Declined in the Wake of the Attack

During the past eight months, employment declines have been deep and widespread. Total employment in the City has declined by 100,000 jobs, or 3 percent of the workforce, since September.[3] Compared with other major metropolitan areas across the nation, New York City's employment decline was among the most severe. By sector, the greatest declines occurred in transportation, communications, and public utilities (TCPU), manufacturing, and finance, insurance, and real estate (FIRE, see Chart 2).

Chart 2

Job Declines in New York City Have Been Deeper and More Widespread than the Nation

Percentage Change: Apr. 01 - Apr. 02



* TCPU represents transportation, communciation, and public utilities.
** FIRE represents finance, insurance, and real estate.
Source: Bureau of Labor Statistics.

The FIRE sector, which includes securities firms, commercial banks, insurance companies, and real estate businesses, is one of the City's primary engines of economic growth. The FIRE sector accounts for approximately 13 percent of the City's workforce but a disproportionate 30 percent of

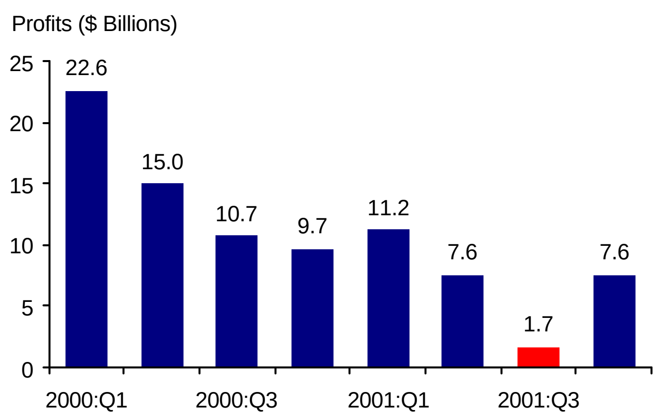
[3] Source: Office of the New York City Comptroller. *The Comptroller's Comments on the Economic Assumptions Underlying the Executive Budget for Fiscal Year 2003*. May 2002. The number represents the month-to-month seasonally adjusted changes in jobs.

annual earnings, which includes primarily wages and salaries of the City's workforce.[4]

Job declines in the securities industry, in particular, hurt the economy because of the very high salaries paid to those employees. The average salary of a securities industry employee in New York City in 2000 was $248,503, substantially greater than the $45,507 average salary of a non-securities industry worker.[5] Securities industry profits had trended down before 9/11, reflecting declining underwriting activity, fewer initial public offerings, and reduced trading volume compared with previous years. These trends, in part, stemmed from the bursting of the NASDAQ and Internet-related bubble, which contributed to declining earnings on Wall Street and to the layoff of approximately 5,000 employees between year-end 2000 and September 2001. The 9/11 attack exacerbated this downward trend, and profits in the securities industry declined sharply in third quarter 2001 (see Chart 3).

Chart 3

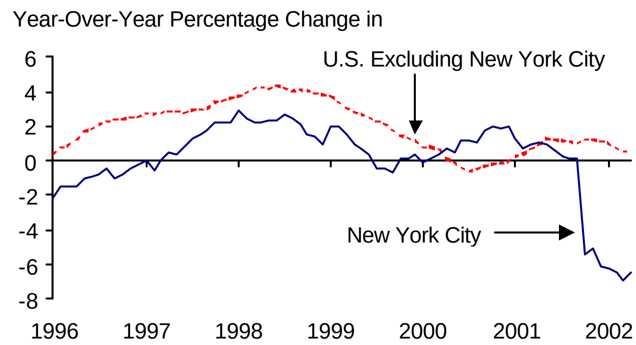
Securities Industry Profits Plunged After 9/11



Source: Securities Industry Association

Following 9/11, FIRE sector layoffs increased significantly as prospects for economic recovery dimmed. An additional 35,000 FIRE-sector employees were laid off between September 2001 and April 2002. FIRE-sector job reductions, which have been caused predominantly by layoffs in the securities industry, have occurred to a greater degree in the City than across the nation (see Chart 4). In contrast to other cities such as Boston and San Francisco where the FIRE sector also has a meaningful presence, New York City's financial sector relies more heavily on investment banking and equity raising activities, which have been adversely affected by weakness in the corporate sector during this recession.

FIRE-Sector Employment Declines Have Been More Severe in New York City than the Nation*



** FIRE represents finance, insurance, and real estate.

Source: Bureau of Labor Statistics

Manhattan's Office Market Has Weakened

Prior to 9/11, Manhattan's office market was considered very healthy. In second quarter 2000, the vacancy rate for the City's office space reached a cyclical low of 2.4 percent—among the lowest vacancy rates in the nation.[6] With limited new supply entering the market during the 1990s, Manhattan's landlords were able to charge--and get--higher rents. While strong demand and low vacancy rates contributed to a surge in new office construction in markets adjacent to New York City such as Central and Northern New Jersey, new supply was minimal in Manhattan. Nonetheless, beginning in the second half of 2000 office vacancy rates in New York City began to creep up as the economy weakened.

4 Source: Report by the Federal Reserve Bank of New York to Congresswoman Carolyn Maloney. April 18, 2002.

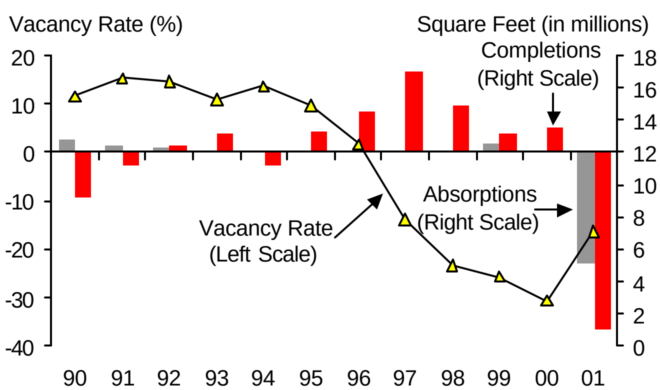
5 Numbers provided by the New York State Comptroller's Office.

6 Source: Torto Wheaton Research. Vacancy rates for Manhattan include Downtown and Mid-town office space.

The attack on the World Trade Center destroyed 13.4 million square feet of office space and damaged an additional 21 million square feet, a total of 60 percent of the Downtown Manhattan Class-A office market. The attack also prompted companies to place a significant amount of space back on the market in response to a less favorable economic outlook. An increase in space on the market and soft demand for new space drove up the City's office vacancy rates in 2001 (see Chart 5). The downtown office vacancy rate increased from a low of 3.2 percent in third quarter 2000 to 9.8 percent in first quarter 2002. Vacancy rates also rose in Midtown (considered to be a more attractive market than downtown) from 1.9 percent in second quarter 2002 to 7.2 percent in first quarter 2002. However, despite these increases, office vacancy rates in the City remained below the national average through first quarter 2002. Office vacancy rates may face moderate increases in the coming months as reports suggest that more space may be returned to the market.[7]

Chart 5

Office Absorption Activity Turned Sharply Negative in New York City After 9/11



Source: Torto Wheaton Research

Recent weakening in office market conditions, however, does not represent a return to the late 1980s or early 1990s, when the City had a supply imbalance coupled with a slowing economy. Today, weaker market conditions are driven by a decline in demand moreso than excess supply. With few new office buildings in the pipeline, real estate analysts suggest that Manhattan remains one of the nation's healthiest markets.[8]

Nonetheless, the ability to obtain insurance against terrorism, particularly for trophy buildings, could constrain New York City's office market. Immediately after the attack, insurance against terrorist acts for commercial real estate properties became either non-existent or prohibitively expensive. Recent reports suggest that the availability of terrorism insurance has improved, and premiums have declined from high levels at the start of this year. However, there is still uncertainty regarding the adequacy of insurance coverage, as new insurance policies are reported to be less comprehensive than pre-9/11 policies.[9] Uncertainty regarding insurance adequacy notwithstanding, the Federal Reserve Board's April 2002 *Senior Loan Officer Opinion Survey*, which surveys large banks, indicated that the majority of respondents had relatively limited exposures to "high-profile" properties. Respondents also indicated that they were most likely to ask for additional collateral or modify insurance related covenants if the borrower could not obtain adequate terrorism insurance.[10]

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[7] Croghan, Lore. "Displaced Firms Unload Excess Space," *Crain's New York Business*. May 6-12, 2002. According to the article, in May 2002 sublet space accounted for approximately 28 percent of available office space in Downtown Manhattan and 35 percent in Midtown. An additional 3 million square feet of sublet space is expected to be on Manhattan's market in the coming months.

[8] Sally Gordon, "CMBS: Red - Yellow - Green Update, First Quarter 2002 Quarterly Assessment of U.S. Property Markets," *Moody's Investors Service*., April 5, 2002.

[9] For more information on implications of terrorism insurance on commercial real estate properties, see Moody's Investors Service, "CMBS 1Q 2002: Rocky Road to Recovery Ahead," April 18, 2002. Also see Friedman, Dan. "Coverage Conundrum-Uncertainty about Terrorism Insurance Slows Large Loans." *Commercial Property News*. May 1, 2002.

[10] Board of Governors of the Federal Reserve System *Senior Loan Officer Opinion Survey*, April 2002. The April survey included responses form 56 large domestic banks and 21 U.S. branches and agencies of foreign banks. "High-profile" properties were defined as landmark buildings and commercial properties in their vicinity, stadiums and other sports/entertainment venues, and large shopping malls. According to the survey, roughly 70

In 2001, New York City's insured institutions reported an increase in delinquency rates on commercial real estate loans (CRE)—albeit from very low levels—likely reflecting the weakening in the City's CRE market.[11] The median past due ratio increased from 0.19 percent at year-end 2000 to 0.43 percent at year-end 2001, but remained below the median of 0.68 percent for institutions in the rest of the nation's metropolitan areas.

Demand for Manhattan Co-ops and Condos Shows Signs of Rebounding

The Manhattan residential housing market, which is dominated by cooperative (coop) and condominium apartments, has struggled over the past eight months with terrorism fears, layoffs, and displaced businesses. Sales recorded during September 2001 sales were down 55 percent from a year ago, while October sales were off by 20 percent.[12] Rather than slash pricing, many sellers pulled homes off the market. By the end of the year, prices had begun to stabilize. In first quarter 2002, condominium prices were rebounding, and the average coop price was up 3 percent in April 2002 from a year ago. Demand for rental units also was significantly affected by 9/11. In the first nine months of 2001, apartment vacancy rates, reported by Torto Wheaton declined from 4.0 to 3.6 percent—the lowest level since the late 1980s. After 9/11, however, demand softened and landlord concessions became more common. Looking ahead, apartment vacancy rates are expected to rise from 3.6 percent in 2001 to 5.7 percent in 2002. While this would represent the highest apartment vacancy rate recorded in New York in at least 20 years, it would remain below the national average of 8.8 percent forecasted for 2002.[13] The Manhattan apartment market typically is demand driven. High prices for homes in the New York area make renting the only viable option for many households, particularly those who wish to live in Manhattan. About 70 percent of Manhattan's residents are renters, the highest percentage in the nation.[14]

Outlook for the New York City Economy

Most analysts expect a slower and weaker economic recovery for New York City than for the nation. Recent employment numbers indicate that for some of the City's employment sectors, including FIRE, business services, tourism and travel-related sectors, rates of job loss may be moderating.[15] Nonetheless, both the **New York City Office of Management and Budget** and the **New York City Comptroller's Office** forecast that the City may have to wait until 2005 or 2006 to regain the 2000 employment levels.[16] The timing and strength of a rebound in the FIRE sector will play an important role in the City's near-term outlook. The potential for a lackluster recovery in the financial markets is expected to dampen the city's immediate economic prospects. Despite $20 billion in federal assistance and the stimulative effects of the reconstruction of Downtown Manhattan, a rebound in corporate profits and an increase in investment banking activity will be the keys to recovery.

The longer-term outlook for New York City depends, in part, on the restoration of services and amenities—and the return of confidence—which

percent of the domestic banks surveyed indicated that high profile buildings secured less than 5 percent of their managed CRE portfolio.

11 For the purposes of this report, institutions with total assets greater than $30 billion and credit card banks are excluded because the operations of these banks extend much beyond the New York metropolitan area.

12 Rich, Motoko. "Is the New York Market Returning to Normal?" *WSJ.com: Real Estate Journal*., January 14, 2002.

13 This forecast represents Torto Wheaton's Spring 2002 Outlook.

14 Marcus & Millichap. "Apartment Research Report: Absorbing the Aftershocks." January 2002.

15 Source: Bureau of Labor Statistics Non-Farm Employment Data, April 2002. Employment data subject to revision.

16 New York City Office of Management and Budget., *The City of New York Executive Budget Fiscal Year 2003: Message of the Mayor*, Office of the New York City Comptroller, April 17, 2002. The Comptroller's Comments on the Economic Assumptions Underlying the Executive Budget for Fiscal Year 2003. A separate analysis by DRI-WEFA, an economic forecasting and consulting company, indicates that the New York City PMSA, which includes New York City, Westchester, Putnam, and Rockland counties, may recover approximately a year faster than OMB or the City Comptroller estimates.

are essential for Lower Manhattan's future business competitiveness. The cleanup of Ground Zero will be completed faster than expected due to the assistance of Federal aid and the commitment of New York City's police, fire, sanitation, construction, and volunteer workers. Equally important, a redevelopment plan for Lower Manhattan is being debated and will take time for all parties to agree on how to proceed. Reconstruction investment would be expected to make a significant contribution to the New York City economy once underway. It is difficult, however, to estimate how many businesses will return as conditions improve. Estimates of the number of employees that have relocated out of Manhattan vary. According to reports, between 18,500 and 31,800 workers have relocated from Lower Manhattan to out-of-state locations since 9/11.[17]

Nevertheless, key strengths within the New York City economy bode well for the future. Quality of life improvements in the 1990s and a reputation that attracts domestic and international talent support economic vitality. Eight months after the attack businesses, residents, and visitors are returning to Lower Manhattan. Buoyancy in Manhattan's residential real estate markets, the absence of major supply and demand imbalance in office markets, and the expected start of reconstruction efforts in Lower Manhattan are among several reasons why the economic outlook should improvefor the City as the year unfolds.

Outlook for New York City's Insured Depository Institutions

Despite significant economic weakening in New York City during the past year, credit quality deterioration reported by insured institutions in the metropolitan area as of year-end 2001 tracked national and regional trends. During 2001, the median percent of past due loans reported by the 86 local and regional banks in the New York metropolitan area increased from 1.14 percent to 1.58 percent.[18]

In the months following the attack, bankers in the New York City area remained optimistic about economic recovery in the second half of 2002, according to a survey conducted by the ***American Bankers Association (ABA)***.[19] Nonetheless, credit quality is typically a lagging indicator. A weakening of credit quality in the City has generally tracked that of the Region and the nation. However, because the recession affected New York City later than other parts of the nation and the City's economic recovery is expected to lag the nation's, credit quality among the City's insured institutions could weaken further relative to banks in other metropolitan areas.

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[17] New York State Assembly Ways and Means Committee Economic Report. March, 2002. Also see DRI-WEFA. Financial Impact of the World Trade Center Attack: Prepared for the New York Senate Finance Committee. January, 2002.

[18] Past due loans defined herein as loans more than 30 days past due or loans in non-accrual status.

[19] American Bankers Association. "Post Sept. 11 Survey Shows Nation's Bankers Are Optimistic." ABA Press Release, December 3, 2001.