Regional Outlook

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FDIC
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In Focus This Quarter

◆ ***High Loan-to-Value Lending: A New Frontier in Home Equity Lending*—High loan-to-value home equity loans have grown in popularity as consumers have sought ways to consolidate credit card debt and lenders have sought ways to deal with declining profit margins on traditional home equity loans. High loan-to-value loans pose unique risks for lenders because of their hybrid nature: they combine characteristics of both a secured home equity loan and an unsecured consumer loan. Losses on such loans are increasing rapidly, and the current rate of loss raises concern about how these loans might perform in an economic recession.** ***See page 4.***

By Diane Ellis

◆ ***Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead*—Following the experience of the 1980s, the threat of an oversupply of commercial real estate is watched with keen interest by market participants and observers alike. This article highlights nine metropolitan areas that may be vulnerable to overbuilding based on the rapid pace of development occurring within those markets, various indicators of current and prospective demand, and projections by credible industry analysts. These concerns could be mitigated to the extent that reduced credit availability within the capital markets leads to a slowing in construction activity.** ***See page 11.***

By Steven Burton

◆ ***Recent Trends in Syndicated Lending*—A strong U.S. economy, intensifying lender competition, and increasing marketability of bank loans have driven record volumes of syndicated lending in the 1990s. These factors led to several years of liberalized underwriting in the syndicated market. While evidence suggests that some banks have tightened standards and terms for loans to large commercial borrowers, market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.** ***See page 19.***

By Steven E. Cunningham, Ronald L. Spieker

Regional Perspectives

◆ ***Commercial and Residential Construction Activity in the Atlanta Region*—Some Atlanta Region real estate markets rank among the nation's most active in terms of new construction. A growing number of analysts are now forecasting slower economic growth within the next couple of years, prompting industry observers to question whether property demand will keep pace with the supply of space scheduled to be delivered into some markets. For the most part, community institutions in the Region are not nearly as heavily engaged in construction and development lending as they were before the last downturn in the late 1980s. Metropolitan Atlanta is clearly the exception.** ***See page 25.***

By Atlanta Region DOI

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From the Editor

The National Edition of the Regional Outlook is now available

To the Reader:

I am pleased to announce the first publication of the *Regional Outlook National Edition.* Since its inception, the *Regional Outlook* has been published quarterly in eight separate volumes that were tailored specifically for each FDIC Region. This format was ideal for the reader who wanted detailed analysis of a specific Region.

Beginning this quarter, the FDIC will publish in a single volume the highlights of our Regional analysis of trends affecting FDIC-insured institutions across the United States. The eight unabridged Regional editions will continue to be published for readers who want more detailed information about trends in their Regions. All editions will continue to offer the In Focus series of articles on trends affecting the risk exposures of FDIC-insured institutions.

For example, this quarter the In Focus series highlights important trends affecting commercial lenders and consumer lenders. The Regional Perspectives articles explore in more detail how these and other trends may affect FDIC-insured institutions around the United States.

Both the Regional and National editions are available by subscription or on the FDIC's website at www.fdic.gov. As always, we welcome your comments on the content or format of this publication. Please refer to the back cover and inside the front cover for information about how to subscribe or comment.

Sincerely,

George French
Executive Editor

High Loan-to-Value Lending: A New Frontier in Home Equity Lending

- **High loan-to-value (HLTV) loans are typically junior liens on owner-occupied single-family residences, but there is limited collateral protection because the combined loan amounts often exceed the value of the home.**

- **Nonbank, specialty lenders have dominated this line of business, and their growth has been fueled by strong demand for asset-backed securities collateralized by HLTV loans.**

- **Insured depository institution involvement in HLTV lending has been increasing, and opportunities for further involvement opened up when market turmoil resulted in a contraction of HLTV specialists.**

- **HLTV lending involves unique risks because it combines characteristics of both secured home equity lending and unsecured consumer lending.**

Just a few years ago, it would have been difficult to imagine a mainstream lender writing a home equity loan in excess of the equity that the consumer had in his or her home. However, intense competition and declining profit margins in traditional home equity lending have lenders looking to boost volume and profits by relaxing underwriting standards. At the same time, consumers are signaling their desire to transfer their credit card balances to lower-costing home equity loans. These trends have given lenders, including insured depository institutions, the impetus to enter the HLTV home equity market. Furthermore, new opportunities have opened up for insured depository institutions to get involved in HLTV lending as a result of turmoil in the equity and asset-backed securities market, which resulted in a severe liquidity crisis that effectively sidelined many HLTV specialists.

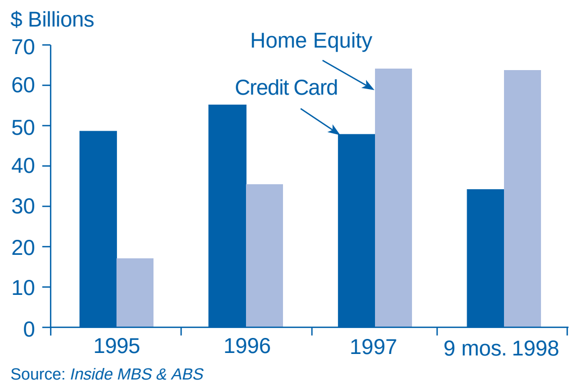
HLTV Lending Taps Consumers' Desire to Shift Credit Card Debt into Home Equity Loans

For the better part of the 1990s, credit card lending was dubbed the Wild West of consumer credit. This title was earned, in part, by lenders' aggressive marketing and solicitation of their cards and consumers' willingness to push their holdings of credit card debt to record high levels. After several years of double-digit growth in credit card outstandings, the growth has slowed. However, this slowdown does not necessarily mean that the Wild West has been tamed. In fact, home equity lenders are blazing new frontiers in consumer credit. Chart 1 shows that the originations of home equity loans for asset-backed securitizations have surpassed the originations of credit card loans over the past two years.

It could be said that the home equity industry owes its resurgence to the boom in credit card lending that preceded it, because today's home equity borrowers primarily use these loans to consolidate their outstanding debt. A survey by the ***Consumer Bankers Association*** found that, whereas in 1991 home improvement was the primary reason for taking out a home equity loan, debt consolidation is now the primary reason, with 40 percent of borrowers using a home equity loan for this purpose in 1997. This shift also is evidenced by another recent survey by ***Brittain Associates, Inc.,*** which estimated that during a 24-month period ending June 1998, 4.2 million households converted $26 billion in credit card debt to home equity mortgage debt. Given the high levels of credit card debt on households' balance sheets, it should be no surprise that consumers with other borrowing options are looking for ways to consolidate their debt and reduce their borrowing costs.

CHART 1

Originations of Home Equity Loans Have Surpassed Originations of Credit Card Loans in the Past Two Years



Source: *Inside MBS & ABS*

HLTV Loans Are Hybrid Loans

HLTV loans are considered hybrid loans and can be thought of as a marriage between secured lending and unsecured credit card loans. HLTV loans are typically junior liens on owner-occupied single-family residences where the combined loan amounts exceed the value of the home—sometimes by as much as 125 to 150 percent. Some lenders also make HLTV first mortgages, which enable consumers to finance their down payment and closing costs and consolidate other debts.

In return for pledging their home as collateral, borrowers are charged lower rates of interest than on unsecured consumer loans. Even at 125 to 150 percent loan-to-value, the rates on HLTV loans generally are lower than credit card loans. In 1997, the average rate on an HLTV was 13 to 14 percent, whereas the average rate on a credit card loan was 16 percent. Because HLTV loans carry lower interest rates and are long-term loans (15 to 30 years), the monthly payment on one is often considerably less than the total monthly payments on the loans that were paid off in the consolidation.

HLTV loans also appeal to consumers because they can benefit from the tax deductibility on a portion of their interest payments. Current IRS rules allow interest to be deducted on that portion of the loan that is equal to or less than the value of the home at the time the loan is closed.

The primary disadvantage of converting unsecured credit card and other consumer debt to an HLTV loan is that in the event of default, the borrower could lose his or her home. However, many consumers burdened by the high cost of unsecured consumer debt apparently have viewed the chance to lower their monthly payments as worth the risk. HLTV loans have been particularly popular in California, where property value declines in the early 1990s left homeowners with little or no equity in their homes. The inset box shows the typical characteristics of an HLTV loan and an HLTV borrower.

Typical HLTV Borrower Characteristics

Annual Income	$60,000
Job Tenure	5 years
Age	Late thirties
FICO Score	680
Outstanding Nonmortgage Debt	$20,000
First Mortgage Amount	$110,000
Property Value	$130,000

Typical HLTV Loan Characteristics

Amount	$30,000
Contract Interest Rate	13 to 14%
Term	25 years
Loan to Value	110%

Notes: HLTV = high loan-to-value; FICO = Fair, Isaac Company
Source: General Accounting Office, based on interviews with public and private officials

Underwriting of HLTV Loans Emphasizes the Borrower's Credit Quality

Because of their limited or nonexistent collateral protection, HLTV loans typically are considered unsecured loans and the emphasis in underwriting is on the borrower's credit quality rather than on collateral value. Large HLTV lenders use credit scoring to underwrite their loans, and a major component of their scoring is a credit bureau or Fair, Isaac Company (FICO) score. Other important factors are the borrower's debt-to-income ratio, mortgage credit history, consumer credit history, bankruptcies, foreclosures, notice of defaults, deeds in lieu of foreclosure, and repossessions.

HLTV loans are not necessarily subprime loans; the term "subprime" refers to the credit quality of the borrower rather than the margin of collateral protection. Instead, many lenders assert that HLTV loans are made to "prime" borrowers and can point to the fact that FICO scores on HLTV loans have been rising, averaging approximately 689 in 1998. Scores above 680 are generally associated with "A" credit quality; however, the average ignores the fact that major HLTV lenders allow FICO scores to go much lower, typically as low as 620.[1] ***Standard & Poor's*** recently reported that performance problems clearly exist on loans for which the borrower's FICO score is below 650.[2]

[1] H.T. Katz and G.T. Costello, Fitch IBCA Credit Rating Company. "Securitization of 125 LTV Mortgages." *Structured Finance Special Report,* March 4, 1998. Underwriting guidelines summary matrices are provided for seven large HLTV lenders.

[2] "High LTV Security Performance Expected to Improve as FICO Scores Rise and FHA Title 1 Loans Disappear." *Inside MBS & ABS,* November 13, 1998, p. 9.

TABLE 1

HLTV UNDERWRITING GUIDELINES					
QUALIFYING PARAMETERS	A+	A	B+	B	C+
FICO SCORE	700+	680–699	660–679	640–659	629–639
MORTGAGE HISTORY (PAST 12 MONTHS)	1x30*	1x30	1x30	1x30	1x30
BANKRUPTCY (YEARS SINCE DISCHARGE)	3	3	3	5	5
MAXIMUM DEBT TO INCOME (%)	50	50	45	45	40
MAXIMUM LOAN TO VALUE	125	125	125	125	125
MAXIMUM CASHOUT	$35,000	$25,000	$15,000	$5,000	$1,000
MAXIMUM LOAN AMOUNT	$100,000	$75,000	$65,000	$45,000	$30,000

* NUMBER OF TIMES DELINQUENT MULTIPLIED BY DAYS DELINQUENT.
NOTE: HLTV = HIGH LOAN-TO-VALUE; FICO = FAIR, ISAAC COMPANY.
SOURCE: THE 10K FILING OF A MAJOR HLTV LENDER.

The agencies that rate asset-backed securities collateralized by HLTV loans offer another perspective on the credit quality of HLTV borrowers. ***Moody's*** has described HLTV borrowers as in the "A–" to "B" grades, and Standard & Poor's has characterized the loans as "A–" to "B+" in terms of credit quality. Any grade below A can be considered subprime. Indeed, according to ***Mortgage Information Corp.,*** the bulk of subprime mortgage activity occurs in the A– category. However, some analysts have preferred to characterize HLTV borrowers as squarely in between the subprime and prime designations.

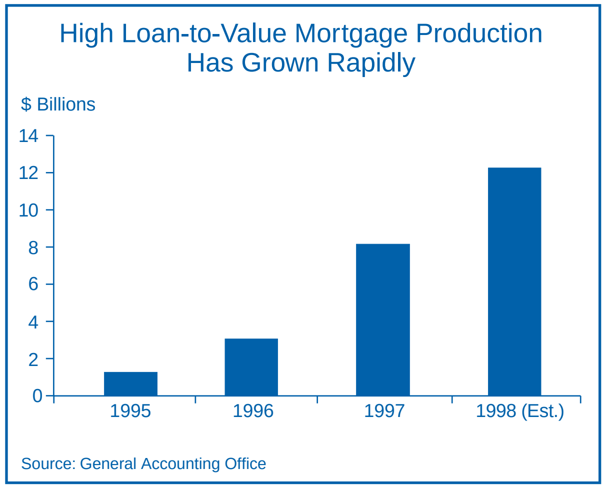
Whatever the label given to the quality of borrowers, they typically have a large amount of high-cost revolving debt, and converting this debt into a second lien on their home is an attractive alternative. They also might have some degree of poor credit performance. Table 1 shows the underwriting criteria used by one of the largest HLTV lenders. Because underwriting classification systems are not uniformly applied among HLTV lenders, this table should be viewed only as a guide.

Fueled by Easy Access to Capital, HLTV Loans Have Grown Rapidly

On the basis of the volume of loans securitized, the HLTV loan market has expanded rapidly over the past several years (see Chart 2). Originations have grown from $1 billion in 1995 to $8 billion in 1997 and are expected to be around $12 billion in 1998.

Nonbank, specialty finance companies presently dominate the HLTV market, and their easy access to capital has been an important factor behind their growth. These specialists depend on their ability to securitize the loans and sell them in the asset-backed securities market. Strong investor demand for all kinds of asset-backed securities has allowed HLTV lenders to raise a substantial amount of funding without a strong degree of corporate credit quality. However, their reliance on the asset-backed securities market to fund operations exposes them to *liquidity risk* if demand for these securities declines.

CHART 2



A healthy initial public offering market also has fueled the growth of these specialty lenders, and gain-on-sale accounting has allowed lenders to establish an earnings track record and attract debt and equity investors. Gain-on-sale accounting requires securitizers to calculate and record a gain on sale from securitizations; however, the use of gain-on-sale accounting exposes lenders to *prepayment risk.* If the securitized loans prepay at a faster rate than the assumption used to calculate the gain, the company could be forced to take a write-down, which can affect earnings, liquidity, and capitalization. Institutions that invest in securities collateralized by HLTV loans also are exposed to prepayment risk. (For more information on gain-on-sale accounting, see "Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings" in ***Regional Outlook,*** second quarter 1998.)

In addition to the easy access to capital, favorable economic conditions also have encouraged HLTV lending. The long economic expansion has brought about the return of home price appreciation to nearly all parts of the country, which has encouraged HLTV lending because rising home values serve to reduce lender and investor exposure fairly quickly. The median sales price of existing single-family residences has increased an average of 4.39 percent per year since 1995, according to the ***National Association of Realtors.***

Market Turmoil Hit HLTV Specialty Lenders Hard

The market volatility that began last summer illustrated the importance of *liquidity risk* and *prepayment risk.* HLTV specialists were faced with a liquidity crunch when they were hit hard in the equity downturn, in many cases significantly harder than the general market. Investors retreated from HLTV lenders and their asset-backed securities, in part as a result of a "flight to quality" as the Asian crisis spilled over into other global markets. A core of investors participating in the HLTV market also exited the market when prepayments occurred at faster rates than anticipated, largely a result of lower market interest rates, and forced lenders to take write-downs of interest-only residuals. Another factor in the investor retreat from this market was the growing skepticism concerning the performance of HLTV loans during an economic downturn.

When investor demand for asset-backed securities dried up, HLTV lenders were unable to securitize their loans profitably. This situation created a severe liquidity crisis for specialty lenders who relied heavily upon this source of funding. As a result, some lenders were forced to put themselves up for sale, and others were forced to undergo massive restructuring.

HLTV Lending Presents Unique Risks to Home Equity Lenders

In addition to the risks associated with the securitization of HLTV loans (liquidity and prepayment risk), HLTV lending poses some unique risks for lenders who hold these loans in their portfolio, service them, or guaranty the performance of asset-backed securities. Because HLTV loans are a relatively new product, their *credit risk* is untested and could be affected by the following factors:

- **Increased rate of default.** Data on the performance of HLTV loans are limited; however, the loss potential is starting to become visible when vintage analysis is performed. Chart 3, next page, shows that when recent vintages are adjusted for seasoning, charge-off rates on HLTV loans are increasing at a rapid rate. Both the severity and frequency of default are much higher than for traditional A-quality home equity loans and are even higher than subprime home equity loans. The fact that charge-offs are higher than subprime loans suggests that the credit quality of HLTV borrowers is not too different from subprime borrowers and that when default occurs, the loss is more severe because of the lack of collateral protection. Lenders who do not accurately forecast the magnitude and costs of default associated with HLTV loans, or who make underwriting mistakes, might find that this line of business is not as profitable as anticipated.

  Lenders that rapidly increase HLTV exposures might consider the use of vintage analysis, also called "static pool" analysis, as a means of evaluating loan portfolio performance. This technique is effective when there is rapid growth, which can make it more difficult to accurately track delinquency and default trends when only an average delinquency or default ratio is calculated. Refer to "Subprime Lending: A Time for Caution" in ***Regional Outlook***, third quarter 1997, for additional discussion on vintage analysis.

- **Untested performance in a recession.** HLTV lending has existed for only a few years and has yet to be tested by economic recession. The rapid rise in charge-offs on HLTV loans has occurred in a relatively robust economic environment, and the losses during an economic downturn could be considerably higher than anticipated. Moody's has asserted that losses will mimic those of credit cards, and losses on credit card loans are usually higher than other consumer mortgage-related products.

HLTV lenders' heavy reliance on credit-scoring models raises further questions about how these loans might perform in a recession because these models are largely unproven in a recession as well. To improve the accuracy of credit-scoring models and the model's ability to appropriately price the risk assumed, lenders can continually test and refine credit-scoring models to ensure that actual performance approximates projections.

Changes in the borrower's financial condition present a greater risk to HLTV lenders than in other types of secured lending, which introduces additional *credit risks.* In the event of default, the lender is likely to suffer a complete loss because foreclosure is probably infeasible and the size of HLTV loans is much larger than other types of unsecured or partially secured loans. Therefore, adverse changes in the borrower's financial condition are very important and can be affected by the following factors:

- **Debt reloading.** The primary reason consumers take out an HLTV loan is to consolidate credit card and other high-cost consumer debt. However, lenders cannot prevent HLTV borrowers from running up additional credit card debt after the loan is made. Consequently, these loans might serve to only postpone or amplify credit problems. A recent survey by Brittain Associates, Inc., indicates that a large percentage of borrowers who take out home equity loans proceed to run up credit card debt shortly thereafter. Their survey of over 6,000 borrowers who used home equity loans to consolidate their debts revealed that only 30 percent of those borrowers remained free of credit card debt one year later.

- **Long-term exposure.** Consumer loans typically have been made on a short-term basis; however, HLTV loans are made for terms up to 30 years. Therefore, the credit quality on an HLTV loan is more vulnerable to catastrophic events such as borrower job loss, illness, or divorce. Furthermore, the term of these loans far exceeds the predictive power of FICO scores, which have proven to be predictive for about a two-year period according to Moody's.

Because of their fixed terms and limited collateral protection, there are some unique *operational risks* associated with servicing and collecting an HLTV loan. Servicing and collecting an HLTV loan differs somewhat from servicing and collecting both secured lending and credit card lending because of the following factors:

- **Limited default remedies.** The servicing and collecting of HLTV loans are complicated by the fact that the threat of foreclosure is not as severe as in traditional secured lending. According to Moody's, HLTV lenders must adopt a collection strategy similar to credit card lenders that will require early intervention and the ability to "talk" the borrower into

Chart 3

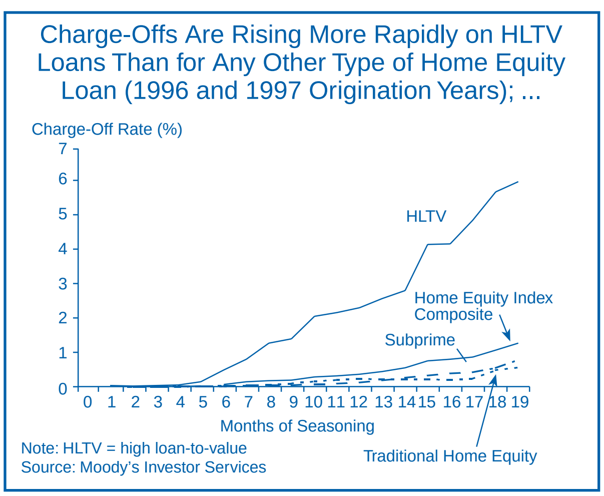
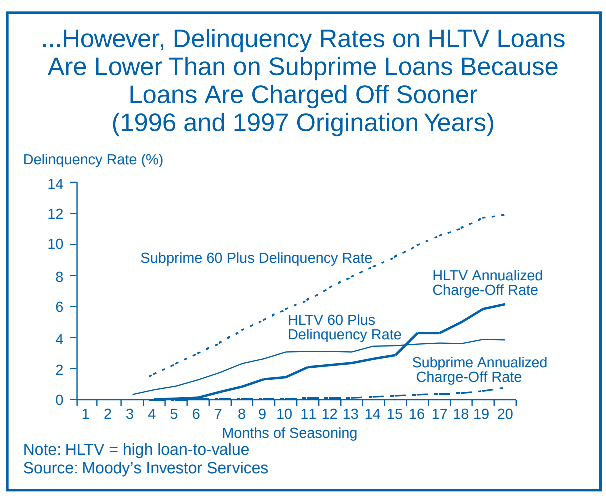


Chart 4



making a payment without resorting to foreclosure. However, unlike credit card lenders, HLTV lenders have less flexibility in collection because lines cannot be adjusted and interest rates cannot be raised. The different demands for servicing and collecting these loans, compared with traditional and subprime home equity loans, could strain institutions that do not have an adequate investment or expertise in collecting these loans.

According to Moody's, HLTV lenders generally write off their loans as a loss once they become 180 days delinquent. In contrast, subprime lenders go through a lengthy foreclosure procedure. The speedier resolution of HLTV loans is reflected in a lower level of delinquencies in HLTV portfolios compared with subprime portfolios (see Chart 4, previous page).

- **Limited borrower flexibility and motivation.** After a borrower has taken out an HLTV loan, opportunities to refinance are limited, and selling the home often is not feasible because of the large amount of cash needed at closing. As a result, counseling borrowers might prove to be harder than in credit card lending. Also, with negative equity in their homes, borrowers might have less incentive and ability to work with the lender to bring the loan current than to allow foreclosure.

Insured Depository Institution Involvement in HLTV Lending Is Increasing

Insured depository institution involvement in HLTV lending reportedly has been growing. Their precise involvement is difficult to quantify because these loans are not delineated in bank or thrift Call Reports. However, one indication of their growing involvement is cited in the Consumer Bankers Association 1998 home equity loan study. Twenty-five percent of respondents to its survey offered home equity loans with loan-to-values in excess of 100 percent, up from only 5.8 percent one year earlier.

Banks and thrifts can become involved in HLTV lending by using a variety of strategies. They can lend directly to HLTV borrowers or purchase HLTV loans from loan brokers and hold them in portfolio. Institutions also can originate the loans and securitize them or sell them to another company that will securitize them. A more indirect way for insured depository institutions to get involved in this market is to lend to HLTV specialty lenders in the form of warehouse lines. Institutions also can service HLTV loans or invest in asset-backed securities secured by HLTV loans.

In light of the contraction of HLTV specialists, the question arises as to whether banks will view this as an opportunity to further expand their presence in HLTV lending, given that consumer demand for these products is still strong. Recent press reports indicate that this is happening, as some insured depository institutions recently have piloted HLTV lending programs by buying loans and keeping them in portfolio.[3] Another way that banks have recently become involved in HLTV lending is by investing in HLTV specialists. Many HLTV specialists have been looking for opportunities to affiliate with firms that have plentiful and stable sources of liquidity ("deep pockets"), and insured depository institutions have been viewed as ideal candidates. Several of the largest HLTV specialists have an insured depository institution as an affiliate.

Insured Depository Institutions Are Subject to Real Estate Lending Standards

Unlike many of the specialty finance companies, insured depository institutions are subject to regulations prescribed by the federal supervisory agencies. In 1992, the federal banking and thrift supervisory agencies finalized a uniform regulation and interagency guidelines for real estate. The regulation, in part, requires institutions to adopt and maintain written policies that establish appropriate limits and standards for all real estate loans, including HLTV loans. When a bank adopts a policy, the regulation requires consideration of the Interagency Guidelines for Real Estate Lending Policies. These guidelines state that institutions should establish their own internal loan-to-value limits for real estate loans; however, they also indicate that the internal limits should not exceed 90 percent on a home equity loan.[4] The guidelines recognize that it might be appro-

[3] Timmons, H. "Banks Poised to Move in as High-LTV Lenders Fall." *American Banker,* October 28, 1998.

[4] The guidelines state, "A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral."

priate to deviate from these guidelines and state that loans made in exception to these guidelines should be identified in the institution's records and reported to the board of directors at least quarterly. Furthermore, the guidelines state that the aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital.

Competition from HLTV Loans Is Driving a Loosening in Underwriting on Other Home Equity Loans

Even for insured depository institutions not directly involved in the HLTV market, the competition posed by this product already is evident in the underwriting of other types of home equity products. The Office of the Comptroller of the Currency reported in its latest survey of the 77 largest national banks in the country that underwriting on home equity loans has been loosening for three years, a time period that corresponds with the life of the HLTV market. They reported that in 1998, the percentage of banks tightening standards on credit card loans is nearly matched by the percentage of banks loosening their underwriting standards on home equity loans. Competition was cited as the primary reason for loosening home equity standards, and an easing of collateral requirements was the primary method.

Conclusion

HLTV lending has provided a new option for consumers to work their way out from under burdensome credit card debt. It also has provided lenders with a new and potentially profitable line of business. Insured depository institution involvement in this line of business is growing and could continue to grow, especially if liquidity problems that have affected HLTV specialists continue. As with any line of business, success is dependent upon understanding the particular nature of the HLTV business and making the appropriate commitment of resources and expertise. With HLTV lending, there are unique risks involved because of the compound nature of these loans, which contain characteristics of both a secured home equity loan and an unsecured consumer loan. The risks involved in HLTV lending are further heightened by the fact that the performance of these loans is largely untested in an adverse economic environment.

Diane Ellis, Senior Financial Analyst

Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead[1]

- **Oversupply within commercial real estate markets typically arises from the difficulty developers face in accurately predicting future demand for a given project, particularly when projections are based on temporary or unsustainable increases in demand. Easy access to investment capital in the form of lower borrowing rates or relaxed underwriting standards can exacerbate the overproduction of space.**

- **This analysis identifies nine major metropolitan markets believed to be vulnerable to broad-based overbuilding.[2] This vulnerability stems from rapid ongoing development across multiple property types, which threatens to outpace absorption or demand levels over the next one to two years. Overbuilding concerns are heightened by cyclical and secular demographic and economic trends that portend lower demand for commercial space.**

- **Trends in the capital markets may have tempered the appetite for further development in some rapidly expanding metro areas. Should such trends continue, construction activity could moderate, thereby mitigating some of the overbuilding concerns expressed in this article.**

Since the boom development years of the 1980s, and the bust that followed, the financial community has devoted considerable resources to analyzing commercial real estate trends. The primary purpose of these efforts is to detect, as early as possible, warning signs of potential imbalances between supply and demand. The markets highlighted in this article are considered vulnerable to possible overbuilding on the basis of various early warning signs. Each of these markets is experiencing rapid commercial real estate development across multiple property types. In addition, each market exhibits one or more of the following characteristics: high vacancy rates relative to the pace of development, declining employment growth trends, declining in-migration trends, projected increases in vacancy rates by credible industry experts, and significant dependence on industry sectors vulnerable to either weak Asian markets or a slowing domestic economy.

The term "vulnerable" is used here to signify a potential, as opposed to a certain, outcome. In previous cyclical downturns, falling commercial real estate values were preceded by economic events that resulted in lower demand: Declining energy prices preceded the mid-1980s decline in Southwestern real estate markets; weaknesses in the financial sector preceded the late 1980s decline in Northwestern real estate markets; and sharp defense cutbacks preceded the early 1990s decline in Southern California real estate markets. It remains to be seen whether weakening Asian markets or prospects for slower economic growth serve as catalysts for slower commercial real estate demand in the current cycle. Whatever the catalyst, markets most affected by a downturn in real estate values will be those in which optimistic expectations, the basis for current construction activity, fall farthest from the mark.

Why Do Markets Become Overbuilt?

Commercial property developers often face substantial lags between a project's conception and its completion: The longer the construction period, the greater the uncertainty surrounding demand projections. These risks can be largely mitigated if the developer enters into presale contracts or preleasing agreements with financially sound parties prior to breaking ground on construction. However, it is not unusual in rapidly developing and highly competitive markets for developers to anticipate or "speculate" what demand levels will be, based on current trends. If the market in question is experiencing a period of temporary or unsustainable growth (a "boom" period, for example), then projections may lead to an overly optimistic outlook for future demand, particularly when forecasts are weighted heavily toward recent rental, sales, and demographic trends. Projection error also arises from

[1] In fall 1998, the FDIC's Division of Insurance published a report ranking the risk of overbuilding within major metropolitan markets (see "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," *Bank Trends,* October 1998). This paper, which was based mainly on market information as of year-end 1997, highlighted six major metropolitan areas where the rapid pace of current construction activities raised concerns over the potential for broad-based overbuilding.

[2] "Broad-based overbuilding" signifies potential overbuilding in two or more of five property types: office, industrial, retail, apartment, and hotel.

the failure to consider competitors' planned development activities.

If a developer's demand projections fail to materialize, the result is an overhang of commercial property beyond what the market can absorb during a reasonable time frame. Easy access to investment capital can exacerbate overproduction of space by reducing or eliminating incentives to make reasoned and prudent investment decisions. Excessive leverage, where the developer has little personal capital at risk on a particular project, is a familiar example often associated with the excessive development of the 1980s. Loan pricing that fails to adequately account for the risks involved in a construction project is another example of how financing incentives could lead to imprudent development decisions.

Ranking the Risks of Overbuilding

The October 1998 ***Bank Trends*** (see footnote 1) study employed a three-step process to rank the vulnerability of markets to possible overbuilding. First, major metropolitan markets were ranked in terms of current construction activity[3] relative to existing space for each of five property types: office, industrial, retail, apartment, and hotel. Second, relative construction activity was compared with current vacancy rates to assess the competitive pressures faced by newly developed projects. Third, market-related research was reviewed to determine which markets analysts considered candidates for possible supply/demand imbalances. Although the same approach was used in this updated analysis, additional factors were considered, including employment and population growth trends, the dependence of rapidly developing metropolitan areas on specific employers or industries, and the relationship between current economic trends and the potential demand for commercial real estate space.

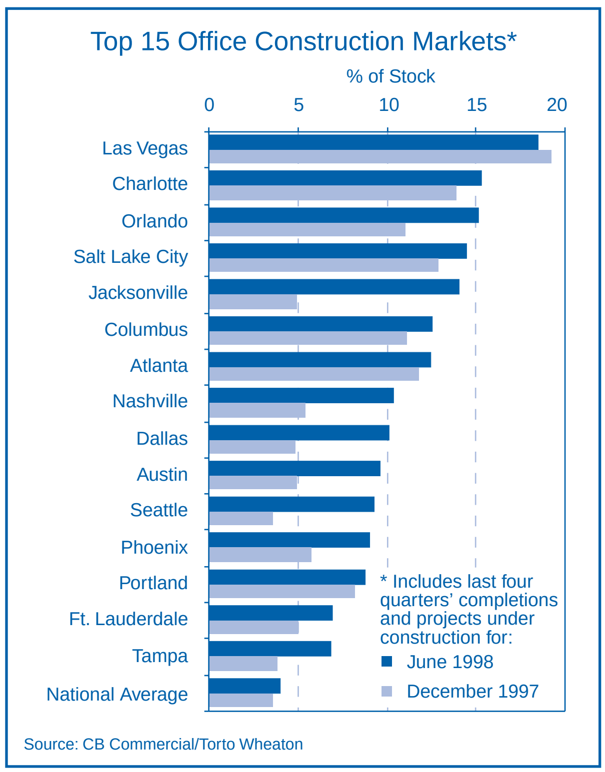
Most Active Construction Markets

Charts 1 through 5 show the level of construction activity, for each property type, relative to the total stock of space as of June 30, 1998, for the top 15 major metropolitan markets. Although slowing somewhat, development in the Las Vegas market continues to lead all other markets in relative terms for office, industrial, and hotel construction. Las Vegas is also among the most active markets in apartment and retail construction. Other markets experiencing rapid development across multiple property types include Salt Lake City, Charlotte, Atlanta, Portland, Phoenix, Orlando, Dallas, Austin, Nashville, Jacksonville, and Seattle. As the charts show, office, industrial, apartment, and hotel construction activity rose from year-end 1997 levels among a majority of the fastest-developing markets. Retail development, however, appears to have slowed in a majority of the most active development markets during the first half of 1998.

Comparing Construction Activity with Vacancy Rates

Newly completed speculative projects must compete with existing vacant space. Accordingly, it is worthwhile to compare measures of relative construction

CHART 1



[3] Construction activity generally refers to recent completions plus projects in process of being built. In the case of office and industrial properties, the source of data is ***CB Commercial/Torto Wheaton Research***, and construction activity refers to completions for the last four quarters plus projects under construction. For all other property types, the source is ***F.W. Dodge*** and ***ERE Yarmouth***, and construction activity refers to completions, projects in process of being built, starts, and pending projects.

CHART 2

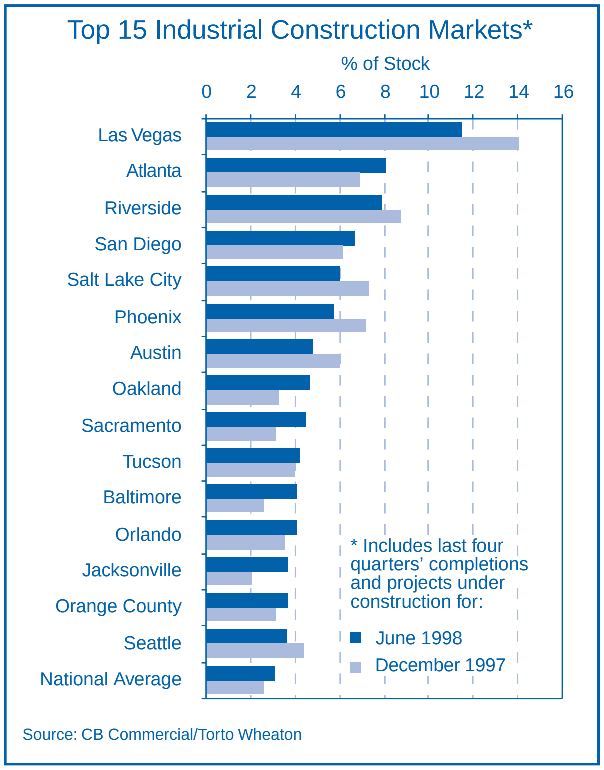


CHART 3

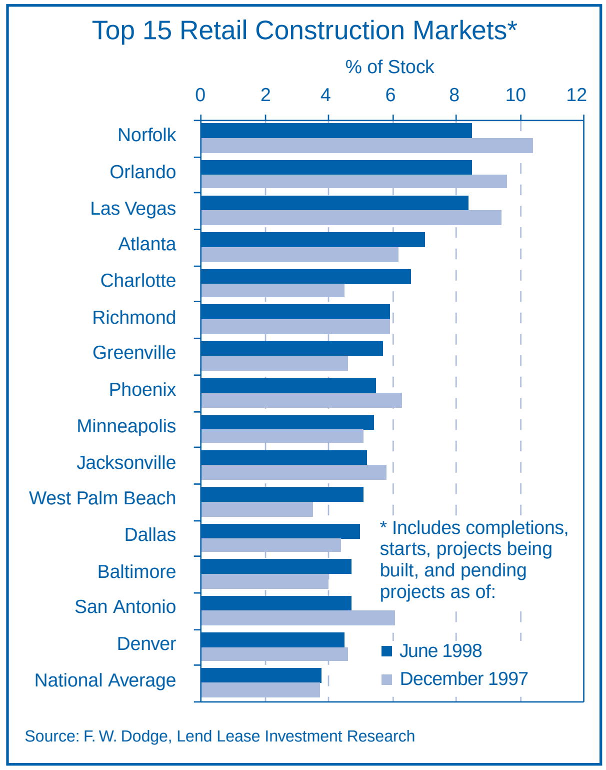


CHART 4

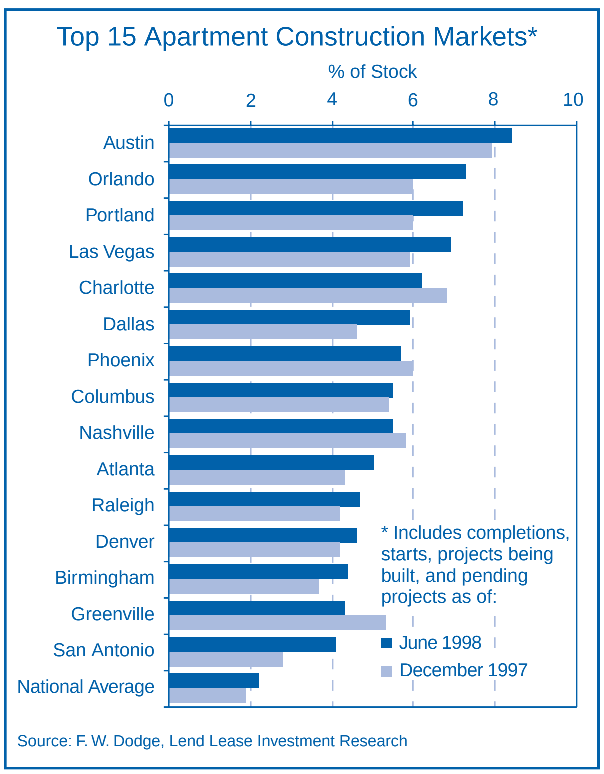


CHART 5

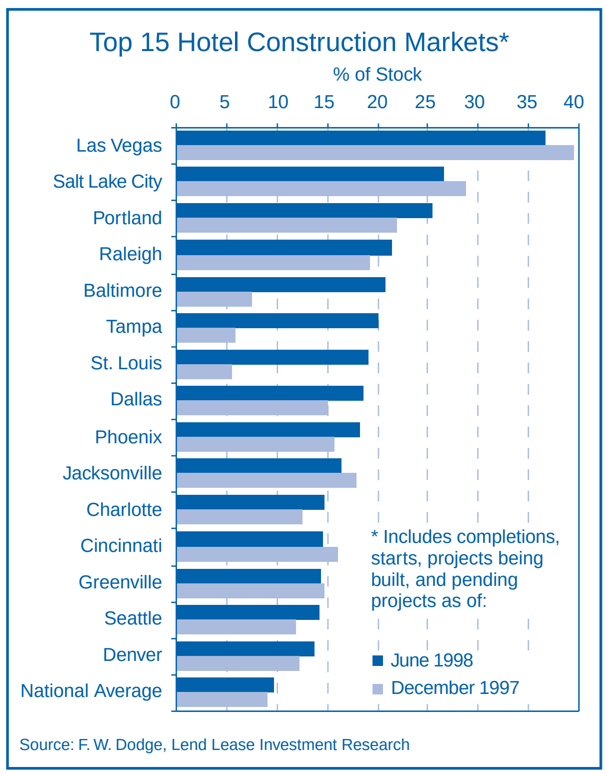


CHART 6

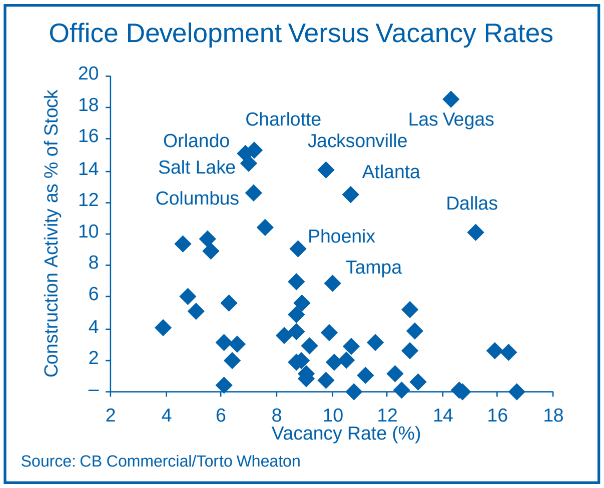
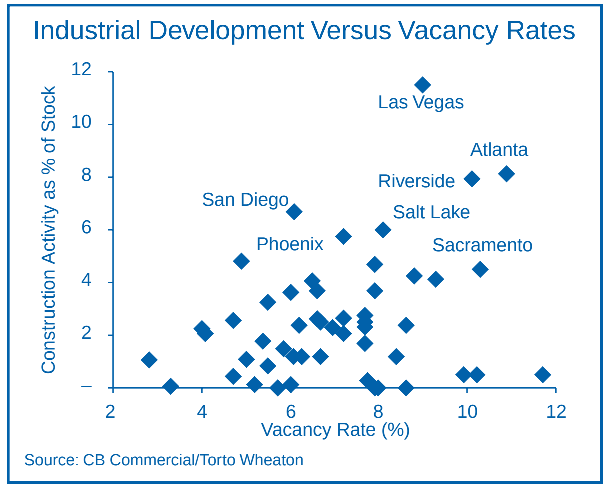


CHART 7



activity with current vacancy rates (as shown in Charts 6 and 7 for office and industrial space). The main idea behind these charts is that market segments with high existing vacancy rates raise the degree of competitive pressure for newly built space; markets with high vacancies may have less justification for continuing increases in new stock.

In the office sector, Las Vegas stands out as having the highest level of new development combined with high existing vacancy rates. Although the pace of development is markedly slower, office markets in both Atlanta and Dallas appear to be expanding rapidly despite high existing vacancy rates. In the industrial sector, Las Vegas, Atlanta, Riverside, Salt Lake City, and Phoenix all appear to be experiencing rapid development despite relatively high existing vacancy rates.

Analyst Outlooks for Commercial Real Estate Advocate Caution

The first six months of 1998 saw continuing strong market fundamentals in most major markets and most property types: ***CB Commercial/Torto Wheaton Research (CBC)*** reported continuing nationwide declines in office and industrial vacancy rates accompanied by increasing rental growth rates,[4] ***Wheat First Union (Wheat)*** reported improvements in occupancy and rental rates across the 30 major apartment markets it follows,[5] and ***Smith Travel Research (Smith)*** reported continuing improvements in average daily room rates despite a modest decline in occupancy rates for the lodging sector (through the first nine months of 1998).[6] The performance of the retail sector has been more mixed, as indicated by a significant decline in estimated rental growth rates from 1996 to 1997 (CBC) while retail vacancy rates have held steady over the past 12 months ***(F.W. Dodge)***.[7]

Despite these generally positive trends, market observers are becoming more cautious about the outlook for commercial real estate markets. Much of their concern stems from significant increases in projected supply in the face of moderating absorption rates. CBC, for example, projects that nationwide office vacancy rates will rise from 9.3 percent as of June 1998 to 12.1 percent by June 2000 as a result of a sharp increase in completions combined with moderating absorption. Markets with the highest and most significant increases in projected office vacancy rates are highlighted in a recent ***Lehman Brothers*** study, which identifies 17 office markets as "danger zones." [8]

Analysts have also raised concerns over rapid development in other property types. F.W. Dodge, for instance, anticipates a sharp rise in the ratio of retail completions

[4] CB Commercial/Torto Wheaton Research, *The Office Outlook, The Industrial Outlook,* and *The Retail Outlook,* Fall 1998.
[5] Wheat First Union, *Industry Report: Quarterly Apartment Review,* October 21, 1998.

[6] Smith Travel Research, *Smith Travel Research Announces 1998 September and Third Quarter U.S. Lodging Industry Reports,* www.str-online.com/news/releasedir/pr981104_3rdgtr.html.
[7] F. W. Dodge, *Real Estate Analysis and Planning Service: 2nd Quarter 1998.*
[8] These markets are Salt Lake City, Columbus, Austin, Nashville, Charlotte, Orlando, Las Vegas, Baltimore, Atlanta, Dallas, Phoenix, Philadelphia, Indianapolis, Chicago, Sacramento, Miami, and Houston (Lehman Brothers, *Commercial REIT Research: Eye on Office Markets,* October 1998).

to absorptions over the coming two years. In addition, the pace of hotel development has picked up substantially over the past two years to levels not seen since the late 1980s (see Chart 8). According to Smith, hotel completions continue to outpace demand and are expected to result in lower occupancy levels in 1999. For the apartment sector, Wheat cautions against a continuing escalation in apartment permits despite some expected slowing in employment growth in various markets over the coming 12 months.[9]

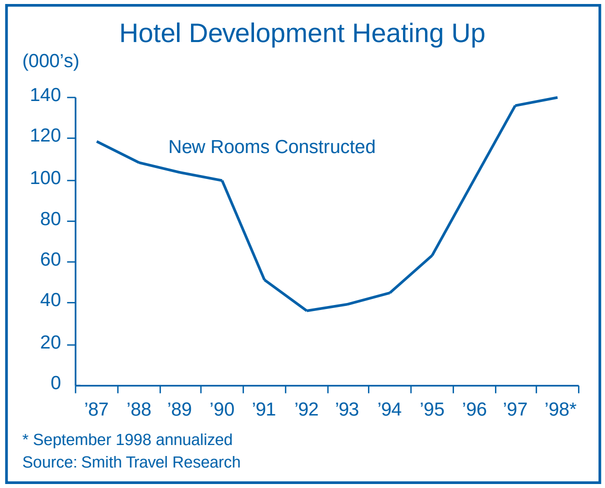
Economic Conditions May Temper Commercial Real Estate Demand

The nation's economy has shown unprecedented resiliency, even as some indicators suggest that growth may moderate in the near term. For instance, weakened global markets have placed increasing pressures on exporters, who have seen a falloff in demand in the wake of weaker foreign currencies relative to the dollar. Domestic firms, too, face rising competition from cheaper imports. These factors have created negative near-term expectations for corporate profitability, which in turn have resulted in rising layoffs and slowing employment growth. Although most economists feel that prospects for a recession are remote in the near term, even a modest slowdown in economic growth could result in higher vacancy rates in markets experiencing rapid development.

Over the longer term, various economic and demographic trends imply a weaker outlook for commercial real estate demand relative to past real estate cycles. In a recent analysis of the commercial mortgage-backed securities (CMBS) market, ***Moody's*** identifies the following trends, each of which implies secular declines in demand for one or more property types[10]:

- more efficient office space utilization as measured by continuing declines in square feet per worker;
- more efficient inventory management as measured by a proportional increase in the ratio of inventory growth to growth in warehouse space;
- shifts in spending patterns by baby boomers, the largest age cohort, away from goods and toward services;

CHART 8



- declining scrappage rates of obsolescent buildings because of a decline in the average age of the current stock of space relative to the comparable stage of prior cycles; and
- expected declines in labor force growth as the proportion of older workers increases.

In addition to these factors, other analysts have pointed out that tight labor markets and overtaxed infrastructure (e.g., water, roads, sewer, and public transportation) constrain demand by limiting growth within a particular market. Suburban areas that have seen the bulk of new construction over the past few years may be particularly hard hit if there is a backlash against the congestion and infrastructure capacity issues that accompany rapid growth.[11]

Markets Most Vulnerable to Overbuilding

Based on a review of supply and demand trends coupled with analyst opinions and projections, the following markets appear to be most vulnerable to broad-based overbuilding in the coming one to two years (see also Table 1, next page, for prevailing trends in these markets). These markets are discussed in more detail in the Regional Perspectives section.

[9] Wheat specifically notes deteriorating supply/demand ratios in Dallas, Houston, Orlando, Charlotte, Nashville, and the San Francisco Bay area.

[10] Moody's Investor Service, *CMBS and the Real Estate Cycle: Less Margin for Error,* October 9, 1998.

[11] See, for example, Price Waterhouse/Lend Lease Investment Research, *Emerging Trends in Real Estate 1999.*

Table 1

Markets Most Vulnerable to Overbuilding: Summary of Trends and Expectations					
	1H97 to 1H98 Vacancy Rates	Construction Activity ('95 to 1H98)	Employment Growth Trends	Net-Migration Trends	Projected Vacancy Rate Trends
Las Vegas	↗	↗	↘	→	↗
Atlanta	↗	↗	↘	↘	↗
Nashville	↗	↗	↘	↘	↗
Salt Lake City	↗	↗	↘	↘	↗
Charlotte	→	↗	↘	→	↗
Portland	↗	↗	↘	↘	↗
Phoenix	↘	↗	↘	↘	↗
Dallas	↗	↗	↘	↗	↗
Orlando	→	↗	→	↗	↗

Note: Arrows for vacancy and construction are intended to capture prevailing trends across all property types; experience with respect to a specific property type in a particular area may differ. H = half.
Sources: CB Commercial, F.W. Dodge, Regional Financial Associates, and Smith Travel Association.

Las Vegas

Las Vegas's hotel, office, and industrial development far surpasses that of other major markets, with ratios of construction activity to current space of 37 percent, 19 percent, and 12 percent, respectively. Rapid development is occurring despite high and increasing office and industrial vacancy rates, which place additional competitive burdens on newly completed space. The area's retail and apartment sectors are also developing rapidly, ranking third and fourth, respectively, among major markets. Although Las Vegas continues to enjoy one of the fastest employment growth rates in the country, the rate of job growth has slowed considerably from 1994 to 1996 levels. Its real estate markets are highly dependent on the gaming sector, which could be especially vulnerable to a nationwide slowdown in economic activity. The city would be particularly hard hit by a downturn in real estate prices, as fully 10 percent of its workforce is employed in the construction sector (twice the national rate).

Atlanta

Of the nation's largest metropolitan markets, Atlanta ranks among the top ten in office, industrial, retail, and apartment construction, with ratios of construction activity to current space of 12 percent, 8 percent, 7 percent, and 5 percent, respectively. Development, much of which is widely reported to be speculative, is very active despite relatively high office and industrial vacancy rates. Atlanta's expanding real estate markets have been driven largely by strong in-migration and employment growth rates. However, both these rates are slowing, and many market observers are concerned that the area's development cycle has reached its peak.[12]

Nashville

Nashville ranks among the top ten metro markets in office and apartment development, with ratios of construction activity to existing space of 10 percent and 6 percent, respectively. Although not among the top 15 markets, Nashville's hotel sector is expanding rapidly as well (construction activity stands at 12 percent of current space). Nashville's economy is reported to be slowing because of recent losses in manufacturing-sector jobs and slowing net-migration rates. The rapid pace of development has recently placed downward pressure on office, industrial, and hotel occupancy rates.

Salt Lake City

Salt Lake City ranks among the top five markets in the nation in office, industrial, and hotel development, with ratios of construction activity to current space of 14 percent, 6 percent, and 27 percent, respectively. The main drivers behind the area's rapid development have been high-tech corporate expansions, population in-migration, and preparation for the 2002 Winter Olympic Games. However, both job growth and in-migration rates are slowing, which could result in lower absorption rates for commercial space in the near term. Over

[12] See the November 1998 issue of the Federal Reserve Board's *Beige Book*.

the longer term, analysts have expressed concerns that development and job growth attributable to the Olympics will result in a significant glut of space following the Winter Games.

Charlotte

Charlotte ranks among the top five metro areas in office, retail, and apartment development, with ratios of construction activity to current space of 15 percent, 7 percent, and 6 percent, respectively. The area's hotel sector is also developing rapidly. Charlotte's real estate markets are highly dependent on the health of the financial industry, which has been the primary driver of development activity. However, job growth in the financial services sector has recently slowed, and the manufacturing sector (which accounts for 19 percent of all jobs) is experiencing net job losses.

Portland

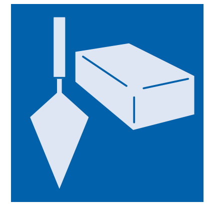
Portland has the third most active hotel and apartment development in the nation, with ratios of construction activity to current space of 25 percent and 7 percent, respectively. The area's office market is also expanding rapidly. Portland's development has been driven largely by in-migration and job growth in the technology sector. However, because of the significance of exports to the overall economy (exports to Asia account for approximately 7 percent of Oregon's gross state product), the technology sector is particularly vulnerable to weak Asian markets. Accordingly, job growth has moderated, reaching its lowest level in five years. The area has also experienced a recent decline in construction-sector jobs. Although still strong, in-migration rates have fallen from 1996 levels.

Phoenix

Phoenix ranks among the top ten metro markets in industrial, retail, hotel, and apartment development, with ratios of construction activity to existing space of 6 percent, 6 percent, 18 percent, and 6 percent, respectively. The area is also experiencing rapid development in the office sector. Phoenix has one of the fastest-growing job markets in the country. Although still strong relative to the nation, employment growth has slowed somewhat since 1996, as has the rate of in-migration. The prominence of the semiconductor and high-tech businesses makes Phoenix especially vulnerable to the economic slowdown in Asia.

Dallas

Dallas ranks among the top ten metro markets in office, hotel, and apartment development, with ratios of construction activity to existing space of 10 percent, 19 percent, and 6 percent, respectively. The area is also experiencing rapid development in the retail sector. Dallas's economy remains one of the fastest growing in the country, and in-migration to the area continues to rise. However, economic growth has slowed somewhat recently because of weakening high-tech and energy sectors. Although its industrial base is more diversified today than in the mid-1980s, Dallas remains exposed to a large energy sector, whose profits are vulnerable to declining oil and energy prices. Concerns over the volume of planned office development have led to widely published reports of curtailments in credit availability to speculative office projects. Although tighter credit availability may ease pressures on vacancy rates over the long term, the market will still have to absorb the large volume of space presently under construction, much of which is speculative.



Orlando

Orlando ranks among the top three metro markets in office, retail, and apartment development, with ratios of construction activity to existing space of 15 percent, 9 percent, and 7 percent, respectively. Of the nine markets discussed in this article, Orlando's current pace of construction is perhaps easiest to support, thanks to rising employment and in-migration growth. However, despite strong employment growth, office vacancy rates have edged higher over the past 12 months because of the rapid pace of construction. Orlando may be more vulnerable than other metropolitan areas to a slowdown in the national economy owing to its dependence on the tourism sector.

Credit Availability Affects the Pace of Commercial Development

CMBS and real estate investment trusts (REITs) have generated a significant share of funding for commercial real estate over the past several years.[13] As a result, any disruption in CMBS and REIT markets strains credit availability for new commercial development. For instance, widening CMBS spreads in the wake of September's market volatility have caused many issuers to either delay or cancel new CMBS issues. REITs, too, have reportedly curtailed purchases because of falling per-share values and a corresponding decline in equity issues to support acquisitions.

Weaknesses in the CMBS and REIT markets also may be dampening many lenders' enthusiasm for commercial real estate development. Construction lenders will be less willing to make speculative loans to the extent that permanent funding is not available, and CMBS and REITs served as major providers of such funding. REITs were particularly aggressive purchasers in such markets as Atlanta, Orlando, and Dallas.[14] Tightened construction lending conditions appear to be borne out by the November 1998 issue of the ***Federal Reserve Board***'s *Beige Book,* which indicates that new construction for speculative commercial projects has either been curtailed or come to a virtual halt throughout many Federal Reserve districts, including Atlanta and Dallas. Most districts also reported tightened credit conditions and higher loan pricing, which could further dampen construction activity.

The turmoil faced by CMBS and REITs presents both opportunities and risks for banks. Many industry participants view tighter credit accessibility as a positive development in light of the rapid pace of construction, which, in some cases, has been accompanied by extremely tight loan pricing margins and a loosening of underwriting standards. However, some lenders may view the changing fortunes of CMBS and REITs as an opportunity to regain market share. In any case, it will take several months for recent market events to be fully reflected in hard numbers for construction activity. Whether tightening credit availability proves to be a temporary phenomenon given the recent, albeit gradual, recovery in CMBS spreads and the broad recovery in the equity markets, remains to be seen.

Summary

This article updates a previously published analysis that used year-end 1997 data to rank the potential vulnerability of major metropolitan areas to overbuilding. Using primarily midyear 1998 information, this update adds three markets to the six identified in the initial analysis as vulnerable to broad-based overbuilding. This assessment is based on a number of factors including construction activity trends, local area employment and population migration trends, as well as a collection of views and projections from credible industry analysts. For many of these markets, the prospects for near-term declines in commercial real estate demand may be increasing because of slower economic growth and weakened markets abroad. Certain secular demographic and economic trends also suggest the possibility of lower demand levels in the current cycle relative to prior cycles. Although data through June 1998 indicate ongoing rapid development, there is growing evidence that recent events in the capital markets have at least temporarily tempered the appetite for further development in some rapidly expanding metro areas. For these markets, most participants view the curtailment in credit availability in a positive light because it would serve to moderate the severe cyclical swings in real estate values experienced by several markets during the 1980s.

Steven Burton, Senior Banking Analyst

[13] See "Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets" in *Regional Outlook,* fourth quarter 1997.

[14] See Lehman Brothers, *Commercial REIT Data Book,* December 9, 1997.

Recent Trends in Syndicated Lending

- **A strong U.S. economy, intensifying competition, and the increasing marketability of bank loans have driven record volumes of syndicated lending in the 1990s.**

- **After several years of liberalized underwriting, evidence suggests that some banks have tightened standards and terms for loans to large commercial borrowers.**

- **Market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.**

Commercial and industrial lending is a major source of revenue for commercial banks, yet this business line has lagged other major lending categories in terms of liquidity, standardization, and commoditization. However, in recent years the transformation of commercial lending has accelerated and is altering the way lenders do business. This trend has been particularly apparent in syndicated commercial lending. This article briefly defines syndicated loans, reviews the 1990s boom in the market, and discusses the implications of competitive pressures and secondary market liquidity for underwriting trends and risk profiles of commercial banks active in this market.

Syndicated Lending Overview

A syndicated loan is a credit extended to one large or medium-sized corporate borrower that is originated by a group, or syndicate, of lenders. Syndicated lending differs slightly from participation lending, which is common in commercial banks. Although both types of lending allow for flexibility in reducing company-specific risk and adhering to legal restrictions for loans to one borrower, only one lender originates a participation loan, which is then sold in undivided participation interests either concurrently or subsequently to third parties.[1] A syndicate usually consists of a group of institutions that work closely on a number of deals that are sold to subscribers at origination.

Syndicated loans can generally be categorized according to rating, terms, pricing, or target investors. The investment-grade loan market, often referred to as the pro-rata or retail market, is the lowest-risk segment of syndicated lending and comprises approximately 80 percent of all volume originated from 1987 to 1997. These loans commonly take the form of liquidity backstops or lines of credit and are marketed to commercial bank investors. ***Loan Pricing Corporation (LPC)*** defines these credits as those rated BBB–/Baa3 or better, or nonrated deals with pricing equal to or less than rated deals in these bands. Near-investment-grade, leveraged, and highly leveraged markets, often referred to as B, C, and D tranche term loans or non-investment-grade loans, include credits with longer maturities, greater risk, and higher pricing. Non-investment-grade loans are typically structured for institutional investors and compete more directly with the traditional high-yield bond market. LPC defines non-investment-grade loans as those rated BB+/Ba1 or worse, or nonrated deals with pricing greater than deals graded BBB–.[2]

Competitive Trends in the Syndicated Loan Market

A handful of large U.S. commercial banking companies originate the vast majority of U.S. syndicated corporate credits across all quality types. According to LPC, 14 U.S. banking companies were among the top 25 syndicated lenders (based on the number of agent or co-agent transactions) and accounted for half of 1998 syndicated loan transactions to U.S. corporations through mid-November.[3] In 1997, nine U.S. banking companies were among the top 25 and executed 36 percent of the market's transactions. Before 1997, the most active domestic commercial banks saw their market share erode from a peak of 45 percent of transactions in 1992 to 34 percent in 1996, primarily because of intensifying competition from nontraditional syndicated lenders such as investment banks and foreign banks. Although U.S. banks have recently recovered market share (as Japanese banks have significantly withdrawn from the market), a strong U.S. economy, expanding liquidity in the bank loan market, and a trend toward one-stop shopping

[1] American Bankers Association, *Banking Terminology,* 3rd ed., 1989, p. 345.

[2] Loan Pricing Corporation, *Gold Sheets*, Third Quarter 1998 Review, p. 2.

[3] Loan Pricing Corporation, *Gold Sheets*, November 16, 1998, p. 6.

in the financial services industry have attracted competitors to the syndicated market in the 1990s.

Syndicated Loan Liquidity

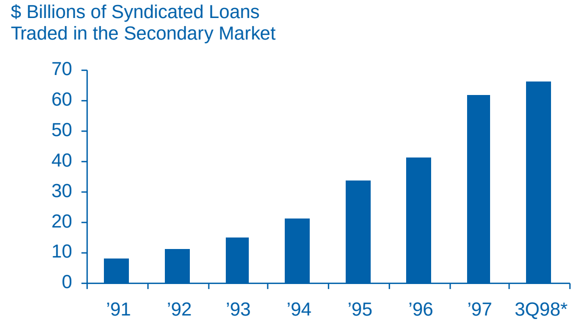
U.S. commercial banking companies retain or buy a large volume of syndicated loans, yet estimates show that most of the volume is sold to other institutional investors. Information from the shared national credit program[4] indicates that at year-end 1997, FDIC-insured commercial banking companies had extended facilities and commitments totaling $1.8 trillion, of which an estimated $565 billion was funded. To put this figure in perspective, an official of the ***Office of the Comptroller of the Currency*** estimated that 57 percent of outstanding syndicated loans were held by foreign banks; 26 percent by originating banks, mutual funds, and insurance companies; and 17 percent by subscribing banks.[5] Indeed, according to ***BankAmerica Corporation,*** the number of nonbank institutional investors in bank loans, including prime rate mutual funds, hedge funds, and insurance companies, increased from 14 in 1993 to more than 100 in 1998. These investors have played a pivotal role in enhancing the bank loan as a distinct asset class by increasing trading activity, demanding third-party loan ratings, and contributing to the development of loan derivative products.

Perhaps the most important new development in syndicated lending has been the deepening secondary market for bank loans as many new investors seek to purchase them. As shown in Chart 1, the volume of secondary trading in bank loans has grown sharply, more than tripling between 1994 and 1997 to over $60 billion. Trading in 1998 through the third quarter was on pace to top the 1997 level. Traded loans are often non-investment-grade issues, which have been the focus of most demand by the burgeoning institutional investor base. One important force behind the development of a bank loan secondary market has been rapid expansion in the number of bank loans rated by third-party rating services.

Independent credit ratings of bank loans were initiated in 1995 when "several years of rapid development in the

CHART 1

Secondary Market Trading in Syndicated Loans Has Tripled since 1994



* annualized
Source: Loan Pricing Corporation

syndicated bank loan market generated a critical mass of interest in the credit characteristics of these instruments."[6] ***Standard and Poor's, Moody's, Duff and Phelps,*** and ***Fitch/IBCA*** are now actively involved in rating bank loans. Through 1997, Standard and Poor's and Moody's combined rated $677 billion in loans. As rating activity increases access to and availability of standardized analysis and research for bank loans, including market analysis, ratings criteria, and historical loss recovery rates, investors are becoming more comfortable with loans as a distinct asset class. Moreover, independent loan ratings allow investors to value a company's loans relative to its other rated loans or bonds.

Bank loan secondary market activity and independent ratings have prompted the development of new ways to package and improve the market acceptance of these assets. As a result, the securitization of bank loans and the development of various types of derivative products have proliferated. As discussed in "CLOs Lure Another Major Bank Asset off the Balance Sheet," in ***Regional Outlook***, third quarter 1998, collateralized loan obligations (CLOs) are a major market development allowing for the securitization of corporate loans. A large investor appetite for varied types of asset-backed securities and a desire to move assets off the balance sheet to lower risk-based capital requirements have helped promote a sharp increase in this type of securitization. Loan derivatives also may allow lenders to better manage the trade-off between maintaining borrower relationships and avoiding excessive concentrations of risk. This trade-off has become increasingly

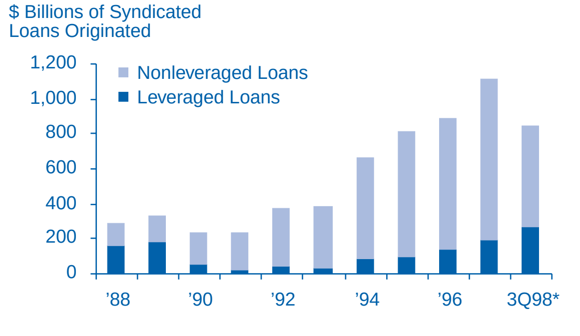
[4] The shared national credit program is a cooperative examination program conducted by the three federal banking agencies and cooperating state agencies to review large, complex credits held at multiple institutions. Loans subject to review are syndicated loans or groups of loans and commitments of $20 million or more shared by three or more supervised institutions.

[5] "Concerns Mounting Over Risks in Booming Syndication Market," *American Banker,* January 29, 1997, p. 20.

[6] "Bankrupt Bank Loan Recoveries," *Moody's Investor Service,* June 1998, p. 5.

CHART 2

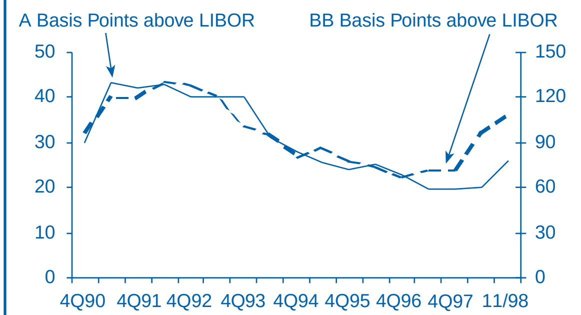
After Several Record Years, Syndicated Loan Originations Have Slowed



* annualized
Source: Loan Pricing Corporation

CHART 3

New Syndicated Loan Pricing Has Reversed after Several Years of Narrowing Spreads



Note: LIBOR = London Interbank Offered Rate
Source: Loan Pricing Corporation

important with the trend toward one-stop shopping in financial services.

One-Stop Financial Providers

For several years, analysts have noted a trend toward financial services supermarkets—financial institutions positioning themselves as providers of a complete array of advisory services and financial products. One aspect of this trend has been the tendency of traditional lenders to improve their ability to offer a full array of equity and debt underwriting, as characterized by the expansion of Section 20 activities among major U.S. commercial banking companies. Traditional securities underwriters view entry into the syndicated loan market similarly. For example, no investment bank had a syndicated loan underwriting department in 1994, but several are now making inroads into the market, especially the leveraged market, and some increased their syndicated loan volume fivefold in 1997.[7] In some cases, the desire of commercial banks to move toward one-stop financial services and the resulting approaches to relationship management have affected the underwriting of loans to large commercial borrowers that have multiple financing and advisory service needs.

Historical Perspective on Syndicated Loan Underwriting Trends

Increased interest by investors in bank loans and strong competition for business resulted in syndicated lending at historically narrow spreads and on more liberal terms. Accordingly, the syndicated loan market was a borrowers' market for much of the 1990s. As shown in Chart 2, the volume of syndicated loan originations increased almost fivefold between 1991 and 1997, with record volume levels achieved in each of these years. Much of the volume was driven by growth in the origination of loans for the purpose of refinancing existing debt, especially from 1995 to 1997, as borrowers took advantage of increased lender competition and investor demand to reduce funding costs and extend maturities. In some cases, borrowers were able to refinance loans obtained just months earlier at significant savings and more favorable terms.

Chart 3 shows that lending spreads compressed sharply from 1993 to 1997, particularly for lower-quality credits. LPC stated that "[e]xcessive competition has driven spreads and fees to all-time lows, with the investment grade market purely a relationship play."[8] Consistent with the financial supermarket concept discussed above, as relationship lending proliferated, many lenders were evaluating transactions on the basis of overall relationship returns rather than individual transaction returns. Consequently, borrowers willing to offer an institution ancillary business, such as cash management, securities underwriting, or securitization services, were likely to receive more favorable loan pricing than borrowers seeking to execute just one loan deal.

During the same period, a clear trend toward weakened underwriting resulted in deteriorating risk/return rela-

[7] "The New Kids in the Syndicate: Investment Banks Are Moving in on the Leveraged Syndicated Loan Market," *Bloomberg,* March 1998, p. 35.

[8] Loan Pricing Corporation, *Gold Sheets,* First Quarter 1995 Review, p. 9.

CHART 4

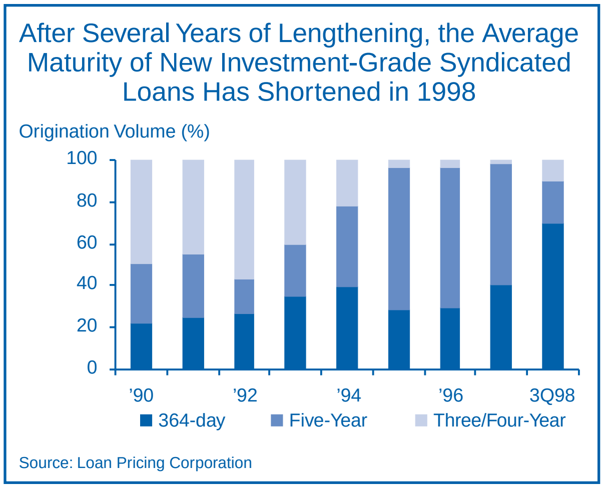
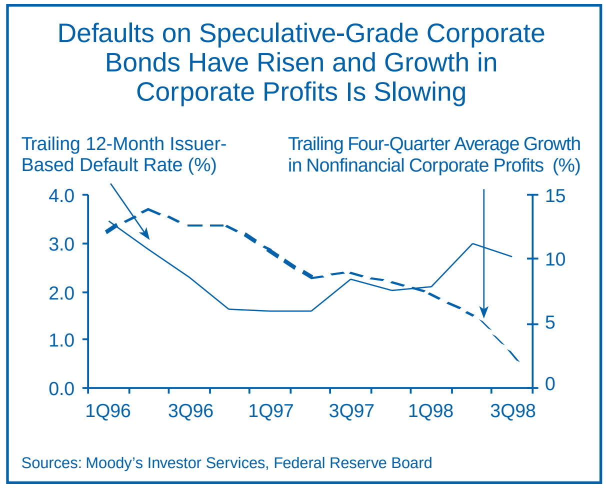


CHART 5



tionships across syndicated lending categories. Financial indicators market analysts use to evaluate whether lenders are being adequately compensated for risk generally weakened. For example, the ratio of debt to earnings before interest, taxes, depreciation, and amortization rose to relatively high levels for an increasing number of leveraged and highly leveraged loans.[9] Moreover, lengthening maturities reflected looser underwriting. A decline in the spreads between loans of one-year and five-year maturities made it cost-effective to borrow for longer periods. LPC indicated that the differential between fees on undrawn 364-day revolving loans and undrawn five-year loans had dropped by one-half during this period.[10] As a result, many borrowers extended maturities on new credits, and, as shown in Chart 4, the average maturity of investment-grade loans originated in the mid-1990s lengthened significantly.

Recent Underwriting Developments

Beginning in late 1997, lenders and investors began to resist aggressively priced investment-grade and near-investment-grade loans. This resistance led to a leveling of pricing, fewer refinancing opportunities for borrowers, and increased focus on the higher-risk leveraged lending market, where nonbank institutional investor demand was strong and pricing was richer. In response, overall syndicated lending volume declined almost 16 percent during the first three quarters of 1998 compared with the same period in 1997. However, within total new syndicated loan volume, leveraged loan originations grew 77 percent to $200 billion during the same period, accounting for approximately one-third of all syndicated credits—the largest proportion of the market since 1989. Of particular note was that this growth in higher-risk lending came at a time when losses in speculative-grade bonds had been trending higher and growth in profits for nonfinancial U.S. corporations had been slowing (see Chart 5).

Global economic turmoil and the flight to quality that disrupted the capital markets during the third quarter of 1998 spilled over into the bank loan market and solidified a shift to a lenders' market. LPC noted in its third-quarter 1998 review of syndicated lending that "[r]ates and fees are on the upswing meaning opportunistic refinancings…continue to dwindle. Concessions suddenly are going to lenders rather than borrowers, and volume continues the drop [from levels] seen earlier in the year."[11] Growth in leveraged lending also declined sharply as the number of institutional investors in the market fell by one-half from the second quarter.[12]

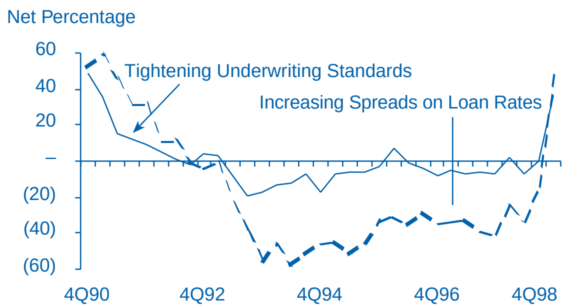
The shifting dynamics of the market in late 1998 were characterized by the aforementioned slowdown in originations, a sharp increase in pricing (see Chart 3, previous page), and evidence that underwriting had become more stringent. The volatility in credit markets resulted in deals being rescinded or incorporating "market flex" pricing language that enabled lenders to manage the yield requirements of investors due to changing yields on competing capital markets instruments. The influ-

[9] Ibid., pp. 16-17.
[10] Ibid., p. 43.

[11] Loan Pricing Corporation, *Gold Sheets,* Third Quarter 1998 Review, p. 3.
[12] Ibid.

CHART 6

Some Banks Have Tightened Underwriting Standards and Terms to Large and Medium-Sized Corporate Borrowers

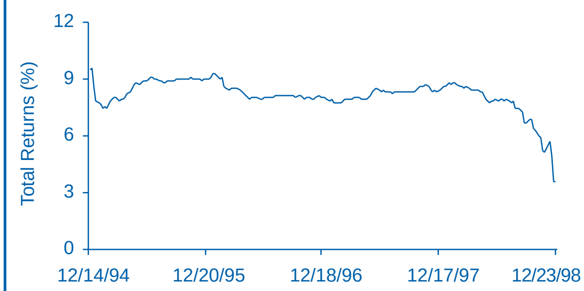


Source: Federal Reserve Board

CHART 7

Total Returns* on Leveraged Loans Have Fallen

Rolling 52-Week Total Returns Measured by the Goldman Sachs/Loan Pricing Corporation Liquid Leveraged Loan Index



* Total Return = Accrued Interest + Bid Changes + Gains from Repayments

Source: Loan Pricing Corporation, Goldman Sachs, Bloomberg

ence of the secondary market on new loan pricing became apparent as investors required underwriters to factor in higher secondary market yields. In addition, as shown in Chart 6, the Federal Reserve Board's November 1998 Senior Loan Officer Opinion Survey on Bank Lending Practices reported that a significant minority of surveyed lenders had tightened lending standards and terms for commercial loans to large and middle-market firms.[13] On net, nearly 40 percent of domestic bank respondents had tightened lending standards for these borrowers for the three months ending November 30, and nearly half had increased pricing. These percentages are the highest reported since the last recession.

Underwriting was also influenced by increased borrower demand for bank loans—a secondary effect of the market volatility in late 1998. The aforementioned Federal Reserve Board survey noted an increased demand for bank commercial loans primarily as a result of shifts from other sources of credit, namely the bond and commercial paper markets. For example, one industry participant estimated that the loan market represented roughly 60 percent of capital market financing in January 1998, 40 percent in July as the high-yield bond market boomed, and nearly 100 percent in September as the bond markets stalled.[14]

[13] Large or middle market firms are those with annual sales greater than $50 million.

[14] "Syndicated Lenders Swiftly Surmounted September Dip," *American Banker,* December 10, 1998, p. 25.

Implications for Insured Institutions

Although recent evidence suggests that some lenders have tightened standards and terms for loans to large commercial borrowers, market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.

- *A slowing economy and stress in industries exposed to weakened international economic conditions could result in increased losses during an economic downturn, especially for banks that are holding higher-risk syndicated loans.* Although nonbank institutional investors hold the bulk of the riskier tranches of syndicated deals, some banks ventured into riskier, longer-term issues in response to narrow pricing on traditional loan pieces held by banks.[15] Should liquidity become an issue in the secondary market, banks planning to sell these pieces may face losses. For example, as reflected in Chart 7, the rolling 52-week total return on the ***Goldman Sachs/LPC*** Liquid Leveraged Loan Index, which measures the performance of a diversified portfolio of the most actively traded performing leveraged loans, has fallen from over 8 percent in early 1998 to less than 4 percent in December 1998. Falling prices have caused reduced returns as required spreads on these credits have risen.

[15] "Banks Compete with Funds in Buying Long-Term Tranches of Syndications," *American Banker,* March 19, 1997, p. 1.

- *Downstream subscribers that purchased thinly priced or loosely structured loans may not be adequately compensated for risk. This lack of compensation may be especially important for institutions that do not receive ancillary relationship income.* Evidence suggests that downstream lenders became more willing to accept loans during the 1990s without receiving full documentation or making an independent credit analysis. The Office of the Comptroller of the Currency reportedly attributed this trend to a desire to add loan volume coupled with comfort about company prospects because of the strong economy and strong corporate profits.[16] As a result, on a risk-adjusted basis, the returns on these credits may hamper the performance of investing institutions.

- *Sustained reductions in syndicated loan liquidity may adversely affect revenues and increase percentages of loan amounts retained by active syndicating institutions.* If institutional investors remain withdrawn from the loan market for an extended period, syndicates may have increasing difficulty marketing deals, especially in the non-investment-grade segment. As a result, institutions dependent on revenues generated by this activity may face declining income as fewer deals are executed, or they may have to hold larger percentages of undersubscribed transactions. This situation may be further exacerbated by consolidation in the U.S. banking industry, which has combined several major syndicate agents in the 1990s and has reduced the number of potential downstream investment-grade subscribers in the market.

- *Rising demand from borrowers exploiting relative pricing in the loan and capital markets may have credit and liquidity implications for underwriting institutions.* Sustained volatility in the capital markets may increase the demand for bank loans and will likely significantly increase funding costs for many borrowers. For example, LPC recently compared loans that were extended to seven companies in early 1998 with similarly structured loans extended to the same companies after the third-quarter disruption in the capital markets. The analysis revealed significant increases in required yields, ranging from 112 to 388 basis points.[17] Rising funding costs combined with a trend toward slower growth in corporate profits may reduce loan repayment capacity of borrowers in more troubled industries. In addition, banks that have extended liquidity backstops or backup lines of credit may be required to fund facilities that traditionally are not heavily used by borrowers. For example, without appropriate pricing adjustments, banks providing backup commercial paper loans may be called upon to fund these facilities as a result of volatility and relatively high spreads in the commercial paper market.

Increases in credit spreads on securities and syndicated loans, the recent rise in speculative corporate bond defaults, and slowing corporate profits may portend an increase in commercial credit problems for commercial banks. Now more than ever, those involved in bank risk management should pay close attention to fundamentals, including careful credit analysis, diversification, and maintenance of prudent underwriting standards. Attention to these fundamentals may help alleviate the need to overreact to sudden changes in the market environment.

Steven E. Cunningham, CFA, Senior Financial Analyst
Ronald L. Spieker, Chief, Regional Programs and Bank Analysis Section

[16] "Concerns Mounting over Risks in Booming Syndication Market," *American Banker,* January 29, 1997, p. 20.

[17] Loan Pricing Corporation, *Gold Sheets,* November 16, 1998, p. 21.

Regional Perspectives

- **Consistent with a Regional economy that has outperformed the U.S. economy for much of the decade, some Atlanta Region real estate markets rank among the nation's most active in terms of new construction.**
- **With a growing number of economists now forecasting slower economic growth, industry observers are questioning whether property demand will keep pace with the supply of space expected to be delivered into some of these markets over the next couple of years.**
- **Insured community institutions in the Atlanta Region generally are not as active in construction and development lending as they were before the last downturn in the late 1980s. Institutions in metropolitan Atlanta are the exception.**

Commercial and Residential Construction Activity in the Atlanta Region

Overview

Growth in population, employment, and income, paired with low interest rates and an ample credit supply, have fostered an environment in which real estate construction and development have flourished in recent years, particularly in metropolitan markets. Consistent with a Regional economy that has outperformed the U.S. economy for much of the decade, some Atlanta Region real estate markets rank among the nation's most active in terms of new construction. Likewise, insured institutions in several Atlanta Region metropolitan areas are providing residential and commercial construction and development financing at a pace well ahead of the national average. There are inherent risks associated with this type of lending, however. Specifically, uncertainty exists during the time it takes to complete a project, as events occurring during the construction phase can alter the project's return, rental, or sales potential. These risks increase as the time to completion is extended.

With a growing number of analysts now forecasting a possible economic slowdown within the next couple of years, some industry observers are questioning whether property demand will keep pace with the supply of space scheduled to be delivered into certain markets. Slack demand could be especially troublesome for speculative projects, the absorption of which is predicated largely on a continuation of current economic trends. In the Atlanta Region, concerns about a supply/demand imbalance are most frequently associated with larger, more active markets such as Atlanta, Charlotte, and Miami, all of which show large numbers of projects under construction and in the planning stages despite rising vacancy rates. Similar circumstances (continued development in the face of rising vacancies) in the late 1980s may have contributed to the plunge in property values that occurred during the recession of 1990 to 1991, which in turn eroded the financial strength of many insured institutions and contributed to the failure of others.

This article summarizes real estate market conditions and insured institutions' construction and development (C&D) lending exposure in the Atlanta Region's largest metropolitan areas. Anecdotal evidence suggests that many of the Region's larger institutions (assets over $1 billion) often lend in more than one market; however, because Call Report data do not provide a geographic breakdown of lending activity, the exposures discussed below refer to community institutions (assets under $1 billion) headquartered within each metropolitan area. These institutions are likely more vulnerable to a downturn in their primary market than larger institutions because they lack geographic and product-line diversity.

Individual Market Analysis

Although high levels of building continue in **Georgia,** especially on the residential side, year-to-date commercial construction is below the same period one year ago. Georgia, dominated by **Atlanta,** is the only state in the Atlanta Region where commercial construction activity has declined during the first half of 1998. Although decline has been recorded in all metropolitan areas except **Columbus, Macon,** and **Savannah,** the largest decline in commercial starts occurred in Atlanta, where economic growth has moderated as well. At the start of

1998, year-over-year job growth in Atlanta was at 4.6 percent and has since steadily fallen to 3.1 percent. Growth has slowed in virtually all areas of the economy except government. Labor markets, though still tighter than the national average, have started to loosen slightly. Further moderation in economic growth could affect absorption rates in real estate markets. A June 1998 ***Bank Trends*** publication entitled "Metropolitan Atlanta Construction and Development Lending Trends" offers an in-depth analysis of the Atlanta market and can be accessed at http://www.fdic.gov/publish/bktrnds/at/bt_9806.html.

Despite the recent moderation, Atlanta's commercial construction remains near recent historic highs, fueling concern that more space may be coming on line than can be absorbed. Considerable space remains in the pipeline, particularly in retail and office markets. By August 1999, the Mall of Georgia will open, adding over 1 million square feet of new retail space to the metropolitan Atlanta market. Homebuilding in Atlanta continues to rise despite slowing population growth. During the first half of 1998, Atlanta ranked first in the nation in terms of permits issued.

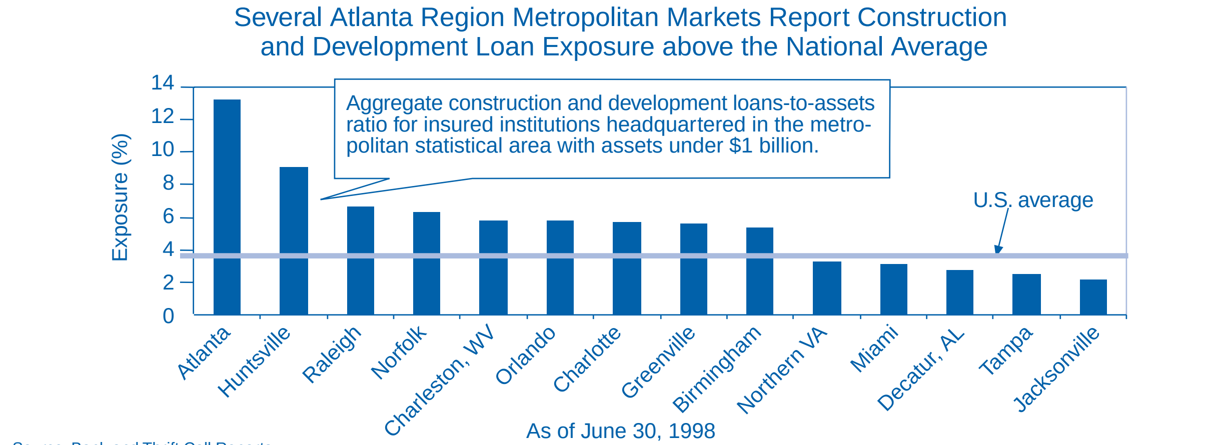
Consistent with the level of building activity, C&D lending at metro Atlanta institutions is significantly higher than in any other market in the Region. Aggregate C&D lending exposure at area institutions, at about 13 percent of assets in the second quarter of 1998, is at a level not seen since the late 1980s. In addition to aggregate exposure that is roughly three times the national average, the number of metro Atlanta institutions (28) reporting a C&D concentration above 15 percent of assets is three times that of any other metropolitan statistical area (MSA) in the nation (Dallas ranks second with 9). To further illustrate Atlanta's C&D lending activity, 19 of the top 100 insured institutions in the nation, ranked by the ratio of C&D loans to assets in the second quarter, were headquartered in the Atlanta MSA (next highest were Salt Lake City with 5 and Memphis with 4). Chart 1 shows Atlanta's exposure relative to other metropolitan areas in the Region.

Miami has maintained stable though moderate levels of growth following its postrecessionary rebound in the early 1990s. During this time, job growth averaged close to 2 percent. Though generally below the national average, gains in employment have been strong enough to apply downward pressure to the metropolitan area's unemployment rate. In the third quarter of 1998, the non-seasonally adjusted rate of unemployment in the metropolitan area stood at 6.4 percent, its lowest level since early 1990.

Sustained economic growth in Miami is linked closely to overseas developments. International trade through Miami International Airport and the Port of Miami has made the metropolitan area a gateway to Latin America for U.S. and European companies. Similarly, Miami Beach and shopping opportunities have made the metropolitan area a key tourist destination for foreign visitors. A recent survey by the Greater Miami Convention and Visitors Bureau suggested that 80 percent of South American visitors to Miami come for the shopping. In 1997, foreign tourists spent nearly $1 billion in Miami-area malls, making their contribution critical to the health of the metropolitan area's retail trade sector. Tourism and international commerce also fuel growth in Miami's wholesale trade, transportation, financial, and services industries. As the metropolitan area grows increasingly interconnected with international developments, exposure to global risks rises. A U.S. Department of Commerce official has quipped that "when Brazil sneezes, Florida catches cold." Given the recent economic and financial turbulence in Brazil, the Miami area may be at risk for slower growth.

International ties and the metropolitan area's prolonged economic expansion have affected some segments of Miami's real estate markets. Retail construction has been the most active segment of the metropolitan area's commercial markets. In the second quarter of 1998, new completions stood at a seasonally adjusted annual rate of 3.7 million square feet. Net absorption was only one-third that level. Consequently, the retail vacancy rate rose to 7.6 percent from 6.9 percent in 1997. Though vacancy rates remain well below the double-digit levels of the early 1990s, some analysts have raised concerns about overbuilding in some submarkets, particularly strip malls. Other areas of Miami's commercial real estate market are expanding. In the office market, absorption continues to outstrip supply, thus applying further downward pressure to vacancy rates. Though still in the double digits, office vacancy rates in the metropolitan area have fallen substantially since the late 1980s and early 1990s when they were above 20 percent. Absorption activity also has picked up in the industrial real estate market. International events, however, could dampen absorption. The economic correction currently under way in Brazil could discourage visitorship to the metropolitan area. Moreover, high interest rates in that country could discourage the

CHART 1



Source: Bank and Thrift Call Reports

financing of imports that move through Florida. The recent decision to allow the Brazilian real to float could make purchasing from and visiting the United States more expensive.

Residential construction activity is mixed, with most new growth in construction occurring in upscale condominiums. Much of the new condominium construction has focused increasingly on high-end market segments of Miami Beach, which has enjoyed a renaissance in recent years. Here too, investment from Latin America has helped foster development. In Sunny Isles (North Miami Beach), for example, low-budget motels are being replaced by high-rise condominiums. Developers envision marketing the condominiums to wealthy Latin Americans. The new high-end development along Miami Beach also could encourage more upscale retail construction in the area.

Single-family homebuilding has been less active. Rising impact fees and construction costs have fueled an escalation in new home prices, discouraging homebuying. Consequently, the market for existing homes remains strong, with sales up nearly 15 percent. Another factor that may be affecting single-family construction is declining population growth. In 1994, the metropolitan area's population rose by 1.3 percent; growth has dropped in each successive year to 0.3 percent in 1997, when the number of residents in the metropolitan area increased only 7,091. This gain contrasts with population gains of approximately 30,000 new residents annually in adjacent Broward County over the past four years.

Despite brisk construction activity, Miami's insured institutions report relatively low C&D lending exposure. In the second quarter of 1998, C&D loans represented just 3.12 percent of assets at Miami institutions, less than half the level seen in this market in the late 1980s. In fact, only 1 of 38 community institutions headquartered in the Miami MSA reported a C&D loans-to-assets ratio above 10 percent in the second quarter. The data likely reflect that a number of development projects are being financed by larger institutions headquartered outside the Miami MSA, which, according to the most recent ***Summary of Deposits*** data, hold roughly a 50 percent share of the Miami deposit base.

Orlando remains one of Florida's fastest-growing economies, with quarterly year-over-year job growth close to 5 percent. Tourism forms the core of the Orlando economy. The nation's prolonged economic expansion and sustained levels of income growth encourage spending on tourism. Economic and financial troubles overseas, however, may be adversely affecting foreign visitorship. Tourism is not the sole source of growth in the metropolitan area. Orlando has been relatively successful in recent years in attracting corporate relocation, which may help support office absorption rates. Retirees are also a source of growth, although the growth of the metropolitan area's 65+ age cohort has moderated since the start of the decade.

Office construction in the Orlando metropolitan area is among the strongest in the country. In the second quarter of 1997, the vacancy rate reached its lowest point this decade, at 6.1 percent. Since then, a slight rise has occurred as increased construction activity has kept pace with demand. As of the first quarter of 1998, the office vacancy rate, at 7.2 percent, was more than 2 percentage points below the national average. The Orlando retail market has been among the most active in the nation for regional mall development, bucking a national trend toward stand-alone buildings. In 1997, just over 755,000 square feet of space was added to the market, but 2.2 million square feet is expected to be delivered in 1998. Increased tourism has been a driver of construction activity in this sector, but economic pressures in Latin America and Canada may lead to declining tourism. This decline could result in rising vacancy rates, as slower retail spending could weaken absorption.

Residential real estate activity continues to be strong in the Orlando market, with permit issuance for second-quarter 1998 rising 11.3 percent above year-ago levels in single-family construction and 89.2 percent in multifamily construction. Median existing single-family home prices in the third quarter of 1998 rose by 3.3 percent from one year earlier. Demographic forces appear to be supporting the high levels of residential construction activity. Over the past three years, population growth has risen significantly, from 2 percent in 1994 to 2.8 percent in 1997. In 1997, Orlando absorbed more than 25,000 new residents. Strong levels of population growth often fuel demand for local goods and services as well as housing.

Although insured institutions' C&D exposure in metropolitan Orlando is above the national average at about 5.8 percent of assets, it is nearly 50 percent below levels seen in this market in the late 1980s. In the second quarter of 1998, only 2 of Orlando's 20 community institutions reported C&D exposure above 15 percent of assets. Given the current level of exposure, as well as the generally downward trend in C&D loans as a percentage of assets throughout this active real estate upcycle, the risk of a broad-based deterioration in Orlando's banking sector as a result of overbuilding is considered low. Like most metropolitan areas in the Atlanta Region, Orlando's financial services landscape is dominated by large regional banking companies.

Jacksonville's strong economic performance continues. Although job growth moderated slightly in 1998, it remains above 4 percent. The metropolitan area is being fueled by high levels of corporate relocation and expansion and in-migration, which have supported absorption rates in most areas of construction. One risk, however, is the closure of Cecil Field Naval Air Station.

Most of the growth in construction has been on the residential side, where home price appreciation is in the double digits and is the highest in the state. Currently, 2,000 apartment units under construction, which is more than the total completions for 1997, are expected to come on-line by mid-1999. Demand for retail space in Jacksonville remains high and seems to be growing, according to information compiled by the ***Jacksonville Business Journal.*** At midyear 1998, new completions in the retail sector nearly quadrupled second-quarter 1997 levels. The Jacksonville vacancy rate for industrial space has been increasing since March 1997, when it stood at 12.5 percent according to the *Jacksonville Business Journal.* In December 1997, the vacancy rate was up to 14.5 percent, and by the end of second-quarter 1998, it had risen to 20 percent. Office vacancy rates have been declining throughout most of the decade, dropping into the single digits in the latter part of 1997 and into 1998. Construction activity for this sector increased, however, and in 1998 supply was keeping pace with demand.

Despite brisk building activity, Jacksonville's insured institutions reported the lowest aggregate C&D exposure of any market covered in this analysis, at only 2.2 percent of assets. This exposure was below the national average and was considerably lower than the 11 percent reported by Jacksonville institutions a decade ago. Of the nine banks and thrifts with assets under $1 billion headquartered in the Jacksonville MSA, none reported C&D exposure above 10 percent of assets in the second quarter. It is likely that much of the area's building activity is being financed by large institutions headquartered outside the metropolitan area, as these institutions hold roughly 90 percent of Jacksonville's deposit base, according to June 1998 ***Summary of Deposits*** data.

Charlotte, North Carolina, has enjoyed solid economic growth throughout much of the 1990s. Population growth, employment gains, and rising per capita income have fueled demand for new office, retail, industrial, and residential space across the seven-county Charlotte-Gastonia-Rock Hill metropolitan area. Recently, however, the pace of new construction has exceeded absorption in each of these property types, pushing vacancy rates higher. Although the Charlotte real estate markets remain strong overall, a continuation of current trends could lead to disequilibrium in certain sectors.

Commercial starts, up 23 percent during the first half of 1998, could post a record high for the year. Residential construction activity continues to expand, with year-to-date permit issuance up 8.6 in third-quarter 1998 from one year earlier. Some weakness does exist in the multifamily sector, however, where construction of buildings with five or more units is off more than 20 percent from year-ago levels.

Office vacancies in the Charlotte metro area fell from a cyclical high of 19.2 percent in 1992 to 7.2 percent at year-end 1997. Higher levels of construction activity pushed the ratio up slightly, to 7.3 percent in the first quarter of 1998. Continued growth in the financial services sector, particularly by two super-regional banking companies, has resulted in a shortage of Class A office space in the uptown business district. Available Class A space in that area measured only 3.3 percent in the first quarter of 1998. Roughly 1.3 million square feet of space currently under construction in the uptown market will enable these two banks to centralize operations currently housed in various locations across the metro area. Although this centralization should ensure occupancy of the newly constructed space, it is uncertain whether demand from other sources will be sufficient to absorb the space vacated by these companies in addition to that being created by other metro area projects. In the retail sector, vacancy rates fell from 11 percent in 1990 to a low of 5.5 percent in 1996 before rising slightly to 5.8 percent in the first quarter of 1998. Retail completions exceeded absorption in 1997 and the first quarter of 1998. Likewise, Charlotte's industrial market experienced strong net absorption in the early 1990s, forcing vacancy rates down from 9.6 percent in 1991 to 4.7 percent by 1994. However, new supply has exceeded demand in each of the past three years, causing vacancy rates to jump three percentage points to 7.6 percent. Charlotte's residential market, though still strong overall, exhibits a trend similar to the above-mentioned sectors. On the positive side, median home prices in the first quarter of 1998 were up 12.5 percent from a year earlier, and new home starts were 5 percent ahead of last year's pace through August. However, the multifamily market has loosened somewhat, as vacancies more than doubled from 4.2 percent in 1995 to 8.8 percent in 1997.

Although a continuation of current trends could have negative implications for some insured institutions, aggregate C&D lending exposure at Charlotte's community banks and thrifts is not considered excessive. The 21 community institutions headquartered in the Charlotte MSA reported an aggregate C&D loans-to-assets ratio of 5.7 percent in the second quarter. Although this level was above the national average, it was only about half that reported by Charlotte institutions in the late 1980s. Furthermore, no institution reported a C&D concentration above 15 percent of assets in the quarter. Clearly, large regional and super-regional banks, some of which are headquartered in the Charlotte metro area, are financing the bulk of the area's construction and development activity. In fact, much of the area's recent construction, particularly office space in the uptown business district, was made necessary by the continued expansion of two large Charlotte-based banking companies. This may be favorable from a risk perspective, as the greater geographic and product diversity of these large institutions should reduce their exposure to weakness in any one market. However, because these banks have a sizable market share in several of the Region's metropolitan areas, they could be negatively affected by overbuilding or an economic slowdown in the Region.

Growth in the **Raleigh** metropolitan area, though moderating, remains well above the national average. Year-over-year job growth in the third quarter of 1998 was 3.4 percent compared with the national average of 2.6 percent. A cornerstone of Raleigh's sustained economic growth has been the continued expansion of high-tech industries and research and development facilities, which have fueled other areas of the economy. One factor that may be contributing to slower growth is the metropolitan area's exceptionally low unemployment rate. Difficulties in finding qualified labor to fuel corporate expansion could constrain absorption in Raleigh's commercial real estate markets.

Demand for office space in the Research Triangle area is strong and is currently outpacing construction. As of October 1, 1998, the office vacancy rate was 5.6 percent, or about half the national rate, according to ***Karnes Research,*** a Raleigh consulting and market research firm. Although the office market appears healthy, vacancies will likely rise over the coming year because developers have about 2.2 million square feet of office space under construction. If absorption returns to a more normal rate of 1 million square feet per year, the vacancy rate could double if space in the pipeline is completed. Industrial vacancy rates are also low, at 5.9 percent for warehouse space and 7.2 percent for flex space (buildings that combine offices with warehouse, showroom, or distribution use). The Triangle industrial market currently has 12.1 million square feet of multi-tenant warehouse space and over 6.7 million square feet of flex space. About 1.4 million square feet of warehouse space is planned or under construction and 790,000 square feet of flex space is under construction with another 1.2 million square feet proposed. In the retail sector, available space is tight, as reflected in the third-quarter vacancy rate of 3.7 percent. The Triangle's retail space totals 26.5 million square feet with an additional 4.4 million square feet planned. A large portion of the retail space coming on-line is preleased; however, if proposed new space materializes, overbuilding could occur. The Triangle's residential market may have passed its peak, with total permit issuance through September 1998 down almost 10 percent from one year ago. Year-over-year permit issuance increased by nearly 18 percent for single-family construction in September 1998, but multifamily construction declined by nearly 9 percent.

Although large regional banks control a commanding share of the Raleigh market, the metro area's community institutions are actively participating in C&D financing. The aggregate C&D loans-to-assets ratio for this group has risen from less than 5 percent in 1995 to 6.7 percent in the second quarter of 1998. Nonetheless, current exposure is below the 1980s levels, and only one institution reported a concentration above 10 percent of assets in the second quarter.

High-tech industrial and software development continues to foster above-average levels of growth in the **Northern Virginia** area. Year-over-year job growth has averaged more than 4 percent during the past several quarters. Rapid growth in these industries has sustained high rates of absorption. Construction in the Northern Virginia area is active. Office space is especially tight, and developers are busily building new space to accommodate increasing demand. Plans have been announced for several 2-million-plus-square-foot office complexes. Although demand is strong in this sector, absorption is constrained by a lack of available supply. Vacancy rates have been below 5 percent since mid-1997, with the vacancy rate for Class A space falling to around 3.6 percent as of December 1998. Rents have been rising considerably and are nearly double what they were just a few years ago. Likewise, rents for industrial space are escalating and the market is growing tighter. The industrial market is composed primarily of service center and flex space; very little distribution and big-box space is available. In December 1998, vacancy rates in this sector were only 5 to 7 percent. With little competitive space available, new completions are absorbed quickly. Available property for industrial construction is scarce, resulting in a 25 percent to 35 percent increase in property value. In the multifamily market, supply and demand are roughly in equilibrium. Occupancy is around 96 percent, and rents are rising accordingly.

Community institutions in the Northern Virginia area do not report any significant C&D lending exposure. In fact, aggregate exposure at area institutions declined slightly in the first half of 1998 and was below the national average at 3.3 percent in the second quarter. Of 74 community institutions headquartered in the Washington, D.C.–Northern Virginia metropolitan area, only four reported C&D loans above 10 percent of assets in the quarter.

Norfolk's economy continues to perform below the national average in terms of job growth. Weak gains may be adversely affecting commercial absorption rates in the metropolitan area, but economic growth may receive a boost with the relocation of naval personnel and aircraft from Florida to Oceana Naval Air Station. Commercial construction starts at midyear 1998 were slightly ahead of second-quarter 1997 starts. Office construction starts rose dramatically, with 706,000 square feet of space under construction in the second quarter of 1998 compared with 474,000 square feet through the second quarter of 1997. Retail construction starts also picked up from 1997. The vacancy rate rose in 1998 as new completions continue to outstrip absorption. A new 500,000-square-foot mall is under construction in the downtown area, which may further increase the vacancy rate. Currently, 5.6 million square feet of additional space is in the planning stages. If this space materializes, retail vacancies could rise. Conversely, industrial construction starts in the second quarter of 1998 declined by nearly 50 percent from 1997. Residential construction starts year-to-date are relatively unchanged from 1997 levels.

Insured institutions in metropolitan Norfolk have gradually increased their aggregate C&D lending, from a cyclical low of about 3.8 percent of assets in 1992 to 1993 to a second-quarter 1998 level of 6.3 percent. Only three institutions report a concentration above 10 percent, however. A large share of Norfolk's construction activity likely is being financed by large regional institutions headquartered outside the Norfolk MSA, which should help reduce the impact of any potential real estate market imbalance on the local banking sector.

The **Greenville** metropolitan area continues to benefit from growth in its emergent industries (see ***Atlanta Regional Outlook,*** fourth quarter 1998, for a detailed discussion of Greenville's economic growth and transformation). During 1998, gains in the local economy accelerated with job growth, which is now in excess of 3 percent. The metropolitan area's above-average economic performance may help support absorption rates. Commercial starts, up nearly 40 percent during the first half of 1998 from the same period one year earlier, are on track to reach their highest level in ten years. In Greenville's residential markets, single-family permitting recovered from a brief moderation in 1997 and was at record levels through the third quarter of 1998. Disequilibrium may be emerging, as median existing home prices in the Greenville metropolitan area actually fell 6.5 percent in the third quarter. In contrast to continued gains in single-family markets, total multifamily permits may have peaked, as family buildings with five or more units are in their third year of decline. Retail space construction has increased gradually since 1993. Absorption has remained steady, however, and the divergence between supply and demand has resulted in a rise in retail vacancy rates to a seasonally adjusted 14.3 percent in the first quarter of 1998. Nonetheless, there is continued optimism about the market's retail potential.

Greenville's economic growth has fueled a corresponding rise in C&D lending by area institutions; aggregate exposure remains relatively low, however. In the second quarter, only three metro area institutions reported C&D loans above 10 percent of assets, and the MSA aggregate of 5.7 percent was not considered excessive. As in most Atlanta Region metropolitan markets, large regional banks are providing much of the C&D financing in Greenville.

After averaging above 2.5 percent during 1997, year-over-year job growth in **Birmingham** has declined to around 2 percent during the first three quarters of 1998. Economic performance has weakened partly because of contracting payrolls in the metropolitan area's metals manufacturing industries. Growing overseas competition has prompted cutbacks in these industries and may ultimately weaken absorption in the industrial market. In contrast, Birmingham's banking industry continues to expand, fueling demand for office space construction.

The pace of commercial construction in Birmingham was at its highest level in ten years during the first half of 1998. Residential markets also continued to advance, as year-to-date permitting for both single-family and multifamily units was at record levels after slipping in 1997. Median home prices in the Birmingham metropolitan area, however, actually fell in the third quarter from the previous year. Office construction starts in square footage in second-quarter 1998 were 3.5 times higher than year-ago levels. According to the ***Birmingham Business Journal,*** developers are moving toward smaller, build-to-suit properties for quicker availability and to satisfy increasing demand. The Birmingham office market is tight and lease rates are on the rise, resulting in increased construction activity. The retail market also is growing. Occupancy rates for Regional retail centers have lingered around 95 percent, while non-Regional center space is around 93 percent occupied. About 1.5 million square feet of industrial space was built in 1997, with nearly 1.6 million square feet absorbed and a vacancy rate of 3 percent at year-end. As of September 1998, 4.7 million square feet of space is in the planning stages.

Large regional banks, particularly four large Alabama institutions, dominate lending activity in Birmingham. Although community institution C&D loan exposure is above the national average at just over 5 percent, only 1 of the metro area's 14 institutions had a concentration above 10 percent of assets in the second quarter. A slowdown in local market absorption is not likely to have a significant adverse effect on Birmingham's community banking sector.

The **Decatur,** Alabama, metropolitan area is growing substantially. In October 1997, Boeing selected Decatur as the site for a new 2.4 million-square-foot plant for the manufacture of Delta IV rocket systems. The new facility will employ up to 3,000 workers when it is completed in early 1999. With the arrival of Boeing, retailers have developed a strong interest in the surrounding **Huntsville** and Decatur markets. Likewise, supporting industries are expected to spring up around the area. These industries will enhance construction activity not only in the retail sector, but in office, industrial, and residential markets as well. According to a Decatur banker, single-family construction will require expansion to provide suitable housing for workers who transfer to the area. All other real estate sectors are growing, but the pace is well supported by escalating economic growth.

Insured institutions in the Huntsville metro area report the Atlanta Region's second highest aggregate C&D loan exposure (Atlanta ranks first) at about 9 percent of assets. This statistic may be a little misleading, however, as only three institutions are headquartered in the metro area and C&D lending is primarily concentrated in one institution. Huntsville's financial sector is dominated by large banks headquartered outside the area. Meanwhile, the four insured institutions headquartered in the Decatur area have very little C&D lending exposure. Aggregate exposure measured less than 3 percent of assets in the second quarter, and no institution reported a concentration above 5 percent.

In **Charleston,** West Virginia, economic performance over the past several quarters has remained stable. In the third quarter of 1998, year-over-year job growth in the metropolitan area, at 2.5 percent, was just under the national rate of increase. Growth has been particularly strong in the finance, retail, government, and services sectors. Sustained gains in these sectors could help support continued levels of absorption in office and retail real estate markets.

Growth in commercial construction activity through the first half of 1998 was up 70 percent over year-ago levels, marking the fourth consecutive year of expanded activity. Year-over-year office construction starts are up from 23,000 square feet of space to 82,000 square feet as of the second quarter of 1998. There has been a significant increase in retail construction starts, according to ***F.W. Dodge,*** with year-over-year construction starts rising from 79,000 square feet at midyear 1997 to 250,000 square feet one year later. Warehouse construction starts also have increased slightly. August year-to-date residential construction activity has declined slightly from the same period in 1997, and housing prices have risen after declining during 1997.

A real estate market imbalance is not likely to have a significant adverse effect on community institutions in the Charleston metropolitan area. In the second quarter, aggregate C&D loan exposure at area banks and thrifts measured about 5.8 percent of assets, and, although that was above the national average, no institution reported a concentration above 10 percent.

Summary and Conclusions

Projects under construction and in the planning stages represent a substantial increase in supply for some Atlanta Region metropolitan markets. This increase could further aggravate vacancy rates, which have edged higher over the past year in some sectors. Real estate disequilibrium, caused by overbuilding or a change in economic circumstances, could pose a risk to insured institutions actively supplying construction and development financing. For the most part, community institutions in the Region are not as heavily engaged in this type of lending as they were before the last downturn in the late 1980s. The exception is in metropolitan Atlanta, where C&D loan exposure is above that of the late 1980s and is significantly higher than in any other major metropolitan area in the nation. In addition to lower community institution exposure in most markets, risk-bearing capacity at insured institutions across the Region has generally improved from a decade ago, as capital and loan loss reserve levels are appreciably higher. Nonetheless, managers of insured institutions, particularly in areas where C&D activity is strong, should closely monitor local real estate market conditions and C&D lending exposures to avoid undue concentrations in this potentially volatile product.

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