Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION | THIRD QUARTER 2000

FDIC
ATLANTA
REGION

DIVISION OF
INSURANCE

JACK M.W. PHELPS,
REGIONAL MANAGER

SCOTT C. HUGHES,
REGIONAL ECONOMIST

PAMELA R. STALLINGS,
SENIOR FINANCIAL
ANALYST

Regional Perspectives

◆ *The expansion of the high-tech industry has represented a key component of the economic momentum in many Atlanta Region metropolitan areas.* **However, as economic growth becomes more dependent on high-tech development, setbacks in the industry could reverberate throughout the rest of the economy and potentially affect insured institutions' asset quality.** *See page 3.*

◆ *The rapid economic and demographic growth and the significant merger and acquisition activity that has occurred in Southwest Florida during the 1990s appear to have contributed to the trend in increased de novo activity.* **The rapid pace of new institution openings and the large number of mergers have changed the competitive landscape for deposits in Southwest Florida.** *See page 7.*

◆ *Given the preponderance of real estate-related lending among new entrants, continued expansion and absorption in local real estate markets may be critical to the prospects for Southwest Florida's non-recession-tested banks.* *See page 12.*

By the Atlanta Region Staff

In Focus This Quarter

◆ *Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding*—**Commercial real estate construction has boomed in a number of U.S. metropolitan markets during recent years. Insured depository institutions have reasserted their role as primary sources of capital for this construction in the wake of the 1998 financial markets crisis. Recent data show that on-balance-sheet exposures of FDIC-insured institutions are by some measures higher now than at the peak of the last commercial real estate cycle during the late 1980s. This article reassesses major U.S. metropolitan real estate markets in search of possible signs of overbuilding that could drive up vacancy rates and drive down rents in the near term. This review points to an underlying trend of markets experiencing more vigorous construction activity across multiple property types.** *See page 13.*

By Thomas A. Murray, Senior Financial Analyst

◆ *Atlanta Region Markets Most Vulnerable to Overbuilding*—**On the basis of the preceding information, the following four markets are considered to be most at risk for broad-based overbuilding: Atlanta, Charlotte, Jacksonville, and Orlando.** *See page 20.*

By the Atlanta Region Staff

◆ *Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate*—**Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios.** *See page 25.*

By Alan Deaton, Financial Economist

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, FJ, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Atlanta Region's ***Regional Outlook,*** please call Jack Phelps at (404) 817-2590 or send an e-mail to *jphelps@fdic.gov.*

Regional Perspectives

- **Despite its relatively small share of the Atlanta Region's total employment, the high-tech sector is one of the fastest-growing employers.**

- **As growth becomes more dependent on high-tech development in many Atlanta Region economies, setbacks in the high-tech industry could reverberate throughout the economy and potentially adversely affect insured institutions' asset quality.**

- **De novo activity in Southwest Florida can be attributed in part to the area's rapid pace of economic and demographic growth and high level of mergers and acquisitions over the past several years. Given the preponderance of real estate-related lending among these institutions, continued expansion and absorption in local real estate markets may be critical to the prospects of Southwest Florida's non-recession-tested banks.**

High Tech Boosts Region's Economy, but Is Not Recession-Tested

The expansion of the high-tech[1] industry is a key component of the economic momentum in many Atlanta Region metropolitan areas. Historically, high-tech has fueled job growth and, for the most part, paid salaries well above other private sector wages. Higher wages boost the surrounding economy through increased consumer spending and heightened residential and commercial real estate development. Furthermore, high tech often draws supporting industries and suppliers to the area, further stimulating the surrounding economy and increasing the demand for other goods and services. Because of the potential benefits high tech has brought to many areas (jobs, higher wages, a more robust real estate sector), some view it as a panacea for any area it enters. However, the industry is evolving, and many of the e-commerce and dot-com firms that are now driving the market have not been recession-tested.

Tight labor markets are making it difficult for many high-tech companies to attract qualified workers. Many sectors within the high-tech industry require complex, specialized skills that are in short supply. With unemployment rates falling to the lowest level since 1969, it has become increasingly difficult to locate and retain the expertise required to remain competitive. The following analysis assesses the high-tech sector's impact on Atlanta Region economies that have significant concentrations in this sector and identifies potential risks to local community banks.

High Tech in the Atlanta Region

Employment in the Atlanta Region is expanding in some high-tech sectors while contracting in others. While high tech accounts for just 4.5 percent of the Region's total employment, the number of high-tech employees is growing rapidly. In 1999, the high-tech industry employed more than one million workers, an increase of more than 30 percent from 1990. For the most part, employment distribution in the Region's high-tech industry mirrors that of the industry nationwide, with the highest concentration of workers employed in computer and data processing services (26 percent), telephone communications (19 percent), and engineering and architectural services (19 percent).

Virginia

The Atlanta Region's fastest-growing high-tech area is in the **Northern Virginia** corridor (see Map 1, next page). According to ***Regional Financial Associates,*** the Northern Virginia metropolitan area's high-tech success is due in part to its proximity to the Metropolitan Area Ethernet for the East Coast (MAE East), which is the point of exchange for major networks offering low-cost Internet access. Further, the metropolitan area has access to a significant amount of fiber-optic cable already installed by Bell Atlantic. As a result, "The area, dubbed *netplex,* has become a mecca for telecommunications and other high-tech companies," which has

[1] For the purpose of this analysis, we use primarily a WEFA, Inc., definition based on multiple standard industrial codes (SICs), which includes drugs (SIC 283), computer and office equipment (SIC 357), communications equipment (SIC 366), electronic components and accessories (SIC 367), aircraft and parts (SIC 372), guided missiles, space vehicles, and parts (SIC 376), search and navigation equipment (SIC 381), measuring and controlling devices (SIC 382), medical instruments and supplies (SIC 384), telephone communications (SIC 481), computer and data processing services (SIC 737), motion picture production and services (SIC 781), engineering and architectural services (SIC 871), and research and testing services (SIC 873).

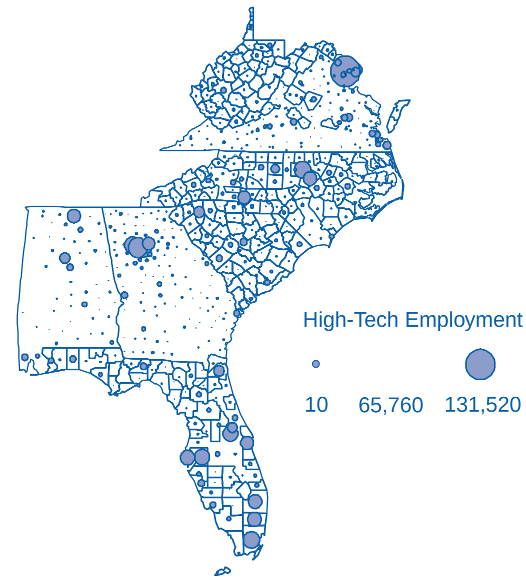
resulted in thousands of new jobs, according to an analyst with ***Real Estate Alert.***[2] With the expansion of the high-tech industry has come a rebound in in-migration, which helped boost annual population growth to 2.5 percent in 1999. (See ***Regional Outlook,*** second quarter 2000, for a more in-depth look at the Northern Virginia high-tech industry.) In addition, the **Richmond** metropolitan area has experienced a surge in high-tech growth. However, several announced delays in Motorola's plans to build a $3 billion semiconductor plant could constrain high-tech growth in Richmond, as suppliers to this plant may be drawn to the Northern Virginia area instead.

Florida

Florida's economy has historically thrived on the tourism industry. However, high tech is becoming more important to the state's economy. In 1999, the state was home to the largest number of high-tech employees in the Atlanta Region (see Table 1), but concentrations differ among the state's metropolitan areas. For example, telephone communications is very strong in the **Orlando** and **Tampa** metropolitan areas but has weakened substantially in the **Jacksonville** and **Miami** metropolitan areas. Likewise, engineering and telephone communications have been strong industry performers, particularly in the southern and southwest metropolitan areas where Latin American trade is vital to the economy. Conversely, defense- and space-exploration-related industries such as guided missiles, space vehicles and parts, search and navigation equipment, and aircraft and parts have declined since the end of the Cold War. This downturn is particularly evident in the Orlando and **Melbourne-Titusville-Palm Bay** metropolitan areas. Unlike the **Huntsville** metropolitan area (discussed below), where the space program is expanding, the Melbourne metropolitan area has experienced sizable cutbacks in this industry, as evidenced by a 71 percent decline in workers since the early 1990s. Included in the layoffs are many high-paying jobs that have been replaced with lower-paid service jobs; however, the high-tech industry has experienced considerable

MAP 1

Atlanta Region High-Tech Employment Remains Concentrated in Key Urban Areas



Source: WEFA, Inc., 1999

TABLE 1

FLORIDA LEADS THE ATLANTA REGION IN HIGH-TECH EMPLOYMENT

	1990		1999		1990–1999	
STATE	LEVEL	SHARE (%)	LEVEL	SHARE (%)	CHANGE IN EMPLOYMENT	PERCENTAGE INCREASE
ALABAMA	68,577	8.1	74,271	6.7	5,694	8.3
FLORIDA	259,536	30.5	320,149	28.7	60,613	23.4
GEORGIA	147,130	17.3	205,900	18.4	58,770	39.9
NORTH CAROLINA	125,672	14.8	160,523	14.4	34,851	27.7
SOUTH CAROLINA	53,847	6.3	55,649	5.0	1,802	3.3
VIRGINIA	180,248	21.2	278,537	24.9	98,289	54.5
WEST VIRGINIA	14,933	1.8	21,417	1.9	6,584	44.1
TOTAL REGION	849,943	100.0	1,116,546	100.0	266,603	—
SOURCE: WEFA, INC.						

[2] *Real Estate Alert,* January 24, 2000, "Flurry of Offices Hits Market in Northern Va.," p.1.

volatility in this metropolitan area. Orlando's Lockheed Martin facility continues to lay off employees in its missiles and electronics unit as the parent company restructures. However, Orlando's diverse economy is adding high-tech jobs, which may offset any industry layoffs.

Georgia

Georgia ranks third in the Region in high-tech growth in terms of the number of employees. The Atlanta metropolitan area accounts for over three-fourths of the state's employment in this sector and dominates the state's high-tech industry. For the most part, Georgia's high-tech growth is concentrated in computer and data processing services, telephone communications, and engineering. High-tech workers in the state earn about 83 percent more than the average private sector worker. These higher-wage jobs have contributed to increased in-migration, and therefore, higher residential and commercial real estate development and consumer spending. Employment in the computer and data processing services sector has more than doubled since 1990, while employment in telephone communications and engineering has risen by 35 percent and 20 percent, respectively. Among Atlanta's major high-tech employers are BellSouth, AT&T, and Lockheed Martin, all of which have announced sizable layoffs over the next two or more years. To date, displaced employees have easily transitioned into similar industries. However, layoffs or a slowing regional economy could cloud the outlook for high-tech growth in the Atlanta metropolitan statistical area.

The flow of capital into high-tech ventures has had a very pronounced effect on real estate markets in metro Atlanta. According to the ***Atlanta Journal-Constitution,*** about 60 percent of leasing demand in 1999 came from high-tech and associated companies. As one principal of ***Corporate Real Estate Service Advisors (CRESA)***[3] ***Partners of Georgia*** observed, "high-tech is everything [to real estate right now]….without the high-tech and telco growth, it would have been a mediocre year." Office and industrial space—that just two years ago required 60 to 70 percent preleasing—is increasingly coming on line with no advance tenants, according to the ***Federal Reserve Bank of Atlanta.***[4] Likewise, high-tech workers on average earn higher wages; as a result, demand and prices paid for residential real estate have risen sharply in the midtown, downtown, and Buckhead areas where high-tech companies are concentrated. According to the ***Atlanta Journal Constitution,*** about one-fifth of public Internet companies could run out of cash within a year.[5] Given Atlanta's strong high-tech presence, consolidation in the industry could pose a risk to absorption in the commercial and residential markets.

North Carolina

The Atlanta Region's outlier, in terms of high-tech employment distribution, is **North Carolina,** specifically the **Raleigh-Durham** metropolitan area. Unlike the Charlotte metropolitan area, which has high-tech concentrations in the services sector (telephone communications, computer and data processing services, and engineering), Raleigh-Durham's concentrations are in equipment manufacturing. Strengthening global economies are expected to keep demand high for computer and telecommunications equipment even if domestic demand wanes, according to ***Regional Financial Associates.*** Growing dependence on this industry may be problematic, however. For example, tight labor markets already are a growing concern among high-tech companies. Continued growth may depend on the area's ability to attract and retain a qualified workforce. For now, vacancy rates in Raleigh-Durham's industrial real estate market, driven by the high-tech industry, are stable, according to ***Reis.com.*** While the absorption rate for office real estate was high in 1999, new supply outstripped demand, resulting in a rising vacancy rate. Reis.com estimated the metropolitan area's office vacancy rate at 7.1 percent in January 2000, which was considerably higher than the previous year's 6.4 percent vacancy rate. Continued disequilibrium in supply and demand may give rise to the risk of overbuilding.

Alabama

The impact of the high-tech sector on **Alabama**'s economy varies. High-tech employment—specifically engineering, telephone communications, computer and data processing services, and computer and office equipment—has been on the upswing in several areas of the state, particularly in the **Birmingham** and Huntsville metropolitan areas and along the southern coast (see Map 1). According to a 1999 study by the ***Milken Institute,***[6] Birmingham ranked second in concentration of

[3] CRESA is a provider of national corporate real estate advisory and tenant representation services.

[4] Commercial Real Estate Market Profiles, "A Review of Markets Affecting Sixth District Financial Institutions," for the quarter ending December 31, 1999.

[5] "Cash on hand becomes rallying cry for dot-com firms," *Atlanta Journal and Constitution*, May 31, 2000, refers to a study conducted by New York-based Pegasus Research International.

[6] Study referenced in *Alabama Business,* Spring 2000, "The New Economy: What is it and is Alabama ready?" Volume 69, Number 2, p. 10.

telephone communications services among all metropolitan areas in the nation. However, high-tech employment growth has been erratic throughout most component sectors. Perhaps the most heavily watched component in the state is guided missiles, space vehicles, parts, and space-related industries located in the **Decatur** and Huntsville metropolitan areas. The National Aeronautics and Space Administration Marshall Space Flight Center in Decatur is a vital contributor to the local economy. The recent opening of Boeing's Delta IV rocket facility, located about 20 miles from Boeing's other facility in Decatur, may dramatically increase the high-tech sector's importance to the Huntsville metropolitan area. Boeing recently invested an estimated one-half billion dollars in the construction of its 1.5-million-square foot Decatur plant, which now employs about 500 workers and is expected to expand to 2,000 workers over the next four years. While the economic impact of the space industry has been positive, significant concentration in a single industry may prove problematic in the long run.

South Carolina and West Virginia

Although limited high-tech growth in **South Carolina** and **West Virginia** may result in lower economic exposure in the event of a recession, the lack of skilled high-tech workers and industries may place these states at a competitive disadvantage, making it difficult for them to attract new industries. In South Carolina, for example, high-tech growth is limited to the **Greenville-Spartanburg-Anderson** and **Columbia** metropolitan areas. Perhaps the driving force behind the high-tech growth in Spartanburg was BMW's decision to build its Z3 Roadster assembly plant in the metropolitan area. This decision drew attention to the area's available labor supply and employer incentives for job creation. It is unlikely, however, that this plant will generate continued growth for the industry, particularly since high-tech growth has been slowing since 1996. In the Columbia metropolitan area, expanding high-tech industries account for 2.3 percent of total employment, compared with the state's 1.5 percent share. ***Regional Financial Associates*** estimates that approximately 7,000 workers in this area are employed in high-tech occupations, particularly in computer and data processing.

Conversely, **West Virginia**'s economy continues to underperform the rest of the Region. A shrinking labor force, combined with the nation's lowest ranking in venture capital funding, has restricted the state's ability to attract high-tech companies. A shortage of qualified labor appears to be a key problem. Amazon.com is planning to open a customer service center in the **Huntington** metropolitan area, which will add about 370 new jobs to the area by midyear 2000. While the company is a high-tech firm, the jobs created will be lower-wage service jobs. Likewise, the **Charleston** metropolitan area has only a small pool of skilled workers to lure potential employers to the area. Failure to attract new companies may limit economic development opportunities going forward.

Economic and Banking Implications for the Atlanta Region

In the new economy, the perception that high-tech growth is the key to guaranteed, rapid, and sustained economic development may be emerging. The addition of more than one-quarter million new, high-paying, high-tech jobs to the Atlanta Region during the 1990s has undoubtedly helped fuel economic growth. The higher incomes have helped boost demand for local goods and services, including real estate development, generating a positive spillover effect in the rest of the economy. However, factors could coalesce that may make continued strong performance of the high-tech industry problematic. Any slowing or a downturn in the high-tech sector could negatively affect other sectors of the economy, as well as the local banking industry.

Nationally, the effects of rising interest rates or bearish trends in the NASDAQ could reverberate, slowing local high-tech industry growth as companies experience problems obtaining financing. Already, stock market turmoil is postponing or canceling expansion by some Internet companies. Cushman & Wakefield reported that northern Virginia landlords are asking for two years of rent as security for some properties—a trend that is emerging in other similar markets throughout the country.[7] An economic downturn could adversely affect the Region because many of its high-tech firms are not recession-tested. Locally, expansion of an area's high-tech industry could be curtailed because of a shortage of qualified workers. Also, changing technology, slowing growth in a component industry, or events such as an individual company falling out of favor could significantly affect a given area's economy.

[7] *The Wall Street Journal,* May 31, 2000, "Landlords Feel Effects of Dot-Com Shakeout," p. B12.

Underwriting high-tech tenants has become a balancing act between risk and reward for many lenders and property managers. According to a recent article in the ***National Real Estate Investor,*** "*Dot.coms* can be out of business in a year, or they can come back to double or triple their space in a year."[8] The unpredictability of many start-up companies, because of the absence of a credit history or rating from which to draw conclusions of credit quality, may pose additional challenges for landlords and lenders. Volatility in the domestic equity markets has caused some lenders to increase collateralization of leased space in the form of options, warrants, letters of credit, or security deposits well in excess of those required of non-high-tech tenants.

As high tech has been an engine of growth in many local economies in the Atlanta Region, a slowdown or contraction in this sector could negatively affect the rest of the economy. Slower economic growth could result in declining real estate absorption or weakening credit quality if layoffs occur. Lenders should be aware that, as growth becomes more dependent on high-tech development, setbacks in the industry could reverberate throughout the rest of the economy and potentially affect asset quality.

De Novo Banking: A Southwest Florida Micro-Analysis

Southwest Florida[9] may be representative of a market that has fostered an amenable environment for de novo bank activity. In ***Atlanta Regional Outlook,*** first quarter 2000, de novo bank activity in the Atlanta Region was analyzed, and one of the key observations was that new bank charters tended to occur in areas of high economic and demographic growth. The following section examines the Southwest Florida market and trends in de novo bank activity in light of the market's substantial recent economic growth. Subsequent issues will focus on other individual markets in the Region to determine whether generalized relationships found at the regional level also exist at the local level.

An Economic and Demographic Analysis of Southwest Florida

The Southwest Florida market experienced substantial growth during the 1990s, as tourism, in-migration, and an emergent high-tech industry helped fuel the local economy. ***WEFA, Inc.***, estimates that since 1992, employment growth in the market area has averaged more than 3 percent annually, ahead of the national average of 2.4 percent. One consequence of this rapid job growth, however, has been a significant tightening in the local labor market. In 1992, the area's jobless rate stood at nearly 7 percent. By 1999, it had declined to 2.8 percent and, by first quarter 2000, had fallen by almost another half percentage point. Growth has been such that, although distinctions remain, the four-metro area of Southwest Florida may be becoming an increasingly integrated economic region.

Rapid population growth in Southwest Florida is attributed to two types of in-migration: retirees and workers in services and retail trade. Retirees form an important component of the local economy, with the 65+ cohort accounting for 28 percent of Southwest Florida's residents. In contrast, this older population group holds 18 and 13 percent shares at the state and national levels, respectively. The needs and consumption patterns of retirees are often different than those of other segments of an area's population. Older residents, for example, often demand more health services than other cohorts. Southwest Florida, for example, is home to more than a dozen hospitals and skilled nursing care facilities.

The needs of Southwest Florida's retirees have boosted demand for workers in the services and trade sectors. This demand also has been augmented by tourism, another critical element in Southwest Florida's economic equation. Rising incomes resulting from the prolonged national expansion have helped support rising demand in the local tourist industry. Growth in tourism and the retiree population has helped push population growth in Southwest Florida to more than twice the national average.

[8] Freeman, Tyson, "What do we do with high-tech tenants?" http://www.nreionline.com.

[9] For the purposes of this analysis, Southwest Florida is considered to encompass four metropolitan areas located south of Tampa: Sarasota-Bradenton (Manatee and Sarasota counties), Punta Gorda (Charlotte County), Fort Myers (Lee County), and Naples (Collier County).

Although small in comparison to the rest of the economy, high-tech[10] industries are slowly starting to make their presence felt in Southwest Florida. Since 1992, job growth in these industries has outpaced total job growth. As of 1999, ***WEFA*** estimates that over 17,000 jobs in Southwest Florida may be classified as residing in high-tech sectors. A 1999 survey by the ***Suncoast Technology Alliance*** puts the figure in the Sarasota-Bradenton metropolitan area at 8,350, distributed among 520 companies. Most of these positions are in software, research, engineering, communications, or electronic components manufacturing. Software development and research posted double-digit annual employment growth throughout the latter half of the 1990s. According to a recent ***Sarasota Herald-Tribune*** article,[11] expectations for Southwest Florida's high-tech industries are tempered by the lack of a large research university nearby. In any event, the high-tech sector, though small, has been a contributing factor to the area's strong growth in recent years.

Reflecting the rapid economic and population growth, building activity and the construction industry's share of total employment in Southwest Florida have increased in recent years. The influx of residents pushed homebuilding to its highest level in a decade during 1999. Demand for local goods and services, resulting from high levels of population growth, has fueled demand for new office and retail commercial space. Growth in high-tech industries likewise has boosted the need for commercial space. From 1997 to 1999, commercial starts have remained at historically high levels.

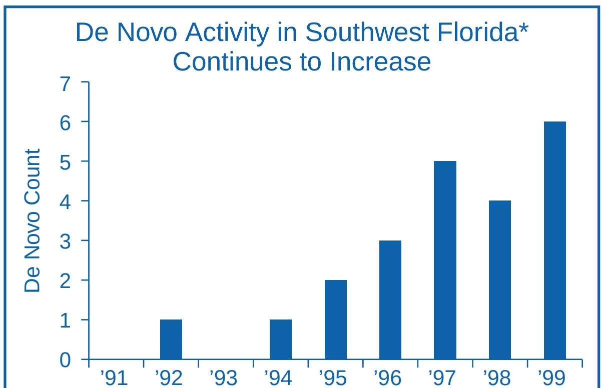
De Novo Bank Activity in the Southwest Florida Market

The analysis presented in ***Atlanta Regional Outlook,*** first quarter 2000, suggested that economic and demographic growth and industry mergers and acquisitions (M&As) are correlated with the incidence of new bank charters. Southwest Florida's population increased significantly during the 1990s as net in-migration rose. The area's average annual population growth of 2.2 percent from 1990 to 1999 was one-half percentage point above the average for Florida and more than twice the national growth rate. In absolute terms, this translated into approximately 300,000 new residents in Southwest Florida during the 1990s. M&A activity has been robust as 27 of the 41 insured institutions headquartered in the area in 1991 have been acquired. A majority, 22 institutions, have been acquired by out-of-state banking organizations. Therefore, the rapid economic and demographic growth and the significant M&A activity that have occurred in Southwest Florida during the 1990s appear to have contributed to the trend in increased de novo activity (see Chart 1).

During the 1990s, 25 new institutions were chartered in Southwest Florida, including six in 1999. By year-to-date April 2000, two additional community banks were chartered while one application was pending. As of fourth quarter 1999, a total of 39 community institutions, each with assets less than $1 billion, were headquartered in Southwest Florida. Over 60 percent of these insured financial institutions, accounting for 33 percent or $1.7 billion of the area's total assets, have never experienced an economic downturn. Moreover, non-recession-tested banks represent a rapidly increasing share of community banks in Southwest Florida (see Chart 2).

The rapid pace of new institution openings and the large number of merger transactions have changed the competitive landscape for deposits in Southwest Florida. As seen in Table 2 and Table 3, the number of banking organizations and offices rose 36 percent and 47 percent, respectively, from 1991 to 1999. The dramatic increase in the number of organizations and offices occurred despite 27 institutions exiting the market during this period via mergers. The M&A activity has resulted in out-of-state acquirers holding more than 73 percent of deposits in Southwest Florida, compared with only 42 percent of deposits in 1991. The preponderance of out-of-state institutions may affect competitive aspects of the local market

CHART 1

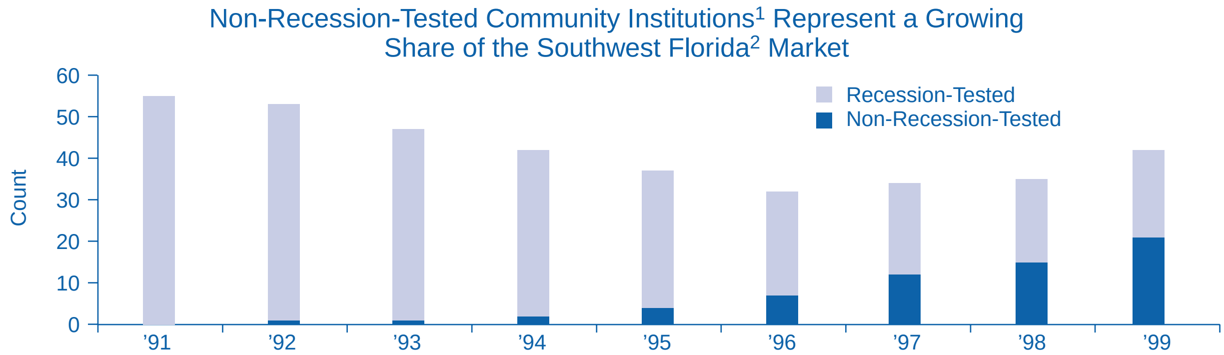


* Southwest Florida includes four metropolitan areas located south of Tampa: Sarasota-Bradenton (Manatee and Sarasota Counties), Punta Gorda (Charlotte County), Fort Myers (Lee County), and Naples (Collier County).
Source: FDIC Bank and Thrift Call Reports

[10] For a description of the component parts of "high-tech" and an analysis of the impact it can have on the local economy, please see the preceding article in this issue.

[11] Hall, Jason. "A Budding Technopolis." *Sarasota Herald-Tribune,* May 1, 2000, p. 12.

CHART 2



[1] Community institutions have assets less than $1 billion and are not affiliated with larger hold companies. Non-recession-tested institutions are community institutions formed after the 1990–91 recession.

[2] Southwest Florida includes four metropolitan areas located south of Tampa: Sarasota-Bradenton (Manatee and Sarasota Counties), Punta Gorda (Charlotte County), Fort Myers (Lee County), and Naples (Collier County).

through the types of services and products offered and differences in corporate cultures.

Many of the new entrants to the local market are pursuing a similar general strategy. Given the large influx of out-of-state companies, many new entrants are emphasizing local roots—ownership and management—to gain market share. While this strategy of "out-local the national players" may prove successful for some new entrants, all may not be able to exploit it because of the saturation of new entrants. According to a recent report in the ***Sarasota Herald-Tribune,***[12] the increased competition attributed to the rising number of entrants may have forced changes in some financial institutions' business plans.

The changes in the structure of the Southwest Florida banking industry, consolidation, and de novo entrants have increased the competition for deposits. As seen in Table 4, the Herfindahl-Hirschman Index[13] (HHI), which measures the degree of deposit concentration, has declined, indicating that the market is becoming more competitive. At the submarket level, the HHI has declined as well, with some counties moving from highly to moderately concentrated. Also confirming the increase in deposit competition is the three-firm ratio,[14] which has fallen from 60 percent in 1991 to 55 percent in 1999. Although these measures indicate increased competition, all firms do not encounter the same level of competition, nor do they compete in similar fashion.

TABLE 2

Banking Organizations[1] with Deposits in Southwest Florida Increased during the 1990s

Location	1991	1999
Charlotte County	11	14
Collier County	19	28
Lee County	19	27
Manatee County	12	21
Sarasota County	19	31
Southwest Florida[2]	47	64

[1] Banking organization is the top owner (affiliates were summed). Thrift data not available.
[2] Banking organizations may be represented in more than one county.

Source: FDIC Summary of Deposit Data

TABLE 3

Banking Offices in Southwest Florida Have Increased during the 1990s

Location	1991	1999
Charlotte County	33	47
Collier County	59	98
Lee County	107	146
Manatee County	55	92
Sarasota County	108	148
Southwest Florida	362	531

Source: FDIC Summary of Deposit Data

[12] Hielscher, John. "Going for Broke?" *Sarasota Herald-Tribune,* January 31, 2000, p. 12.

[13] The Herfindahl-Hirschman Index is a mathematical formula that determines if a banking market is highly concentrated (over 1,800 points), moderately concentrated (1,000 to 1,800 points), or unconcentrated (below 1,000 points).

[14] The three-firm ratio is the sum of hte market share held by the three largest firms.

Table 4

The Competition[1] for Deposits in Southwest Florida Has Changed during the 1990s

Location HHI[2]	1991	1999
Charlotte County	2,006	1,702
Collier County	1,626	1,310
Lee County	1,598	1,587
Manatee County	1,901	1,577
Sarasota County	1,700	1,324
Southwest Florida[3]	1,464	1,286

[1] Competition is limited to banking organization as thrift data are not available. Computations based on the top owner (affiliates were summed).
[2] The Herfindahl-Hirschman Index (HHI) is a measure of market concentration.
[3] Southwest Florida is calculated independently and is not an average of the five counties.

Source: FDIC Summary of Deposit Data

The high three-firm ratio and HHI indicate that the local deposit market structure remains dominated by a few firms but is becoming increasingly competitive because of the large number of new entrants. This stratification in the deposit market suggests that the top firms may not have to compete as aggressively within the market to hold a large share, while the smaller firms may have to compete intensely on price or nonprice (convenience or service) terms to acquire or retain market share. Because of the high costs of moving some banking relationships, the smaller or new entry firms may be forced to offer above-market rates or lower-cost or free services to gain market share.[15]

In general, the new entrants to the market have pursued different lending strategies than established players. The differences may result because the established firms may have long-standing customer relationships, gained a reputation, developed a niche, or have a risk preference that results in domination of certain segments of the local lending market. Alternatively, differences in loan portfolio structure could result from new firms trying to reach the breakeven point more quickly by focusing on originating larger or higher-yielding loans. As seen in Table 5, a majority of the non-recession-tested institutions are engaged more heavily than established institutions in construction and development (C&D) lending. At new institutions, C&D loans represent 10.17 percent of assets, versus 5.89 percent at established institutions. Conversely, consumer loans are 10.56 percent of assets at established banks, compared with 3.80 percent at new institutions. Anecdotal reports also suggest that new entrants are engaging in out-of-territory lending by purchasing loan participations or establishing loan production offices outside Southwest Florida in response to intense lending competition.

Although there are no significant differences in nominal funding costs and asset yields between new and established institutions in Southwest Florida, the data raise some concern (see Table 5). New institutions have been able to grow deposits competitively with a funding cost of 4.60 percent, slightly better than the 4.66 percent cost at established institutions. However, the lower funding costs and higher capitalization and volume of noninterest-bearing deposits have not translated into a higher net interest margin at new institutions. Lower asset yields at new firms help explain the comparative net interest margin performance. A lower asset yield at new firms appears inconsistent with their seemingly higher risk appetite, as indicated by lending strategies that emphasize C&D lending. The lower nominal asset yield may suggest that new firms are not being adequately compensated on a risk-adjusted basis.

On the positive side, the non-recession-tested banks currently outperform established banks in a few metrics. Table 5 also shows that the new entrants have a greater percentage of core funding and a much higher equity-to-assets ratio, 10.11 percent, compared with 7.72 percent for established banks. However, the higher capital ratio will likely erode, as the average life of the new entrants is 2.2 years, and the statutory minimum capital maintenance requirement of 8 percent usually expires after the third year of operation. As a result, following the capital maintenance period, new institutions tend to increase their amount of financial leverage to the same degree as established institutions.

The new entrants in Southwest Florida are reaching the quarterly breakeven profitability point in the same quarter of operation as all new entrants in Florida, the eighth quarter (see Chart 3). Nevertheless, the new entrants in Southwest Florida have posted slightly lower operating results than the statewide average in most quarters. Although the short period to reach breakeven profitability is encouraging, research[16] indicates that start-up

[15] For further discussion see The Robinson-Humphrey Company, LLC, "Florida's Community Banks," July 7, 2000.

[16] For further discussion see Robert DeYoung, Federal Reserve Bank of Chicago. "Birth, Growth, and Life or Death of Newly Chartered Banks." *Economic Perspectives,* third quarter 1999.

TABLE 5

Concept	Southwest Florida[1] Non-Recession-Tested[2]	Southwest Florida[1] Recession-Tested[2]	Florida[3]
Count	25	14	242
Average Age (yrs)	2.2	17.1	20.2
Asset Yield	8.20%	8.23%	8.09%
Funding Cost	4.60%	4.66%	4.53%
Net Interest Margin	4.24%	4.11%	4.30%
Loans/Assets	67.00%	75.07%	64.15%
Construction & Development Loans/Assets	10.17%	5.89%	4.08%
Commercial & Industrial Loans/Assets	7.37%	7.66%	9.18%
Consumer Loans/Assets	3.80%	10.56%	4.57%
Core Deposits/Assets	72.21%	70.62%	66.98%
Non-Interest-Bearing Deposits/Assets	11.82%	11.51%	14.07%
Equity/Assets	10.11%	7.72%	9.14%

Construction and Development Loan Exposures Are Higher among Non-Recession-Tested Community Institutions Headquartered in Southwest Florida

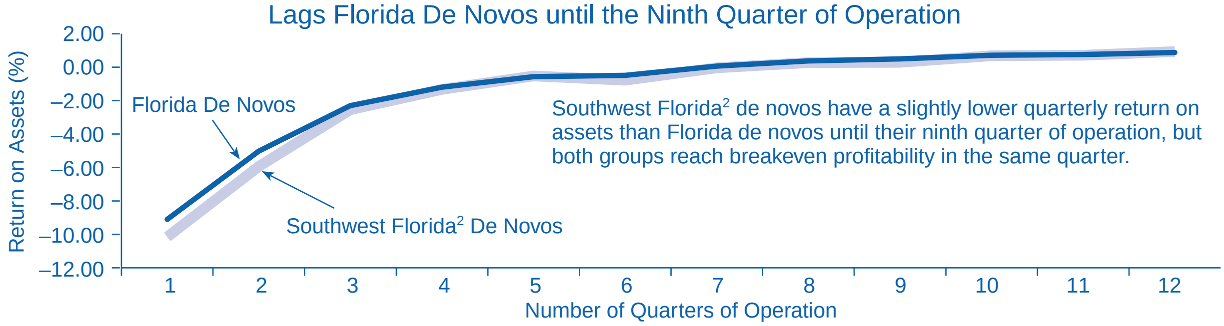
[1] Includes all independent insured institutions headquartered in Southwest Florida (the metropolitan areas of Sarasota-Bradenton, Fort Myers, Punta Gorda, and Naples).
[2] Institutions formed after the 1990-91 economic downturn are considered non-recession-tested.
[3] Includes all insured institutions headquartered in Florida with assets less than $1 billion. Excludes special-purposes entities and multibank holding company subsidiaries.

Source: Bank and Thrift Call Reports, March 2000 data.

institutions generally have earnings streams that are lower and more variable than established banks. Typically, the earnings instability of new entrants contributes to increased vulnerability to failure or poor examination rating during economic downturns (see ***Atlanta Regional Outlook,*** first quarter 2000).

CHART 3

Quarterly Return on Assets for De Novo Banks[1] in Southwest Florida[2] Lags Florida De Novos until the Ninth Quarter of Operation



[1] De novos include all new commercial bank openings from 1991 through 1999 and exclude any new openings for special-purpose entities or those resulting from mergers and acquisitions or intercompany reorganizations.
[2] Southwest Florida includes four metropolitan areas located south of Tampa: Sarasota-Bradenton (Manatee and Sarasota Counties), Punta Gorda (Charlotte County), Fort Myers (Lee County), and Naples (Collier County).
Source: FDIC Bank and Thrift Call Reports

Risks and Implications for Non-Recession-Tested Banks in Southwest Florida

Given the preponderance of real estate-related lending, continued expansion and absorption in local real estate markets may be critical to the prospects for Southwest Florida's non-recession-tested banks. Despite recent performance, Southwest Florida's economy and, consequently, real estate markets are not without risk. Several factors could coalesce to constrain absorption and growth in construction activity, possibly calling into question the viability of current real estate development projects or impairing borrowers' ability to service debt. A weaker real estate market combined with greater competition in the local banking industry, as new entrants increase, could affect institution earnings.

Given the real estate sector's interest rate sensitivity and its significant role in the Southwest Florida economy, economic conditions may be affected by changes in interest rates. Since mid-1999, the Federal Reserve has boosted the Federal Funds target rate six times, including a 50-basis-point increase in May 2000, in an effort to constrain the national economy's rapid growth. For financial institutions in Southwest Florida, whose business lines are dependent on real estate lending, the successive rate hikes could slow loan originations, reduce interest income, and raise credit costs. The recent increase in rates may be affecting local real estate market conditions, as commercial construction starts and residential permit issuance have slowed, albeit from historically high levels. Non-recession-tested institutions' business plans that assume continued rapid growth in real estate markets may need to be revised.

Local and other environmental issues also could adversely affect Southwest Florida's real estate markets. In one way, Southwest Florida may become a victim of its own economic success. Years of rapid growth have depleted the pool of qualified labor, despite continued high levels of in-migration and the presence of potential labor resources drawn from the area's retired residents. Given the growing shortages of qualified labor, growth in the emergent local high-tech industry may become constrained. Inability to expand because of a lack of qualified labor may constrain absorption expectations in commercial real estate markets. Likewise, a slowdown in job creation might lessen demand for residential real estate.

Environmental factors in Southwest Florida, such as growing congestion, shrinking water resources, and endangerment of wetlands, may curtail real estate development opportunities in the future. Years of prolonged development and in-migration have led to areas of congestion along the I-75 corridor. Moreover, as is often the case in areas of high growth, infrastructure development may not be keeping pace with the growing number of residents and businesses. Other issues such as depletion of water resources, especially when accompanied by the current drought, may restrict growth as well. Also, as development encroaches on adjacent wetlands, calls for limits on real estate development may emerge.

Last, in addition to the risks facing the Southwest Florida real estate market, the local banking industry may face challenges simply by virtue of the pace of new institution chartering activity. Is the market deep enough to allow these new entrants to gain market share at reasonable costs?

The Atlanta Region Staff

Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding

- **In analyses conducted in 1998 and 1999, nine metropolitan areas were identified as at risk for overbuilding; this analysis notes more vigorous building occurring across multiple property types and identifies 13 markets, including eight of the previous nine, as at risk for overbuilding.**

- **Construction activity has accelerated during the current economic expansion with cyclically high levels of supply and demand.**

- **Capital markets scaled back their investments in commercial real estate in 1998 and 1999, while FDIC-insured institutions increased their construction and development lending by more than 20 percent each year.**

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

Two recent studies published by the FDIC evaluate the risk of overbuilding in major U.S. metropolitan areas.[1] These studies identified nine cities—**Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland** (Oregon), and **Salt Lake City**—as markets at risk for rising commercial vacancy rates. This article revisits the FDIC's previous analysis of CRE markets. Using a more restrictive definition of at-risk markets, we find that eight of the previously identified nine markets remain on the list, joined by five additional markets: **Denver, Fort Worth, Jacksonville, Sacramento,** and **Seattle.**[2] In general, more markets are experiencing increased levels of construction activity across multiple CRE property sectors than was the case just two years ago.

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

Previous Real Estate Cycles Are Well Documented

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

[1] See "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," *Bank Trends,* October 1998, and **"Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead,"** ***Regional Outlook,*** First Quarter 1999.

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

[3] See, for example, Freund et al. 1997. *History of the Eighties: Lessons for the Future,* Chapters 9 and 10. FDIC.

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

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

Factors Contributing to Cycle of Overbuilding in CRE

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

[4] The U.S. vacancy rate is calculated as an aggregate of selected major markets tracked by Torto Wheaton Research.

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

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

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

Recent Developments

Following a lull in commercial construction activity that resulted from adverse market conditions in the early 1990s, construction activity has gradually accelerated during the current economic expansion. The increased pace of construction occurred first in industrial and retail markets, where growth in net new completions of space picked up starting in 1993. The pace of multifamily construction accelerated in 1995, followed by increasing levels of office and hotel construction in 1997. Regionally, commercial construction activity recovered first in the Southeast and Northwest, where the effects of the previous overbuilding had been the least pronounced. Only later did the pace of construction increase in California, the Southwest, and the Northeast. As the U.S. economic expansion endures into its tenth year, construction activity continues to pick up steam across most property types. In the 54 major metropolitan areas tracked by ***Torto Wheaton Research,*** total annual office space completions rose from just over 3 million square feet in 1994 to 78.7 million square feet in 1999.

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

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

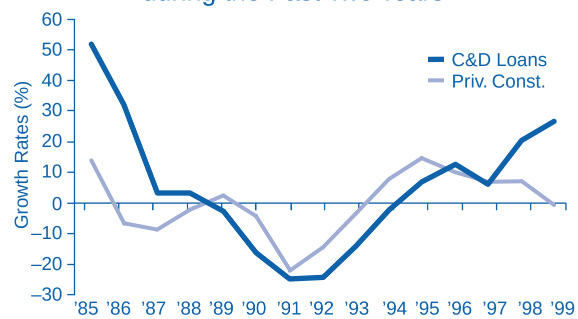
While the availability of market-based sources of capital has helped to facilitate growth in construction during this expansion, the financial market turmoil of late 1998 cast a cloud over the CMBS market that has yet to lift fully. Significant events in the global capital markets in 1997 and 1998, including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

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

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

CHART 1

Growth Rates of Private Construction Expenditures and C&D Loans Diverge during the Past Two Years



C&D = construction and development loans
Sources: Bureau of the Census (Haver Analytics), Bank and Thrift Call Reports (Research Information System)

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

Identification of Markets at Risk for Overbuilding

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

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

[7] Federal Deposit Insurance Corporation. October 1998. Ranking the Risk of Overbuilding in Commercial Real Estate Markets, *Bank Trends.*

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

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

Most Active Construction Markets

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

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

CHART 2

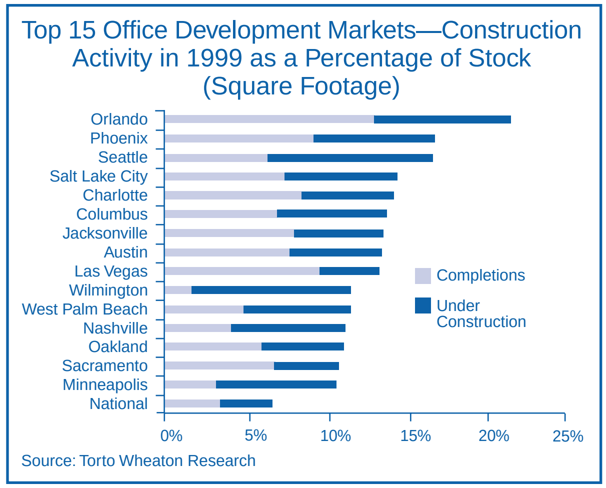


CHART 3

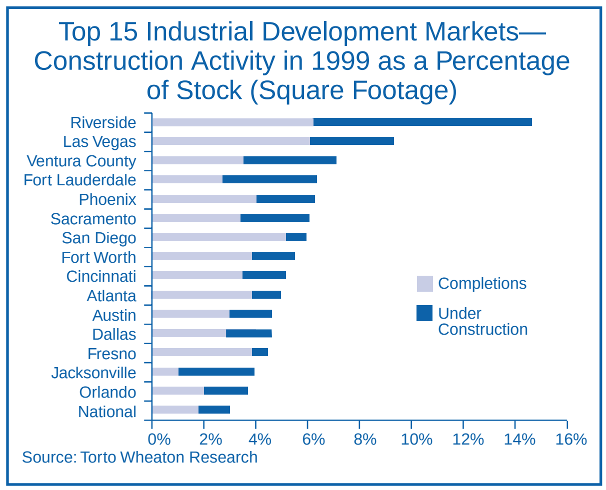
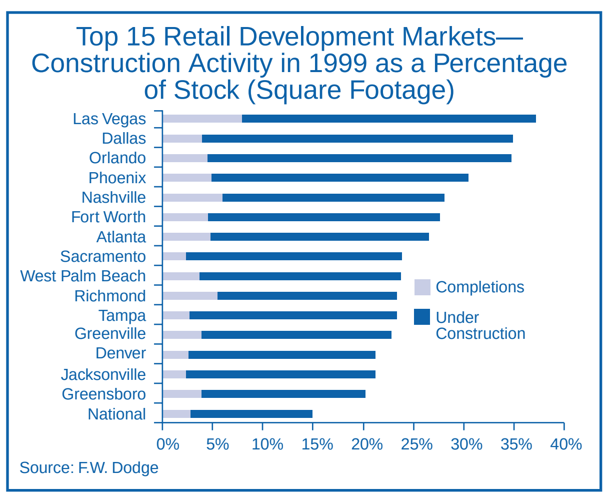


CHART 4



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

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

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

C&D Loan Concentrations

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

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

Construction Employment Concentrations

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

[11] Community banks are FDIC-insured institutions with assets less than $1 billion.

[12] For community banks that have C&D loans.

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

[14] Construction concentrations are the percentage of construction employees relative to the nonfarm workforce.

CHART 5

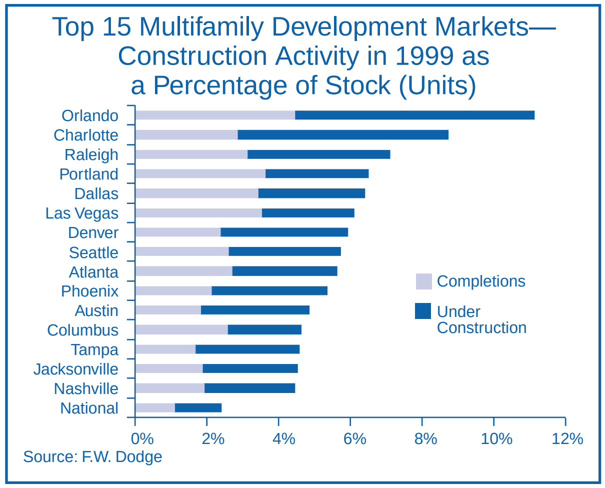


CHART 6

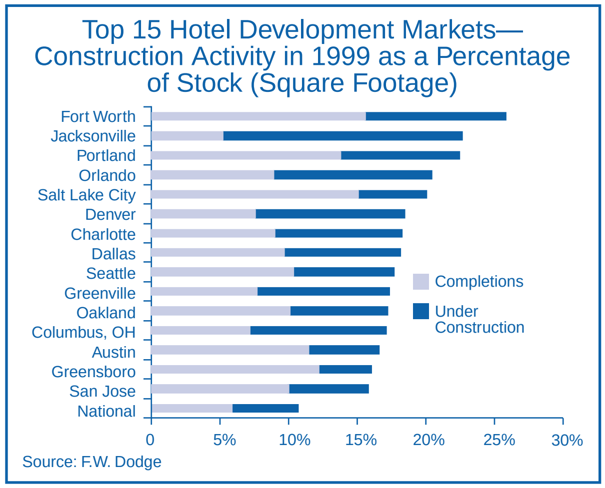
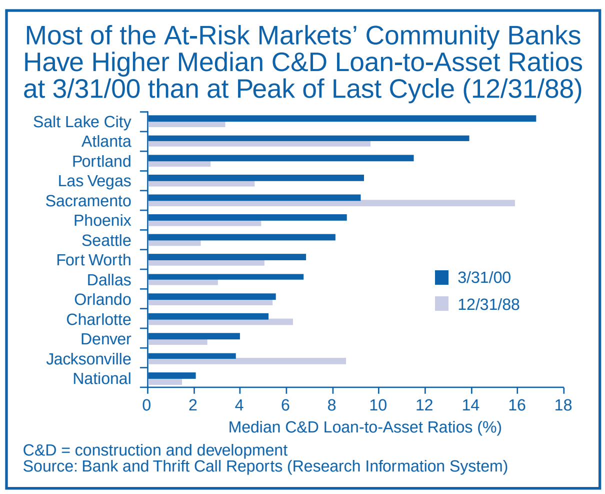


CHART 7



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

High Construction Activity and High Vacancy Levels

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

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

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

CHART 8

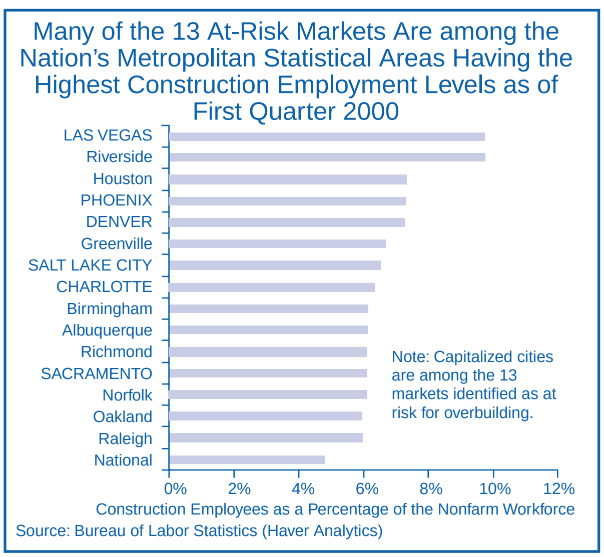


CHART 9

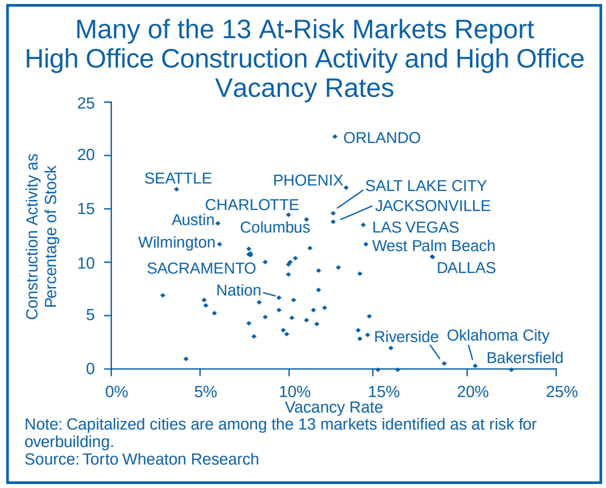


CHART 10

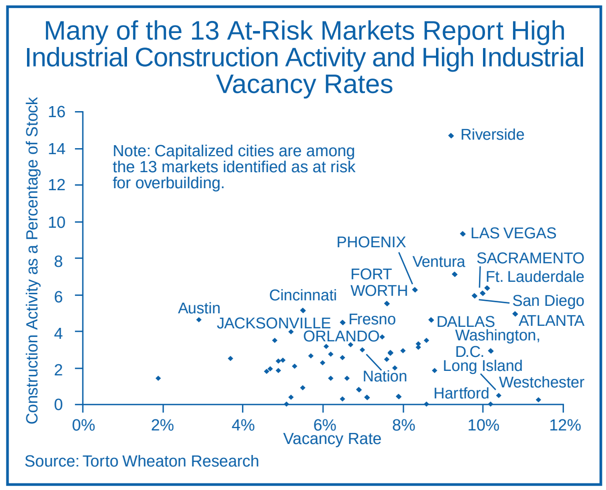
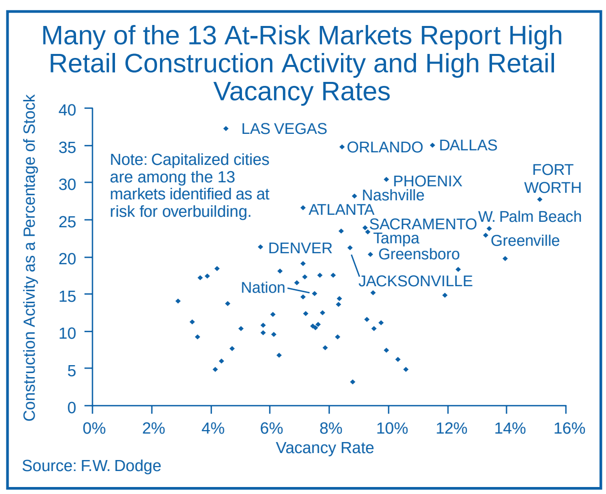


CHART 11



[15] The data vendors do not provide category breakdowns for construction activity into speculative versus nonspeculative (preleased) properties.

What Market Analysts Are Saying

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

Office

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

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

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

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

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

Multifamily

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

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

Industrial

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

Retail

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

Hotel

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

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

[16] Torto Wheaton Research. Spring 2000. *Office Outlook.*
[17] Thierry Perrein, Donaldson, Lufkin & Jenrette. April 2000. *DLJ REIT Corporate Handbook, "Cautious Optimism."*
[18] Urban Land Institute. *ULI 2000 Real Estate Forecast.*
[19] Templin, Neal. June 7, 2000. Economic Focus: Houston, Dallas Are Draw for Immigrants. *The Wall Street Journal.*
[20] Barnes, Brooks. June 7, 2000. Economic Focus: Seattle Enjoys Influx of Foreign Workers. *The Wall Street Journal.*
[21] Gordon, Sally. June 2, 2000. Moody's Investors Service, *Special Report—CMBS: Red-Yellow-Green Update, Second Quarter 2000, Quarterly Assessment of U.S. Property Markets.*
[22] PaineWebber. June 6, 2000. *Real Estate Investment Trust—Initiating Coverage on the REIT Industry.*
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] PaineWebber. June 1, 2000. *Industry Outlook Lodging, U.S. Hotel Construction Update—First Quarter 2000.*

CHART 12

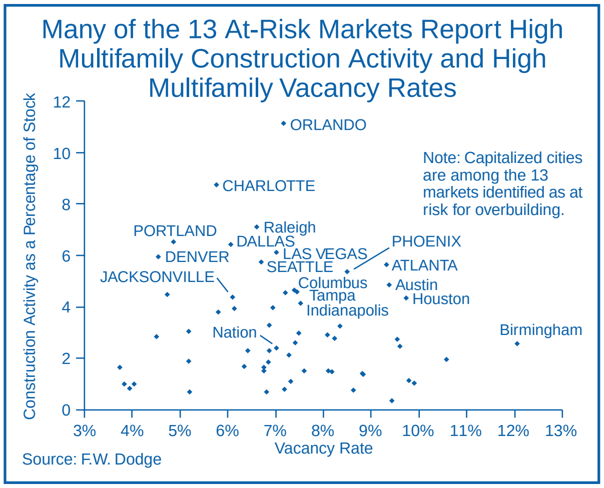
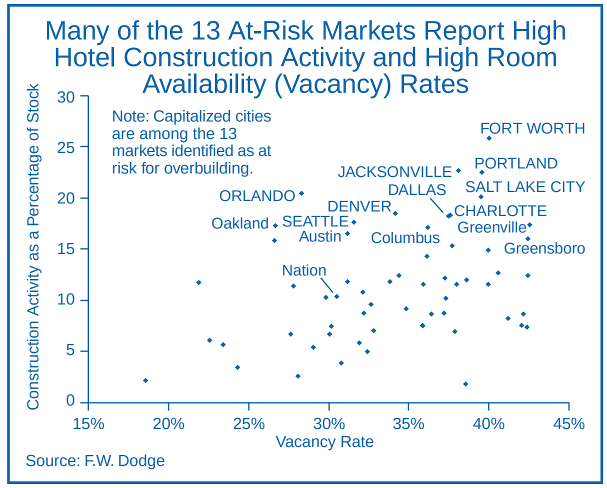


CHART 13



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

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

Conclusion

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

On the basis of the preceding information, the following four markets are considered to be most at risk for broad-based overbuilding: Atlanta, Charlotte, Jacksonville, and Orlando. (See page 21.)

Thomas A. Murray, Senior Financial Analyst

Atlanta Region Markets Most Vulnerable to Overbuilding

Atlanta

Atlanta has enjoyed rapid economic growth for several years and is among the top economic metropolitan area performers in the nation. The essential driver of the growth is the service sector, accounting for half of the jobs created. Atlanta is rapidly becoming a hub for Internet companies. ***Economy.com, Inc.,***[27] estimates the Atlanta high-tech employment at 3.7 percent of the workforce. The Atlanta metropolitan area ranks in the top ten for most active construction retail sectors.

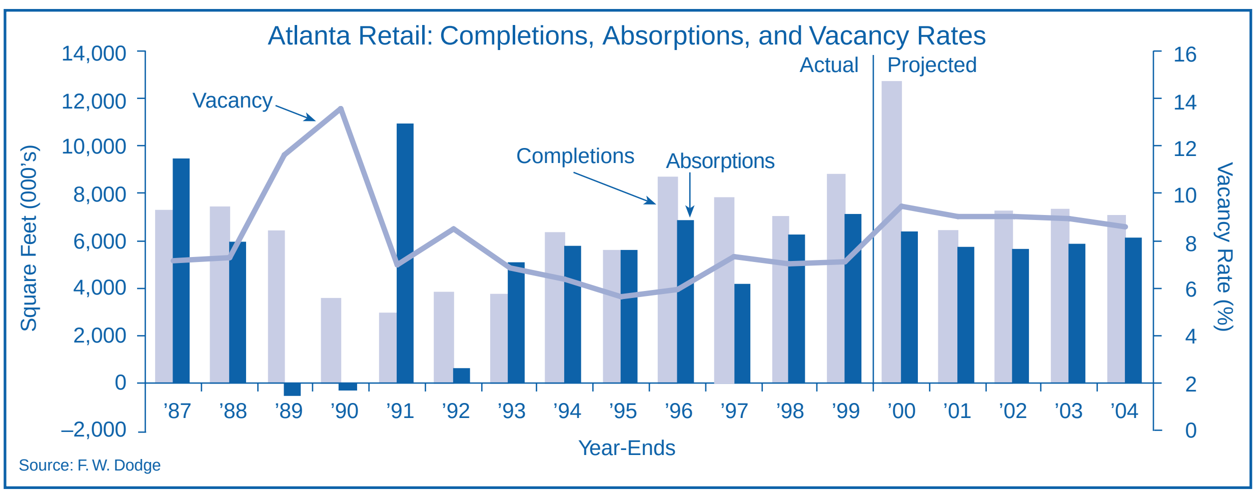
The Atlanta metropolitan market added 8.8 million square feet (or 4.8 percent) to retail inventory during 1999, according to ***F.W. Dodge.***[28] With two new regional malls coming on line, the increase was the largest since the 1980s. Although substantial space remains under construction, F.W. Dodge reports that starts in the first quarter of 2000 were down from one year earlier.

Rapid population and income growth can help support demand for retail space development. Evidence for this can be seen in Atlanta, where population growth averaged 3.0 percent annually during the 1990s. In 1999, the ***U.S. Bureau of the Census*** estimated that Atlanta's population increased by 113,000—the largest increase in a metropolitan area in the nation. Similarly, since 1993, per capita income growth in Atlanta has exceeded the national average. Fueled by the metropolitan area's continued strong growth, retail space absorption in 1999 reached a level last exceeded in 1991 (see chart).

Although Atlanta's retail market continues to expand, new space construction has outpaced absorption (see chart). Consequently, vacancy rates may increase slightly and effective rents, which increased by 3.4 percent in 1999, may see lower gains this year. Unanticipated weakening in consumer demand, economic growth, or net in-migration could adversely affect absorption rates and result in higher vacancy rates.

Many of the 88 community banks (those with assets less than $1 billion) headquartered in Atlanta are actively engaged in local CRE lending. According to first quarter 2000 bank and thrift call report data, C&D loans accounted for 13.5 percent of this peer group's total assets, the highest among the Atlanta Region's metropolitan areas. Nearly one-third of these institutions reported C&D exposures in excess of 20 percent of assets, and several have not been tested by a market or economic downturn. A retrenchment in Atlanta's real estate market could compromise the viability of development projects and consequently affect these institutions' asset quality.

Atlanta Region Staff



[27] Economy.com, Inc. (formerly RFA, Dismal Science), July 2000. *Precis: Metro 2000.*

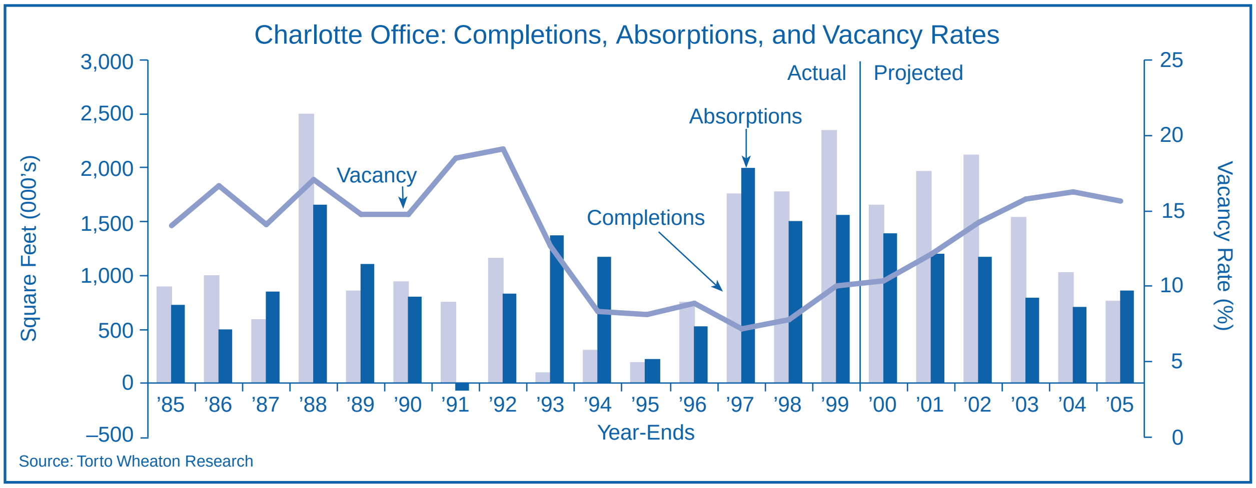
[28] F.W. Dodge. *REAPS.* Fourth Quarter 1999.

Charlotte

Banking is a critical component of Charlotte's economy and its office real estate market. According to ***Economy.com, Inc.,***[29] the two large bank companies headquartered in the metropolitan area and associated service industries account for 50 percent of office space in the uptown market area. Since 1993, strong absorption due to growth at these two financial institutions helped support increased office space development. The Charlotte metropolitan area ranks in the top ten for most active construction in the office sector. In 1999, a near-record 2.3 million square feet of office space was completed in Charlotte (see chart). However, given the recent decreases in the financial sector's job growth, absorption is expected to decline this year. Recently announced planned cost-cutting and workforce-cutting in the financial sector may exacerbate the threat of weaker absorption and could create the potential for office market oversupply.

Community bank exposure in commercial real estate lending is limited, with C&D loans accounting for 5.5 percent of total assets in first-quarter 2000, according to bank and thrift call reports. Of the 22 banks comprising this peer group, only two have C&D loan exposure in excess of 10 percent. Reported past-due C&D loans are low as well. Local bank asset quality may be affected more by the indirect economic effects of cost-cutting and job losses in the financial sector.

Atlanta Region Staff



[29] Economy.com, Inc. (formerly RFA, Dismal Science). July 2000. *Precis: Metro 2000.*

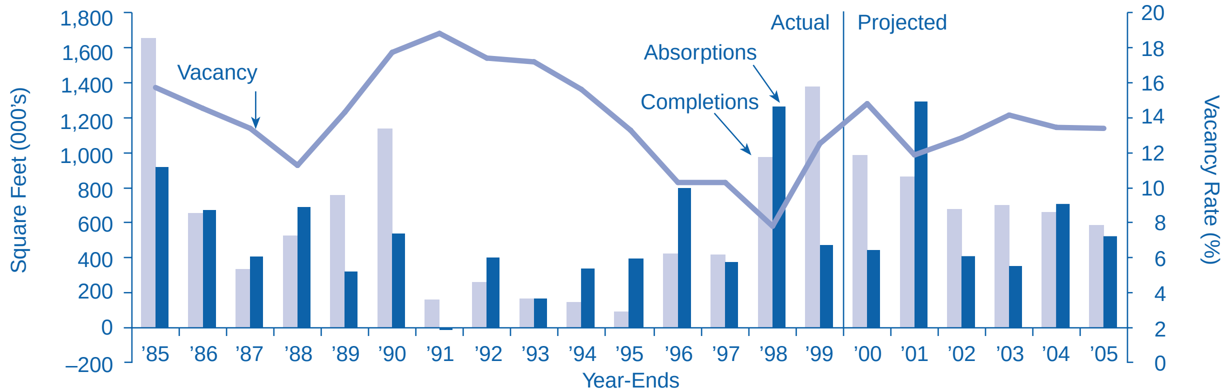
Jacksonville

The Jacksonville metropolitan area ranks in the top 14 most active construction markets for all five property sectors. It ranks second and seventh highest for hotel and office construction. At the same time, Jacksonville has moderately high vacancy levels for office (see chart), retail, and hotel spaces. Jacksonville's office rental rates fell 3.2 percent between year-end 1998 and year-end 1999 at the same time as the suburban office vacancy rate jumped from 8 percent to 15.3 percent. One of the greatest concerns in the metropolitan area's CRE market is too much new office supply coming on-line. Population growth has slowed, primarily because of the closing of a naval base and employee relocations. Analysts report the hospitality sector as having a static occupancy level as a result of a large number of new properties, and report that more are in the pipeline.

Jacksonville's 13 community banks have limited exposure to CRE development lending. In first quarter 2000, construction and development loans accounted for 2.2 percent of this group's total assets.

Atlanta Region Staff

Jacksonville Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

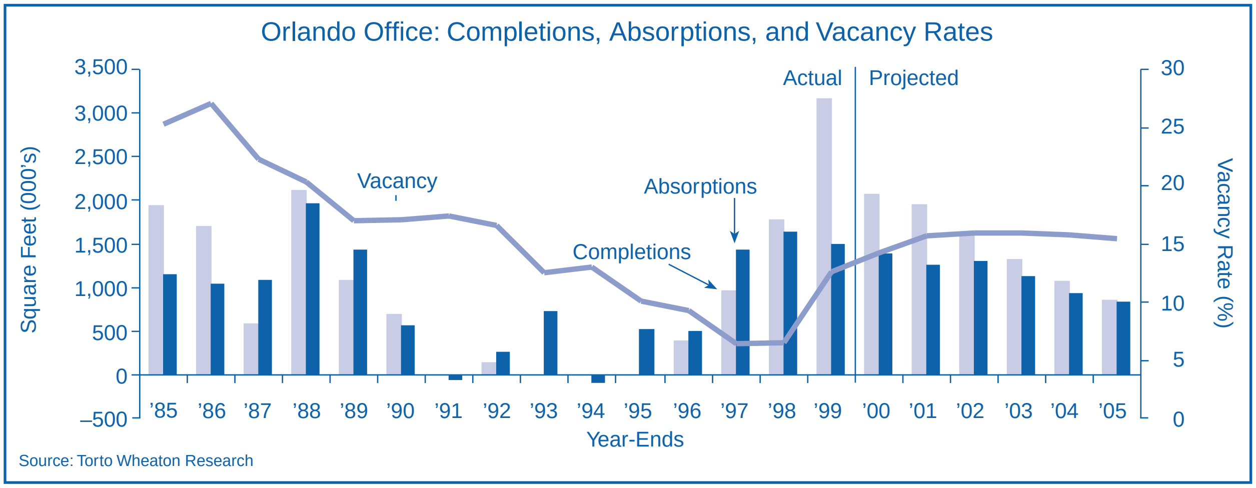
Orlando

High levels of in-migration and a rapidly expanding economy have helped foster a favorable environment for CRE development. Orlando has the most active construction market in the nation as a percentage of stock. It is first in both office and multifamily construction and third and fourth, respectively, for retail and hotel construction. Office construction has increased over the past three years, and 1999 saw a record 3.16 million square feet in completions delivered to market, according to ***Torto Wheaton Research***[30] (see chart). Many analysts expect 2000 to be a pivotal year in Orlando's office market as completions could rise to nearly 3.5 million square feet.

Orlando is more dependent than perhaps any other metropolitan area on continued high levels of economic growth to generate sufficient demand to absorb the large supply of new construction products. However, net absorption is expected to moderate this year, while completions continue to increase substantially.

The majority of Orlando's 26 community banks have limited exposure to local CRE lending. According to first quarter 2000 bank and thrift call report data, C&D loans accounted for 6.8 percent of this peer group's total assets.

Atlanta Region Staff



[30] Torto Wheaton Research. Spring 2000. *Office Outlook.*

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

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

Introduction

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

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

Single-family mortgages have traditionally been associated with low loss rates compared with other, higher-risk lending lines at insured institutions. However, the real estate market is still susceptible to boom and bust cycles, which could pose a risk to institutions with exposures to residential real estate. This risk would be heightened by the formation of asset price bubbles in local markets. Furthermore, as the competition among mortgage lenders becomes more intense, insured institutions are increasingly participating in new, higher-risk types of mortgage lending, such as high loan-to-value (LTV) lending and subprime lending. These new lending practices—still largely untested in a recession—raise some concerns about the future credit quality of residential loan portfolios.

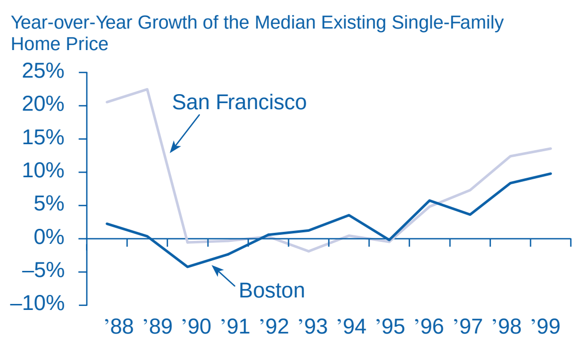
Home Prices in Some Local Markets Are Soaring

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

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

CHART 1

Some Large U.S. Metropolitan Areas Have Seen the Return of Soaring Home Prices



Source: National Association of Realtors (Haver Analytics)

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

Table 1

Of the 20 U.S. Cities with the Most Expensive Housing, More than Half Have a Concentration in High-Tech Employment			
The shaded areas indicate markets where high-tech employees constitute at least 5 percent of the total payroll employment (see note).			
Metropolitan Statistical Area Ranking by Median Home Price		Median Price of an Existing Single-Family Home March 2000	Percent Change from One Year Ago
1	San Francisco, CA	$418,600	25.0%
2	Orange County, CA	$300,800	10.3%
3	Honolulu, HI	$289,000	–2.0%
4	Boston, MA*	$255,000	8.4%
5	San Diego, CA	$251,400	16.1%
6	Bergen-Passaic, NJ	$250,200	9.8%
7	Newark, NJ	$229,500	18.8%
8	Seattle, WA	$226,100	8.3%
9	New York, NY	$221,500	14.3%
10	Nassau-Suffolk, NY	$209,200	12.8%
11	Los Angeles, CA	$202,900	5.6%
12	Middlesex, NJ	$198,500	8.6%
13	Monmouth-Ocean, NJ	$186,200	19.4%
14	Denver, CO	$181,500	12.9%
15	Washington, DC-MD-VA	$177,500	5.6%
16	Portland, OR	$166,700	0.8%
17	Chicago, IL	$166,700	0.4%
18	Lake County, IL	$162,600	–2.2%
19	Aurora-Elgin, IL	$158,200	7.5%
20	Raleigh-Durham, NC	$156,300	–4.2%
Nation		**$133,533**	**2.7%**

* Ranking based on the latest data available (third quarter 1999).
Note: High-tech, as defined by Dismal Sciences, Inc., includes industries such as pharmaceuticals, computers, electronic components, communications equipment, and communications services.
Sources: National Association of Realtors (Haver Analytics); Dismal Sciences, Inc.

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

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

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

Favorable Economic Conditions Have Sustained Consumer Spending Patterns

As the current U.S. expansion entered its 113th month in July 2000, consumer spending continued along a path of rapid growth. In the second quarter of 2000, personal consumption expenditures increased by 8 percent over the previous year. Nearly ideal conditions for consumers have contributed to high levels of spending. The unemployment rate remains near the record low of 3.9 percent set in April 2000, and consumer confidence remains near the record high set in January 2000. Moreover, consumer buying power has been boosted by real wage gains, generally low interest rates, and stock market earnings.

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

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

Overall Credit Quality of Residential Mortgages Has Been Solid

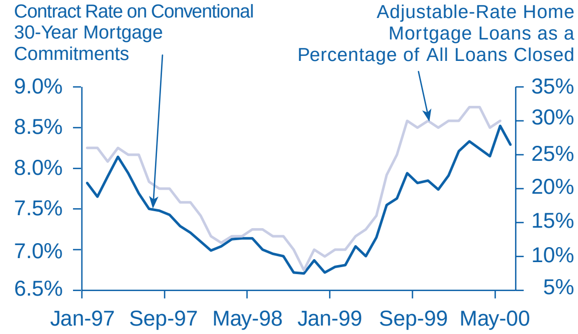
Historical losses from residential real estate exposures at insured institutions are well documented. In the 1980s, areas such as Texas, California, and New England experienced strong economic growth, rapid residential development, and sharp home price appreciation that created asset price inflation. Coastal California markets, in particular, experienced double-digit growth rates that propelled the median home price in California to more than double the national average.[4]

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

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

CHART 2

More Consumers Have Chosen ARMs as Mortgage Rates Have Risen



Sources: Federal Reserve Board; Federal Housing Finance Board (Haver Analytics)

[3] National Association of Realtors Press Release. August 1, 2000. Housing Affordability Drops to Eight-Year Low, NAR Reports.

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

[5] "Past due" refers to loans that are 30 or more days past due.

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

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

CHART 3

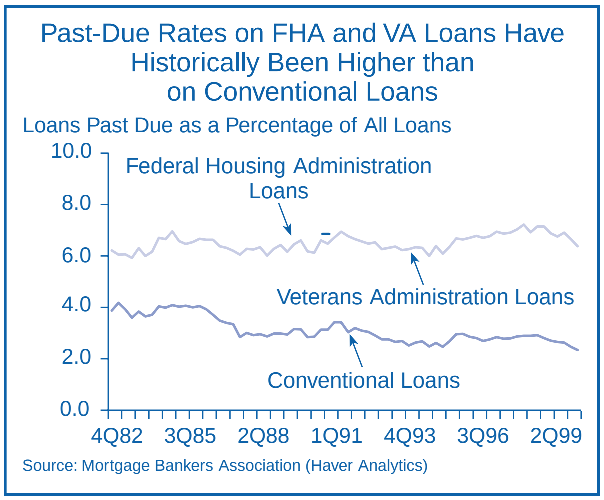
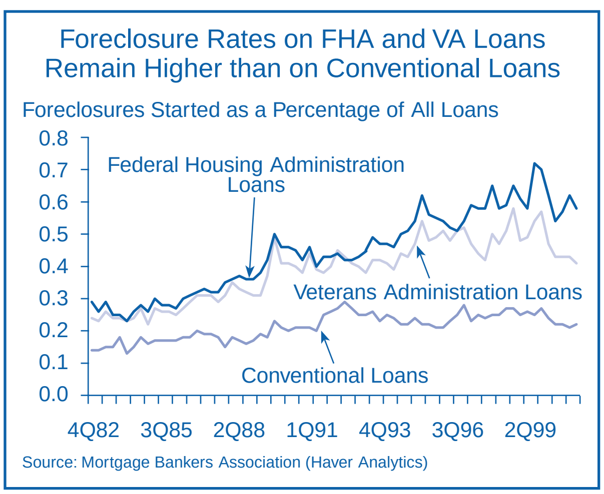


CHART 4

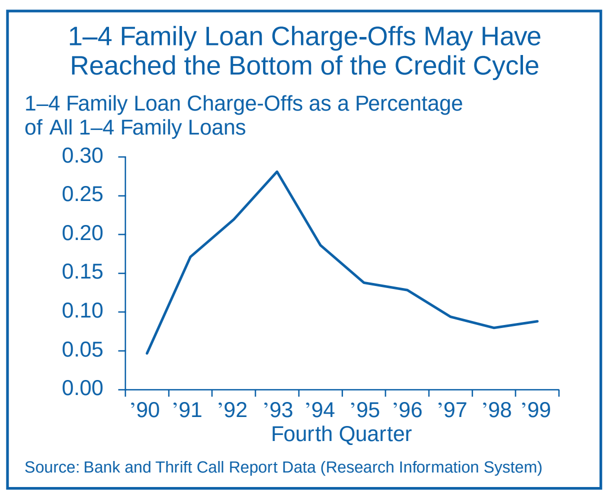


A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving submarket residential real estate problems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

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

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

CHART 5



[6] Board of Governors of the Federal Reserve System. July 20, 2000. Monetary Policy Report to the Congress. p. 7.

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

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

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

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

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

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

Table 2

Pockets of Risk May Be Forming Where the LTV Is Highest

Metropolitan Statistical Area (MSA) or Consolidated MSA Ranked by Percentage of Loans with LTV Greater than 90 Percent	Percentage of Loans with LTV over 90 Percent 1999
1 Greenville-Spartanburg-Anderson, SC	50%
2 Honolulu, HI	42%
3 Memphis, TN	38%
4 Charlotte-Gastonia-Rock Hill, NC-SC	37%
5 Birmingham, AL	35%
6 Houston-Galveston-Brazoria, TX	35%
7 Atlanta, GA	32%
8 Jacksonville, FL	32%
9 Nashville, TN	32%
10 Oklahoma City, OK	32%
11 Tulsa, OK	32%
12 Greensboro–Winston-Salem–High Point, NC	31%
13 Kansas City, MO-KS	30%
14 Las Vegas, NV-AZ	30%

LTV = loan-to-value
Source: Federal Housing Finance Board

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

[8] Federal Housing Finance Board.

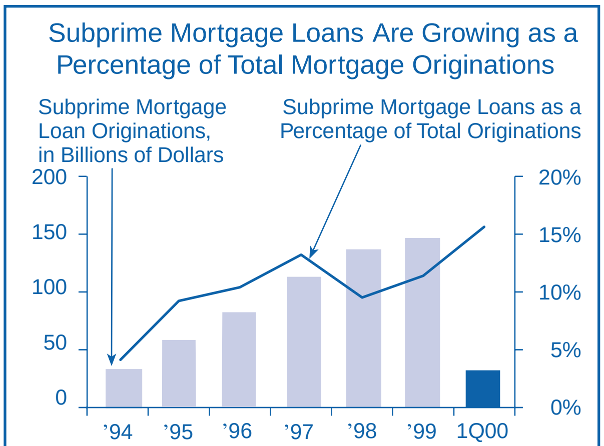
[9] See also Kathy R. Kalser and Debra L. Novak. **"Subprime Lending: A Time for Caution."** ***Regional Outlook,*** third quarter 1997; http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf.

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

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

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

CHART 6



Sources: The Mortgage Market Statistical Annual for 1999; Inside B&C Lending

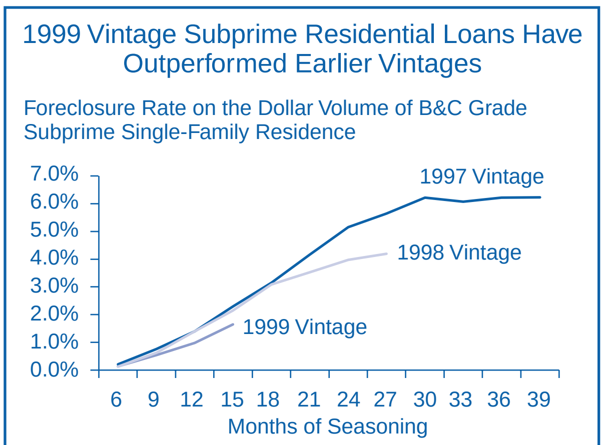
Conclusion

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

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

Alan Deaton, Financial Economist

CHART 7



Source: Mortgage Information Corporation

[10] Subprime Mortgage Market Faces More Challenges in Second Half of Turbulent 2000. *Inside Mortgage Finance.* July 7, 2000.

[11] Mortgage Delinquency Rates Decline in Early 2000 But Industry Braces for Shift in the Wind. *Inside Mortgage Finance.* July 14, 2000.

[12] Seriously delinquent loans are defined as loans at least 90 days delinquent or in foreclosure.

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta ________	Dallas ________	New York ________	National ________
Boston ________	Kansas City ________	San Francisco ________	All ________
Chicago ________	Memphis ________		

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE MAIL
Postage & Fees Paid
FDIC
Permit No. G-36