Regional Outlook

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Region

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Regional Perspectives

◆ ***Region's Economy Remains Healthy, Even as Interest Rates Rise***—**Economic activity in the Chicago Region remained healthy through mid-2000 despite rising interest rates. However, several factors that tempered the effect of rising interest rates are weakening, and short-term rates rose an additional 50 basis points in mid-May 2000. As a result, the traditional interest rate sensitivity of the Region's manufacturing and housing sectors may become more apparent in the future, particularly if interest rates continue to rise.** ***See page 3.***

◆ ***Liquidity Management Is Becoming Increasingly Important***—**Although most institutions in the Region appear to have adequate liquidity levels, recent trends indicate that liquidity management may become more complex in the future. Securities portfolios are providing less liquidity, short-term borrowings and brokered deposits are increasing, and unused commitments have risen slightly. In addition, Federal Home Loan Bank advances are poised for continued growth, partly because of the enactment of the Gramm-Leach-Bliley Act.** ***See page 6.***

By the Chicago 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 amid falling vacancy rates and growing demand for new space. Insured depository institutions have reasserted their role as primary sources of capital for this construction boom, particularly in the wake of the 1998 financial markets crisis that left some important market-based lenders on the sidelines. Recent data for some metropolitan areas show that on-balance-sheet exposures of FDIC-insured institutions are by some measures higher now than at the peak of the last commercial real estate cycle during the late 1980s. This article reassesses major U.S. metropolitan real estate markets in search of possible signs of overbuilding that could drive up vacancy rates and drive down rents in the near term. This review points to an underlying trend of markets experiencing more vigorous construction activity across multiple property types.** ***See page 10.***

By Thomas A. Murray, Senior Financial Analyst

◆ ***Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate***—**Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios.** ***See page 18.***

By Alan Deaton, Financial Economist

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Regional Perspectives

- **Several factors that tempered the effect of increasing interest rates on the Region's economy during the past year and a half may become less influential in coming quarters. Thus, the traditional sensitivity of the Region's economic health to higher interest rates may be more evident as 2000 unfolds, particularly if interest rates continue to rise.**

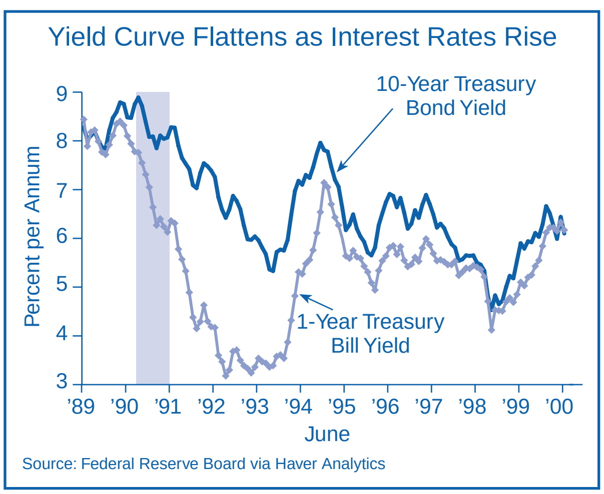
- **Recent trends have highlighted the importance of liquidity management in the Region. The number of institutions with weak liquidity ratings, while at historically low levels, has increased slightly over the past two years. Some newer institutions are also showing evidence of liquidity pressures. Securities portfolios are providing less liquidity, short-term brokered deposits and borrowings are increasing, and unused commitments have risen slightly. In addition, Federal Home Loan Bank advances are likely to continue to grow, in part because of enactment of the Gramm-Leach-Bliley Act.**

Despite Rising Interest Rates, Region's Economy Remains Healthy

On the surface, it appears that rising interest rates since late 1998 have done little to moderate the level and pace of economic activity in the Region. The subdued reaction may be surprising because demand for a relatively high proportion of the Region's output historically has been sensitive to rising interest rates and financing costs. Recent developments, however, suggest that the impact of higher interest rates may become more pronounced as the year unfolds.

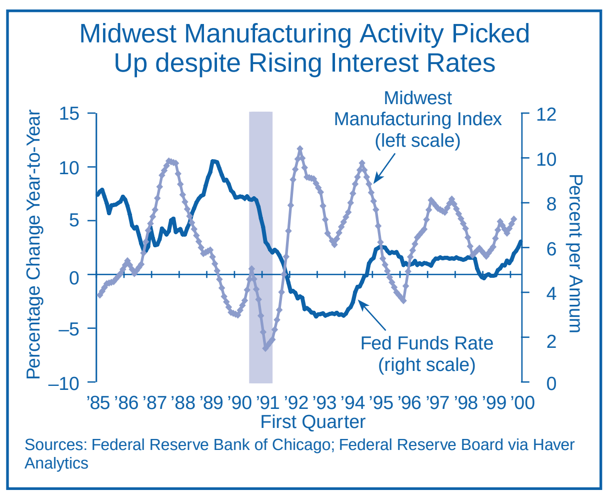
Looking back, interest rates on U.S. Treasury securities have been rising since late 1998, and the yield curve became relatively flat in 2000 (see Chart 1). The yield curve was previously flat in 1998. At that time, the flattening reflected financial investors' dramatic flight to highly liquid federal debt and accommodative monetary policy. In contrast, the recent flattening of the yield curve is characteristic of the situation that typically occurs late in a business cycle expansion. Specifically, interest rates are rising across the maturity spectrum, with rates on short-term securities rising faster than on longer-term securities. Yet it appears that rising interest rates have done little thus far to moderate the level and pace of economic activity in the Region.

Chart 1



Growth in the Midwest Manufacturing Index (MMI)[1] accelerated after mid-1999 (see Chart 2). Faster growth in the machinery sector and the return of growth to the steel sector[2] were contributing factors

Chart 2



[1] The MMI is compiled by the Federal Reserve Bank of Chicago to reflect activity in manufacturing industries important in the area's economy.

[2] The machinery sector covers industrial machinery and equipment, electronic and other electric equipment, and instruments and related products. The steel sector covers primary and fabricated metal industries.

(see Chart 3). In part, these sectors are improving because the brunt of the negative effect from Asia's economic turmoil has passed. In addition, foreign demand for the Region's manufacturing exports is strengthening. The auto sector component[3] of the MMI, which may be less dependent on demand from abroad, has posted moderate growth recently, and activity in the resource sector[4] expanded modestly in 1999 before leveling out in first quarter 2000.

Motor-vehicle sales and production remain robust, with first quarter 2000 sales of automobiles and light trucks setting a record of 18.1 million units (at an annual rate), partly because of motor-vehicle manufacturers' sales incentives. Although news reports suggest that rising market interest rates may trigger a shift away from reduced-rate financing by producers, other sales incentives may be offered. About 646,000 jobs in the transportation equipment sector,[5] or 35 percent of the nation's total, are concentrated in the Chicago Region.

Manufacturers' new and unfilled orders suggest that, should interest rates plateau at current levels, the Region's manufacturing sector may be expected to continue producing goods at a healthy pace for some time. New orders for manufactured goods (exclusive of defense and aircraft and parts, which are not major drivers of the Region's economy) have rebounded since mid-1999. Because orders have grown faster than production, firms' backlog of orders also has risen (see Chart 4). Unless order cancellations surge, orders currently on manufacturers' books should support healthy production by the Region's manufacturers over the next few quarters.

The effect of rising interest rates on housing markets in the Region appears modest to date, as the levels of resales and new permits remain high. Households' ability to afford a home remains in the range of recent years even though an index of affordability[6] was 12 percent lower at midyear 2000 than in late 1998 and early 1999. Mortgage payments as a percentage of income remain relatively low, at less than 20 percent of household income. The Region's healthy 4.5 percent personal income growth in 1999 helped maintain affordability. Despite these conditions, housing activity in the Region appears to be leveling off: Single-family home permits in the first five months of 2000 were no higher than in the comparable 1999 period, and year-over-year growth in home resales also had stalled. In addition, price appreciation in the Midwest, which is composed of the FDIC's Chicago and Kansas City Regions, slowed to less than 2.0 percent during the first five months of this year. This pace compares with 4.0 percent in 1999 and 6.9 percent the year earlier.

Finally, rising interest rates might be expected to trim bank loan growth. Historical experience, however, suggests that this relationship is lagged. Some borrowers, for example, may borrow more from banks when inter-

CHART 3

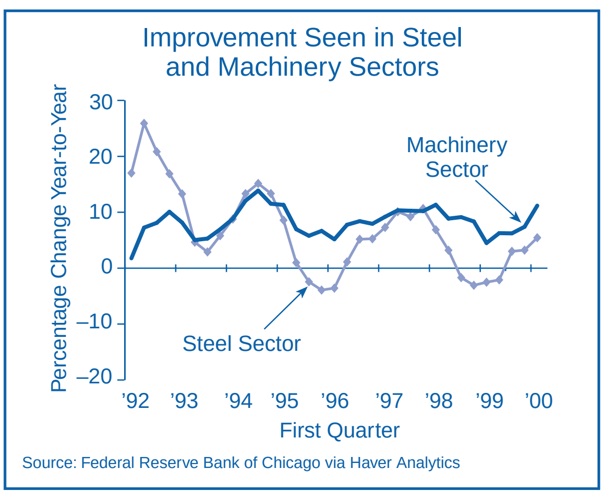
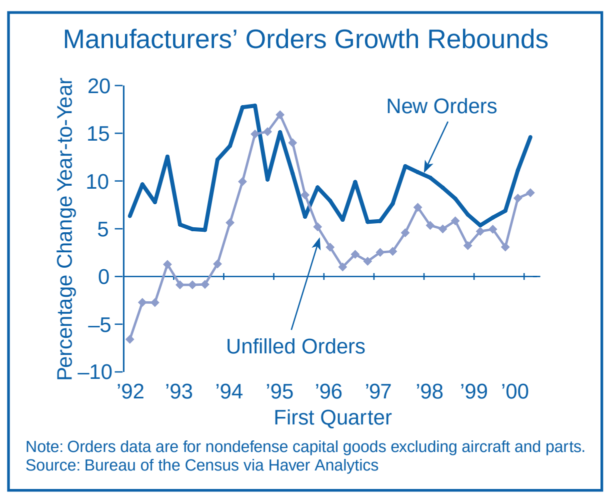


CHART 4



[3] The auto sector index covers transportation equipment, rubber, and miscellaneous plastic products.

[4] The resource sector covers food and kindred products; lumber and wood products; paper and allied products; chemicals and allied products; petroleum and coal products; and stone, clay, and glass products.

[5] The transportation equipment sector is broader than motor vehicles and parts.

[6] The National Association of Realtors calculates an affordability index based on national data for median family income, the median price of an existing home, and mortgage rates.

est rates rise because capital market funding becomes more difficult or expensive to obtain. In the Chicago Region, continued economic growth and other factors countered the effect of higher rates, leading to median growth of 11 percent in banks' and thrifts' loan portfolios during the year ending March 31, 2000. This pace was the fastest in at least a decade (see Chart 5).

Has the Region's Vulnerability to Interest Rates Changed?

The Region's continued economic health and accelerating bank loan growth through early 2000, in the face of rising interest rates, does not mean that economic activity in the area has become noticeably less sensitive to interest rates and financing costs. Rather, a number of other factors apparently tempered the effect of interest rate increases through mid-2000, including the following:

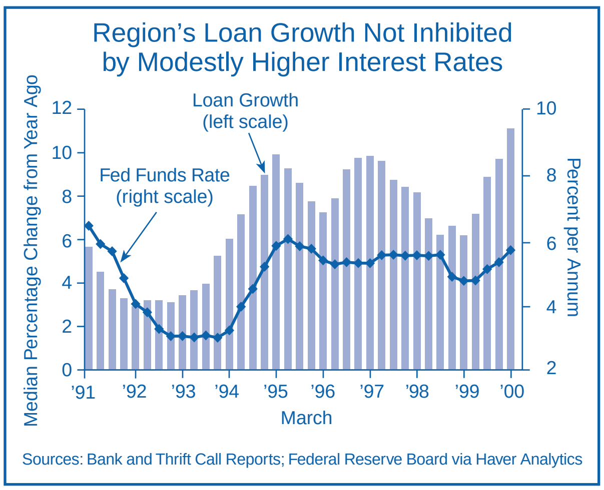
- Seventy-five basis points of the increase in the federal funds rate merely reversed the easing of monetary policy that took place in 1998 during a period of turmoil in domestic and foreign financial markets. Similarly, the rise in yields on Treasury securities reversed about half the decline experienced in 1998.

- The results of changes in monetary policy may be slow to manifest themselves, and the economy's continuing strength in the first half of 2000 may reflect the tail end of stimulus resulting from interest rate reductions in 1998.

- Interest rates are not the sole driver of the Region's economic growth. To date, for example, the potential dampening effect from rising interest rates may have been mitigated by continuing job growth, reviving foreign demand for the Region's exports, and the halting of steel dumping in U.S. markets.

- Consumer confidence in the Region remains high, which suggests that the past year's interest rate increases have not seriously crimped households' purchasing power or attitudes.

CHART 5



Although the Region weathered rising interest rates without slowing significantly through mid-2000, it remains more vulnerable than other parts of the country to manufacturing sector weakness, which could be triggered by rising rates. The Region's economy is more diversified now than 15 years ago, but the manufacturing sector remains relatively more dominant in this Region than elsewhere in the country. Last year, the manufacturing sector generated 25 percent of nonfarm earnings in the Region, compared with 29 percent in 1989 and 36 percent in 1979. Despite this trend, the Region's current 25 percent share is 1.7 times the share of manufacturing elsewhere in the nation.

Should interest rates continue to rise,[7] the direct and indirect effects may combine with other developments to slow the Region's growth more noticeably. Other factors that may dampen growth include a shortage of workers seeking employment and higher energy prices, which are trimming households' discretionary income and increasing costs for some businesses. In addition, stock market corrections in the first half of 2000 trimmed the market value of some investors' portfolios, although many still reflect net appreciation over the past two- or three-year period.

[7] Several Federal Reserve officials suggested in early June that another increase in interest rates is likely, according to ***The New York Times.*** See Lou Uchitelle, "Small but Uncertain Indications That the Economy Is Slowing," ***The New York Times,*** June 14, 2000. C1.

Liquidity Management Is Becoming More Important in the Chicago Region

Aggregate loan-to-asset levels and noncore funding are increasing, leading to declining liquidity trends. Traditional liquidity measures, such as the loan-to-deposit ratio, have been deteriorating modestly for some time; however, these measures are declining in usefulness. A broader view reveals concern as institutions report lower levels of marketable and short-term securities, higher noncore funding[8] levels, and more unused loan commitments. At the same time, deposits have trended toward shorter maturities. Furthermore, widespread profitability declines may continue to pressure institutions to operate with lower liquidity levels.

Lower levels of liquidity have the potential to exacerbate financial difficulties that may occur. Financial institutions relying significantly on noncore funding may be more vulnerable to events such as an auditor's adverse opinion, a sudden loss of profitability, or economic developments that may lead to funding difficulties. In an economic scenario of severe monetary tightness, the cost of purchased funds may become prohibitive to some insured institutions.

Examination Information Reveals Heightened Liquidity Risk at Some Institutions

Recent examination information shows an increase in the number of institutions with weak liquidity ratings,[9] though the number remains historically low. The number of relatively new institutions that have weak liquidity ratings has been rising as well.[10] Banks that are maintaining less liquidity expose themselves to the possibility that financial difficulties, such as asset quality or earnings problems, will be exacerbated. In fact, Deputy Regional Director Susan Madson, of the FDIC's Division of Supervision, addressed this situation during the Interagency Liquidity Conference at the Federal Reserve Bank of Chicago in May. According to Madson, the FDIC has recently encountered a few community banks whose problems have been magnified because of their volatile funding base. Madson stated that while banks have historically failed because of equity insolvency, there is now an increasing likelihood that liquidity problems may arise.

Securities Portfolios Are Less Liquid, Longer Term, and Represent a Smaller Percentage of Assets

Over the past several years, the increased availability of liability-side funding options and margin pressures apparently have led to less reliance on securities portfolios for meeting liquidity needs. Commercial banks' securities portfolios have shrunk, the ratio of highly marketable securities[11] to total securities has declined, and the ratio of pledged securities to total securities has increased (see Chart 6). At the same time, banks have lengthened the maturities of the securities they do hold. As of March 31, 2000, community commercial banks[12] reported 56 percent of combined securities portfolios maturing or repricing after three years, compared with 46 percent two years ago. Not surprisingly, recent interest rate increases and lengthening maturities have resulted in more banks experiencing significant depreciation (see Chart 7). Despite increased reliance on liability-side funding options, the securities portfolio may become increasingly important as a source of liquidity in a period of economic stress, particularly if an institution's funding sources lose confidence in its financial soundness.

Federal Home Loan Bank Borrowings Are Poised for Continued Strong Growth

On the liability side of the balance sheet, banks and thrifts in the Region have turned to alternative funding sources to supplement weak core deposit growth. Federal Home Loan Bank (FHLB) advances have grown at a particularly strong rate, and several recent develop-

[8] Refer to the Chicago Region's ***Regional Outlook,*** third quarter 1999, for a detailed discussion of trends in bank funding strategies.

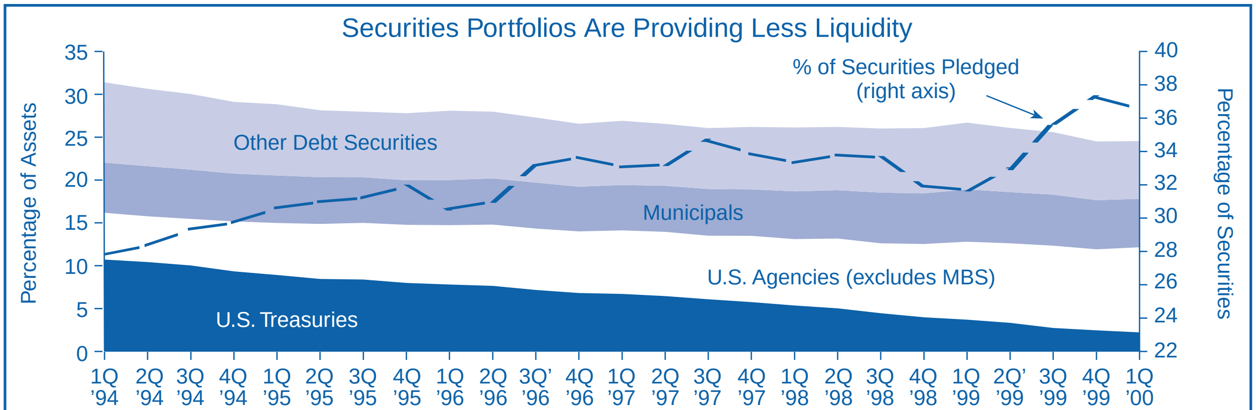
[9] As of March 31, 2000, 66 insured financial institutions, or 3.33 percent of total institutions in the Chicago Region, had liquidity ratings of three, four, or five. This is a slight increase from the prior year, when 43, or 2.12 percent of institutions, were rated three, four, or five.

[10] As of March 31, 1998, 6 percent of new institutions (defined here as those established within the past nine years) had liquidity ratings of three, four, or five. The percentage had risen to 12 percent as of March 31, 2000.

[11] U.S. Treasury, U.S. government agency, and U.S. government-sponsored agency obligations (excluding mortgage-backed securities) are generally considered highly marketable for the purposes of this analysis. However, some securities issues in this category may have characteristics that negatively affect liquidity.

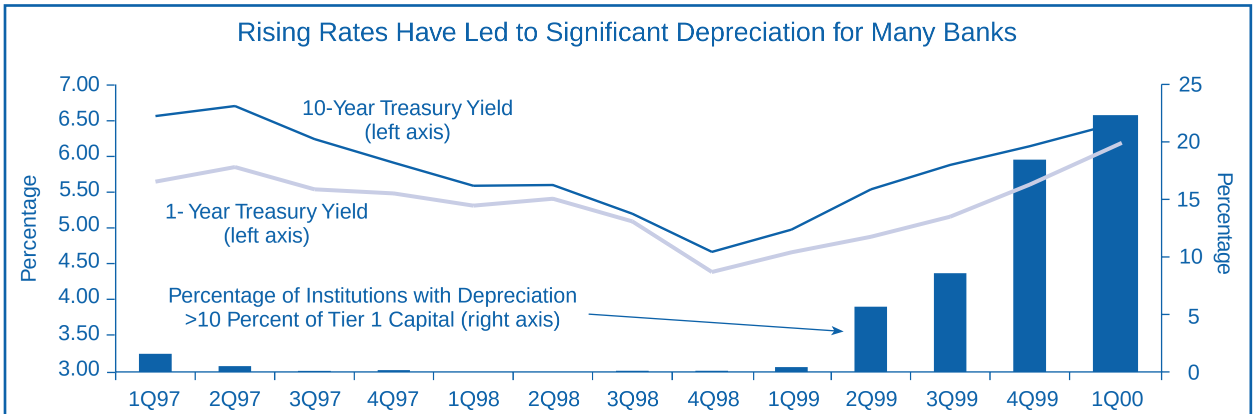
[12] Community commercial banks are defined here as banks with less than $1 billion in assets, excluding institutions established within the past three years.

CHART 6



Note: Only debt securities are shown.
MBS = mortgage-backed securities
Source: Commercial bank Call Reports for community banks (<$1 billion in assets), excluding de novos

CHART 7



Source: Call Reports for commercial banks, excluding de novos; Federal Reserve Board

ments point to even greater use of FHLB advances in the future. For example, the Gramm-Leach-Bliley Act broadened access to the FHLB system for institutions with less than $500 million in assets:

- More small banks can meet membership requirements. Banks with assets less than $500 million are exempt from the requirement that 10 percent of assets must be held in residential mortgages.
- Agricultural and small business loans, in addition to mortgage loans, can be pledged as collateral for advances.
- The amount of stock that must be purchased to gain membership to the FHLB has been reduced, making access to the system less costly for community banks.

Based upon these changes, nearly all institutions in the Chicago Region are eligible for membership in the FHLB.

Recent Trends in FHLB Advances May Affect Liquidity Management

Although FHLB and other forms of borrowing do present the opportunity for institutions to lock in funding over a long period, FHLB advances have trended toward shorter maturities. As of year-end 1999, the percentage of FHLB advances with a maturity greater than one year had fallen to 50 percent from 62 percent a year earlier.[13]

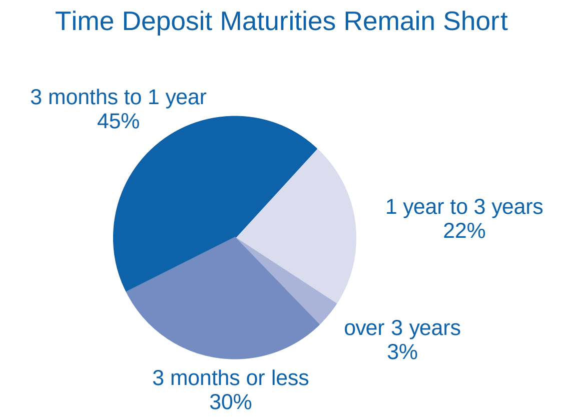
[13] Federal Home Loan Bank System, 1999 Financial Report. FHLB borrowing data in this article are for banks, thrifts, insurance companies, and credit unions.

In addition, the extent to which banks rely on convertible advances[14] is an important consideration in liquidity management. Convertible advances were 13 percent of total advances as of year-end 1997 and 28 percent a year later. As of year-end 1999, the level had dropped to 22 percent,[15] likely because many of these advances had been converted as interest rates rose. Shorter-term and convertible FHLB advances will require greater oversight in the context of banks' liquidity management strategies, particularly if interest rates continue to rise.

Depositors Shift toward Shorter Maturities and Brokered Deposits Continue to Grow

Recent interest rate increases appear to have influenced depositors to opt for even shorter-term investments in certificates of deposits, likely in order to avoid locking in savings rates during the recent rise in interest rates. As of March 31, 2000, 75 percent of total time deposits at community banks were scheduled to mature or reprice within one year (see Chart 8), compared with 73 percent two years earlier. As a result, even core deposits, which comprise a substantial proportion of these time deposits, are increasingly becoming a liquidity consideration. Not only has the competitive environment made attracting core deposits more difficult and costly, but the potential for short-term deposit outflows has increased as depositors opt for shorter-term instruments.

CHART 8



Source: Community bank (<$1 billion) Call Reports, excluding de novos

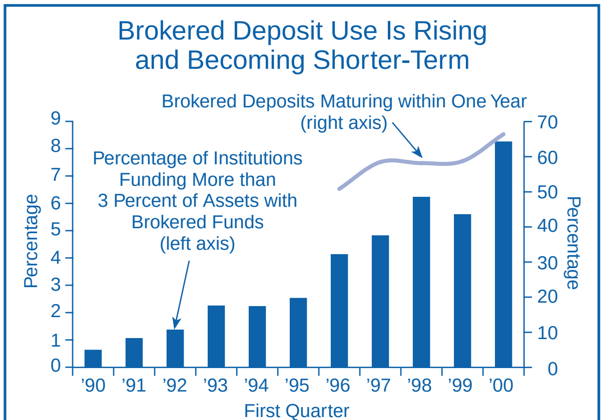
During the past several years, the number of institutions funding a fairly significant percentage of assets with brokered funds has been increasing (see Chart 9). Brokered deposits also are becoming a more immediate funding concern as a higher percentage of brokered funds are scheduled to mature within one year. Although longer-term brokered deposits do not present immediate liquidity concerns, reliance on short-term volatile funds does present heightened liquidity risk.

Funding Strategies May Be Affected by the Increased Popularity of Internet Banking

Even though only a small number of banks and thrifts are using the Internet to attract deposits nationally today, it is clear that more institutions will be using this delivery channel to remain competitive and maintain deposits in the future. A recent survey[16] found that 29 percent of community banks are experiencing demand for Internet banking services from their existing customers and that 54 percent of community banks believe that Internet delivery is essential to attract new customers.

The Internet is being used more frequently to attract depositors from outside banks' traditional geographic market areas. In some instances, community institutions offer higher interest rates on deposits generated through the Internet. This strategy may alienate existing customers who bank through traditional channels. However, if they offer the higher rate to existing customers,

CHART 9

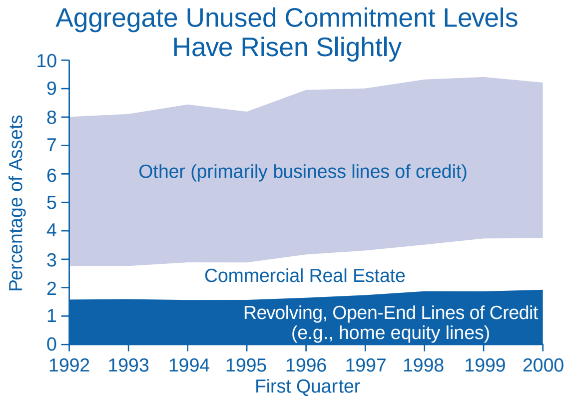


Source: Commercial bank Call Reports for community banks (<$1billion), excluding de novos

[14] Convertible advances generally give the FHLB the option to convert the advance from a fixed to a floating rate if interest rates increase or to terminate the advance and extend additional credit on new terms.
[15] Federal Home Loan Bank System, 1999 Financial Report.

[16] ***Grant Thornton's Seventh Annual Survey of Community Bank Executives,*** March 2000.

CHART 10



Note: Unused credit card commitments are not shown.
Source: Call Reports for commercial banks (<$1billion in assets), excluding de novos

banks may be placed in the position of paying more for existing accounts that were not that sensitive to interest rates. Notwithstanding the low penetration of Internet banking in the Chicago Region, similar mechanisms exist for obtaining nonlocal deposits. For instance, anecdotal evidence indicates that "bulletin-board" computer systems that allow banks to post certificate of deposit rates nationally are experiencing increased use. Although deposits gathered through this mechanism often are not considered brokered deposits, they presumably will cost more and will be more price-sensitive than traditional core deposits.

Unused Commitment Levels Have Risen Slightly, and Commitment Funding Patterns May Be Changing

During the 1990s, unused commitments increased slightly as a percentage of total commercial bank assets in the Region (see Chart 10). This growth has occurred in all categories and is likely being driven by strong demand for credit and the increasing emphasis that some institutions are placing on generating noninterest income. Higher levels of unused commercial real estate commitments may indicate that the strong commercial real estate loan growth experienced in the Chicago Region will continue. The Grand Rapids, MI; Champaign, IL; Madison, WI; Milwaukee, WI; and Chicago metropolitan statistical areas (MSAs) are among those that have the highest community commercial bank exposure to unfunded commercial real estate commitments relative to assets. The levels range from 7.55 percent in the Grand Rapids MSA to 3.55 percent in the Chicago MSA.

The reevaluation of funding assumptions regarding unused commitments seems prudent given recent increases in interest rates and prospects for slowing in the economy. Assessing the likelihood of funding loans and how they would be funded as well as how borrowers' prospects may change in a weaker economy will help institutions manage liquidity profiles.

Unencumbered Liquid Assets[17] and Open Communication Are Becoming Increasingly Important

The need for unencumbered assets and open communication is increasing in light of rising loan-to-asset levels, less liquid securities portfolios, and the trend toward shorter-term liability structures. Institutions that rely on noncore funding should be aware of the potential for heightened reputation risk because many noncore funding sources are volatile and susceptible to withdrawal when signals point to financial difficulties. If an institution's reputation becomes tarnished and funding sources lose confidence, the availability of unpledged securities or other marketable assets will become increasingly important. These "name neutral" assets can be a key source of funds if liquidity problems develop.

Also, if an institution relies heavily on a limited number of funding sources, communication between the institution and those funding sources becomes paramount. If a bank or thrift encounters financial difficulties, communication with its largest funding sources will help ensure that withdrawals do not occur because of a lack of information.

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[17] Unencumbered assets are those that are not pledged and therefore available for liquidity needs.

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.

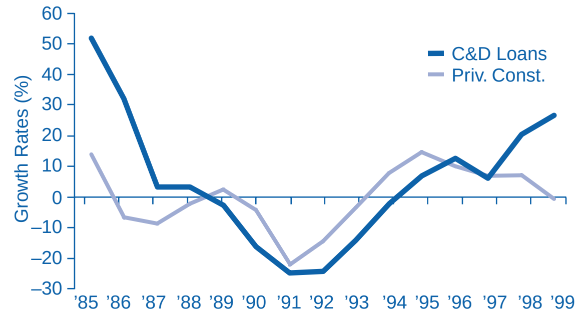
While the availability of market-based sources of capital has helped to facilitate growth in construction during this expansion, the financial market turmoil of late 1998 cast a cloud over the CMBS market that has yet to lift fully. Significant events in the global capital markets in 1997 and 1998, including 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

[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.

Chart 2

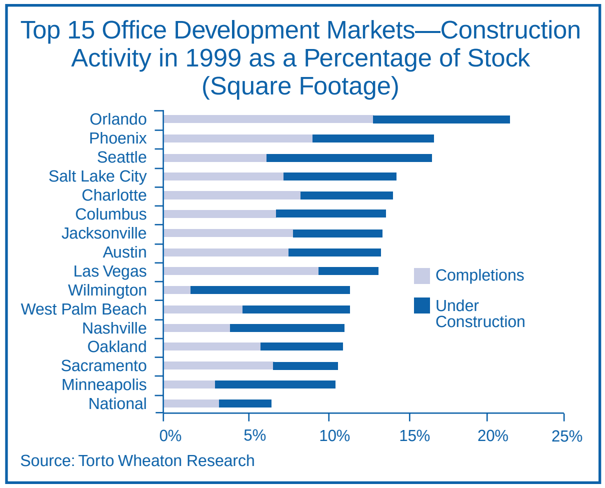


Chart 3

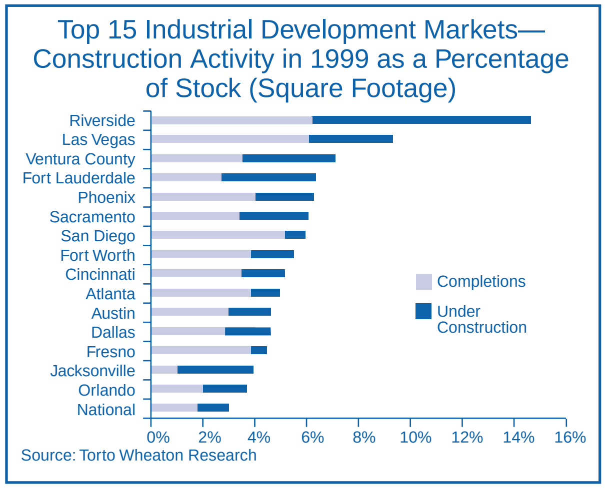
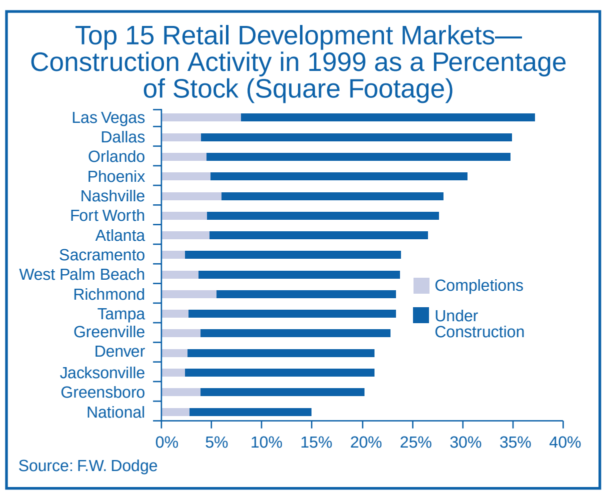


Chart 4



each of the five property sectors except hotel construction, where it ranks sixteenth.

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).[14] In addition, all of the 13 have construction concentration levels exceeding the national average. With slightly under 10 per-

[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

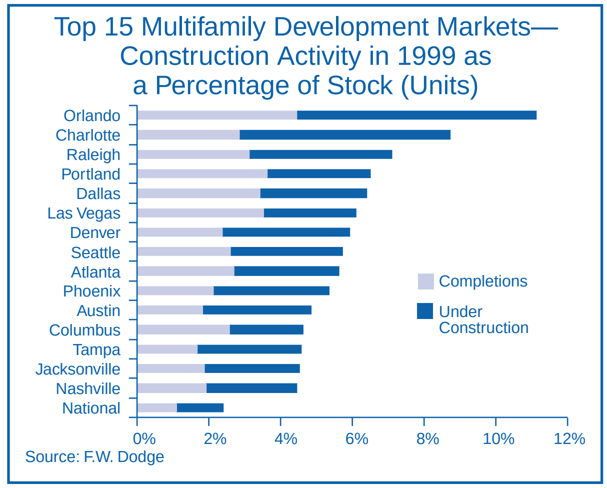


CHART 6

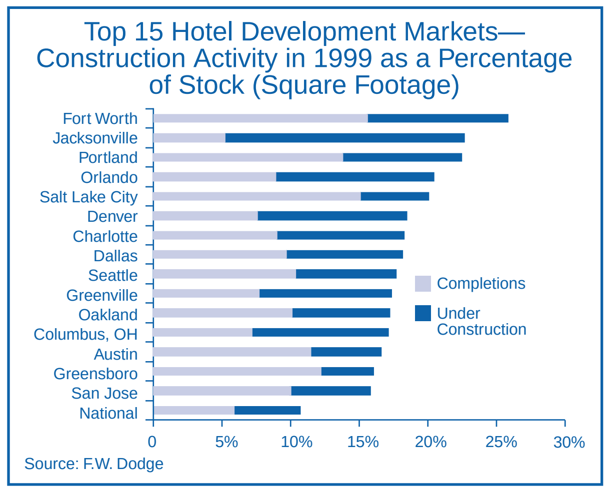
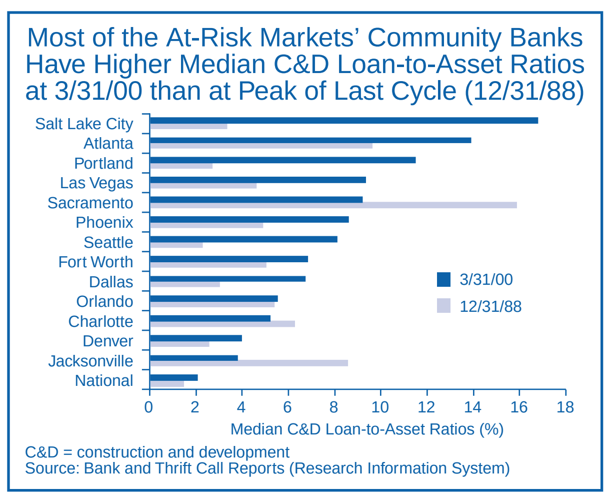


CHART 7



cent of its nonfarm workforce employed in construction, **Las Vegas** has the highest construction-concentrated workforce of all metropolitan areas in the United States and is slightly over twice the national rate of 4.8 percent.

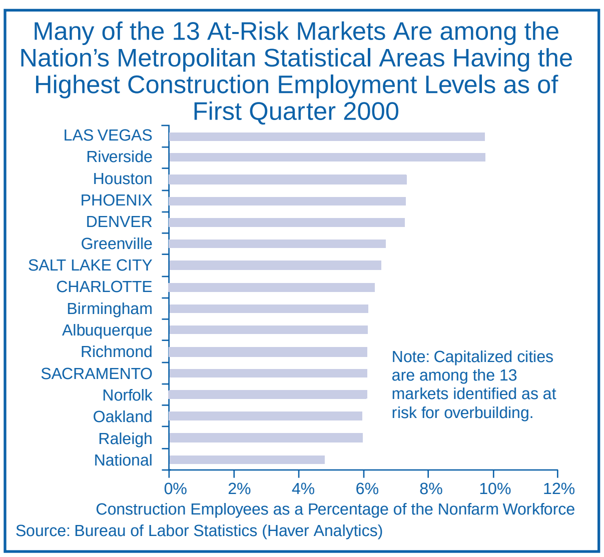
High Construction Activity and High Vacancy Levels

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



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

CHART 9

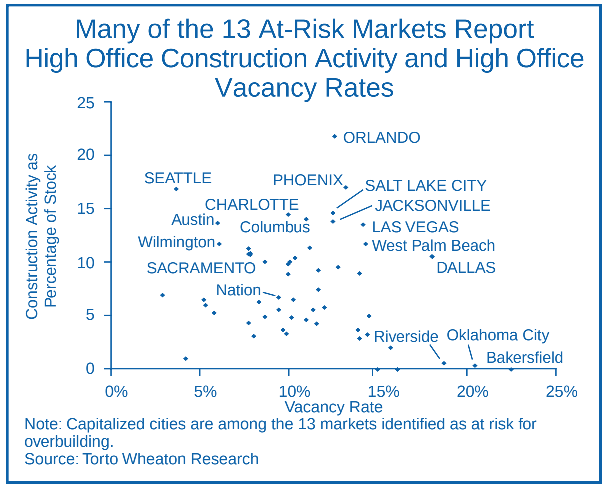


CHART 10

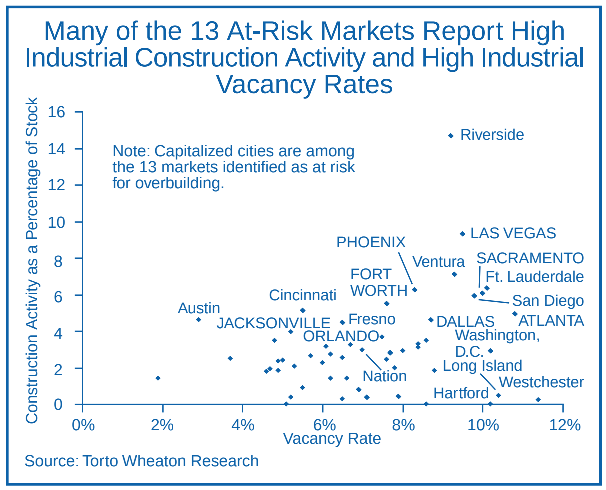
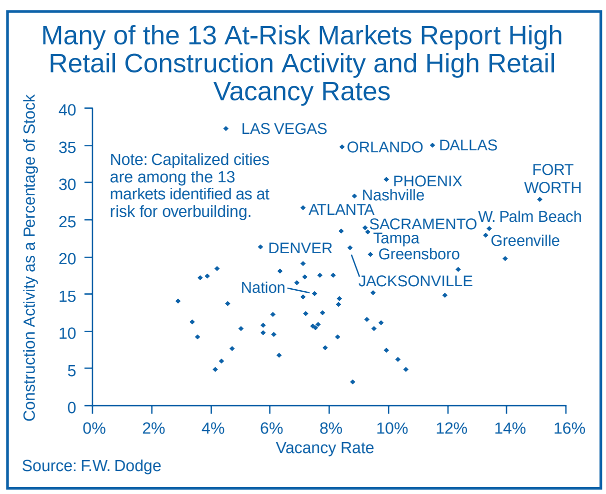


CHART 11



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]

[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.*

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]

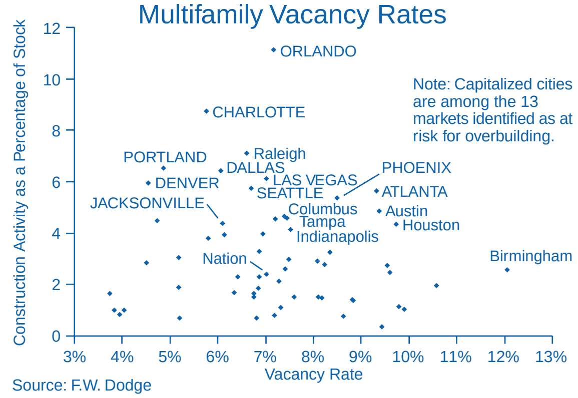
Hotel

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.

[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.*

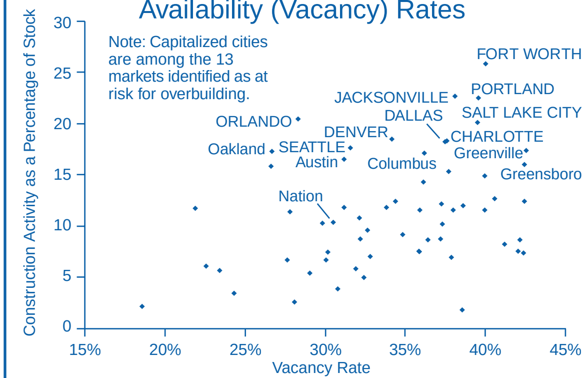
CHART 12



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

Source: F.W. Dodge

CHART 13



Many of the 13 At-Risk Markets Report High Hotel Construction Activity and High Room Availability (Vacancy) Rates

Source: F.W. Dodge

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.

Thomas A. Murray, Senior Financial Analyst

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

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

Introduction

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

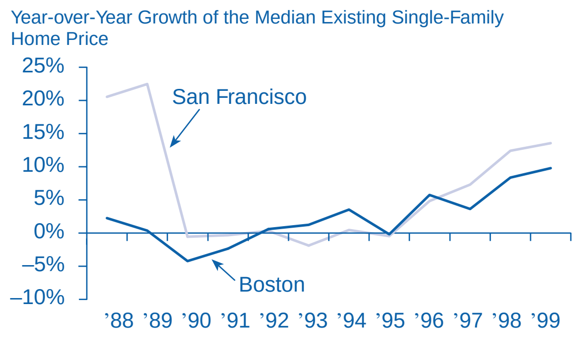
Home Prices in Some Local Markets Are Soaring

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]

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

Favorable Economic Conditions Have Sustained Consumer Spending Patterns

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

[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.*

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

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

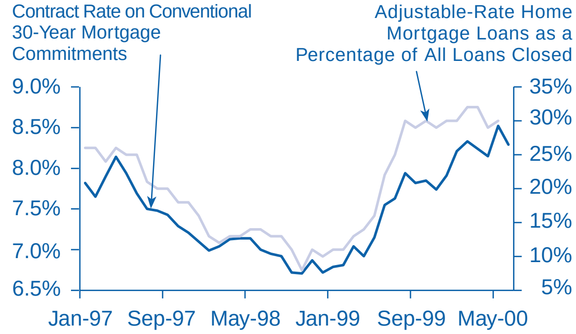
Nonetheless, as interest rates have risen, overall activity in the single-family housing market has slowed noticeably. After reaching an annualized rate of 1.4 million units in December 1999, monthly starts of single-family homes have declined by more than 15 percent to 1.2 million units in June 2000. Similarly, the annualized rate of single-family permits issued in June 2000 was down 14 percent from January 2000 levels. The ***National Association of Realtors (NAR)*** reports that, despite current high levels of activity, deteriorating affordability conditions are expected to slow the resale housing market over the course of the year.[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]

CHART 2

More Consumers Have Chosen ARMs as Mortgage Rates Have Risen



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

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).

[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.

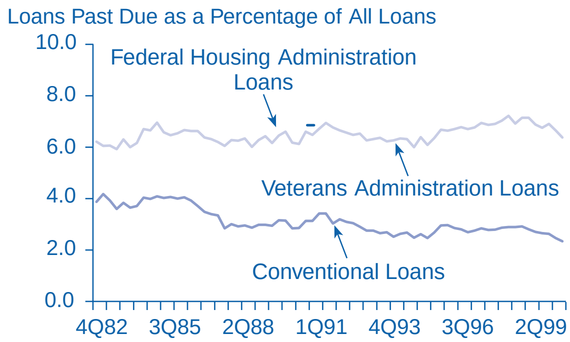
[5] "Past due" refers to loans that are 30 or more days past due.

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

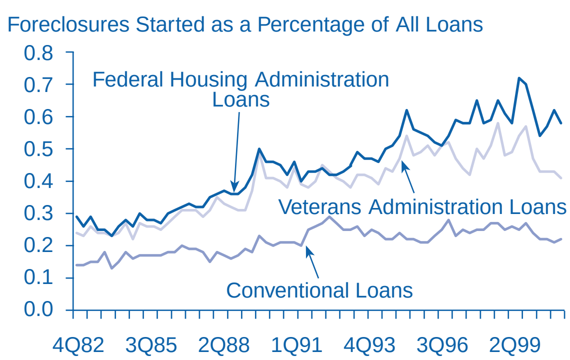
Past-Due Rates on FHA and VA Loans Have Historically Been Higher than on Conventional Loans



Source: Mortgage Bankers Association (Haver Analytics)

CHART 4

Foreclosure Rates on FHA and VA Loans Remain Higher than on Conventional Loans



Source: Mortgage Bankers Association (Haver Analytics)

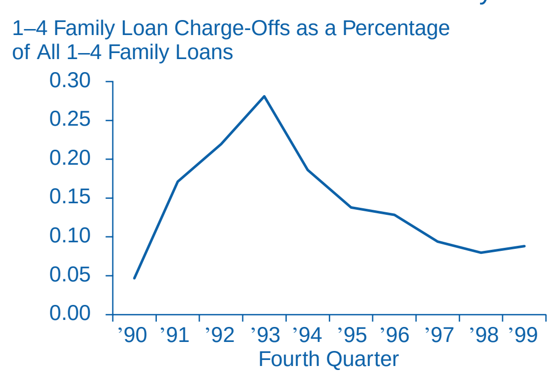
A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving submarket residential real estate problems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

1–4 Family Loan Charge-Offs May Have Reached the Bottom of the Credit Cycle



Source: Bank and Thrift Call Report Data (Research Information System)

[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.

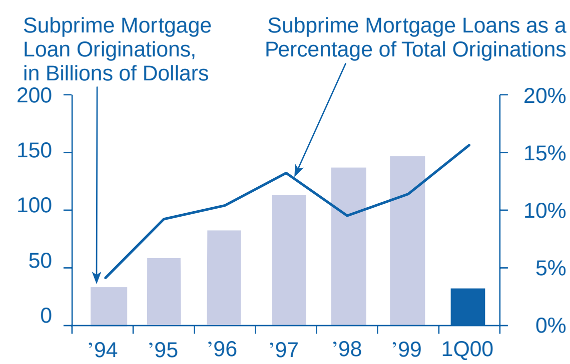
lending activities to limit projected losses.[10] In some cases, excessive losses related to the business of underwriting subprime loans have contributed to the failure of insured institutions.

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

Subprime Mortgage Loans Are Growing as a Percentage of Total Mortgage Originations



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

Conclusion

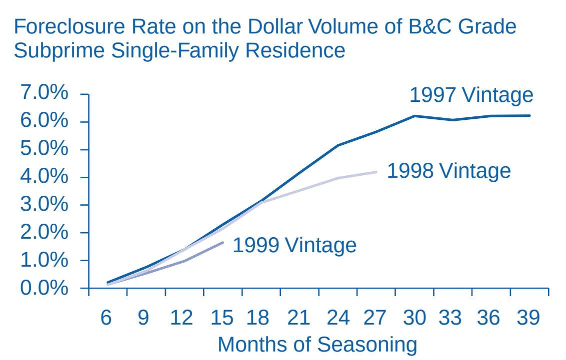
Rising home prices in some U.S. metropolitan areas may be a warning sign that asset price bubbles may be forming in some areas. A number of these areas also contain concentrations of employment in the high-tech sector, placing them at higher risk in the event of a downturn in that sector. Mortgage lenders 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

1999 Vintage Subprime Residential Loans Have Outperformed Earlier Vintages



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.

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