Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — THIRD QUARTER 2000

FDIC MEMPHIS REGION

Regional Perspectives

◆ *Overview of Economic and Banking Conditions*—**Memphis Region employment growth continues to lag that of the nation. Employment growth has been driven by gains in the construction and service sectors as well as in Kentucky's automobile industry. Job growth in the Region's automobile sector may slow, however, as the potential for a slackening economy, higher interest rates, and high gasoline prices point to a potential slowing of automobile sales. Bank performance was largely unchanged in the first quarter of 2000, but earnings pressures remain.** *See page 3.*

◆ *The Level of Risk in Construction Lending May Rise with Interest Rates*—**Although overall construction activity in the Region remains fairly robust by historical standards, development is slowing as interest rates have risen and demand has begun to wane. Even as construction activity moderates, many banks and thrifts in the Memphis Region continue to aggressively grow construction loan portfolios.** *See page 7.*

By the Memphis 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 13.*

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 21.*

By Alan Deaton, Financial Economist

DIVISION OF INSURANCE

GARY L. BEASLEY, REGIONAL MANAGER

HARRY W. JOHN, REGIONAL ECONOMIST

ROBERT L. BURNS, SENIOR FINANCIAL ANALYST

F. MIGUEL HASTY, FINANCIAL ANALYST

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 Memphis Region's ***Regional Outlook,*** please call Gary Beasley at (901)821-5234 or send an e-mail to *gbeasley@fdic.gov.*

Chairman	Donna Tanoue
Director, Division of Insurance	Arthur J. Murton
Executive Editor	George E. French
Writer/Editor	Kim E. Lowry
Editors	Lynn A. Nejezchleb Maureen E. Sweeney Richard A. Brown Ronald L. Spieker
Publications Manager	Teresa J. Franks

Overview of Economic and Banking Conditions

- **Although the Region's employment growth lags the nation's, overall economic conditions remain positive.**
- **Arkansas and Kentucky continue to benefit from strong construction and service-sector job growth; Louisiana struggles because of stagnant oil and gas industry employment.**
- **Pressures on bank and thrift net interest margins abated in the first quarter of 2000 but are likely to resume with weakening loan demand, a compression of spreads between short- and long-term interest rates, and balance sheet repricing.**

The past 15 months have been marked by the efforts of the Federal Reserve to slow economic growth and combat inflationary pressures by raising short-term interest rates. Conditions at midyear 2000 suggest that while growth and inflationary concerns may have moderated, the national economy remains strong. Although the effects of recent rate increases may not yet be completely realized at either the national or regional level, additional rate hikes appear likely. The outlook for the Region's economy, as a result, is continued slow growth as specific sectors continue to adjust to the higher interest rate environment.

Memphis Region Employment Growth Improves Slightly

Economic performance in the Memphis Region, as measured by payroll employment, edged up at the end of second quarter 2000. The Region's payroll employment rose 1.7 percent compared with 1.4 percent for the same period in 1999 (see Table 1). Although the Region's job growth continues to lag the nation's, employment conditions remain strong by historical standards. At the end of the second quarter of 2000, the Region's average unemployment rate was a low 4.5 percent.

Table 1

Memphis Region Employment Growth Increases Slightly		
	2Q99	2Q00
Arkansas	1.6	2.8
Kentucky	2.6	2.4
Louisiana	–0.2	1.1
Mississippi	2.1	0.3
Tennessee	1.3	1.9
Region	1.4	1.7
Nation	2.3	2.4

Source: Bureau of Labor Statistics

The service sector, the largest and fastest-growing segment of the Region's economy, continued to add jobs. Year-over-year job growth in this sector was unchanged at 2.4 percent at the end of second quarter 2000 compared with 2.4 percent over the same period last year. Gains in professional service jobs led the growth.

By contrast, employment growth in the Region's retail sector is slowing. Year-over-year retail job growth in the first half of 2000 rose 1.1 percent compared with 1.9 percent during the same period a year ago. Consumer spending, which has fueled one of the longest economic expansions in the nation's history, appears to be slowing in response to rising interest rates. In addition to increasing the real cost of borrowing, higher interest rates could adversely affect stock market performance, leading to weaker consumer confidence and a decline in consumer spending, which could weaken retail sales.

Arkansas and Kentucky Report Strong Growth

Although the Region as a whole reported little change, job formation in **Arkansas** and **Kentucky** was strong. Employment growth in these two states exceeded averages in the Region and the nation, benefiting from strong construction and service sector growth.

Many areas in the nation reported slowing construction, but Arkansas's year-over-year construction job growth rose sharply, boosted by strong residential construction and numerous infrastructure projects, particularly highway improvements. Also, the state's retail job growth was the highest in the Region, with residential construction activity fueling demand for retail sales of appliances, furniture, and other household goods.

In addition to construction and service sector growth, Kentucky benefited from gains in automobile industry employment. In 1999, employment in the state's automobile industry grew by more than 12 percent, adding over a full percentage point to the manufacturing sector's employment growth. Employment gains in automobile manufacturing continued into the first half of 2000 but may have peaked as the potential for a slackening economy, higher interest rates, and high gasoline prices point to slowing automobile sales (see page 5).

Louisiana's Labor Markets Continue to Languish

Louisiana's economy is constrained by exposure to retrenchment occurring in the oil and gas industry. Despite a sharp upturn in oil prices since early 1999, employment growth in Louisiana's energy sector has remained flat (see Chart 1).

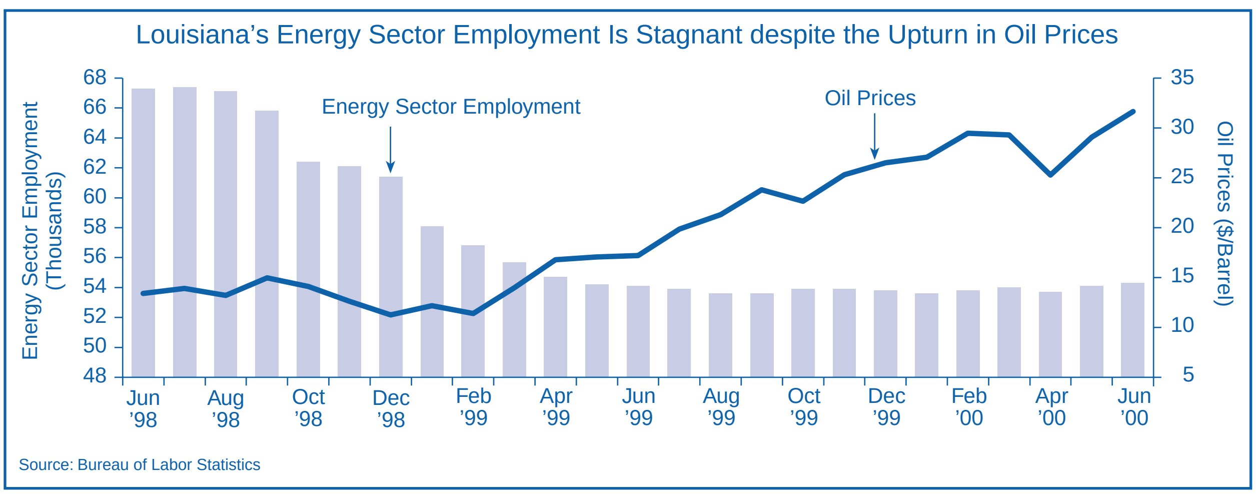
When oil prices dropped in 1998, many energy companies laid off workers in an effort to reduce operating expenses. The number of operating oil rigs dropped sharply, reducing exploration and development payrolls in the sector while curtailing domestic production. In addition, many oil and gas companies reduced overhead expenses by curtailing administrative operations. Shell, Chevron, and Texaco announced administrative staff reductions in **New Orleans** in 1998 and early 1999. While most of these administrative job losses occurred in New Orleans, many smaller oil companies and oilfield service companies in **Lafayette** and in the **Acadiana** area also reduced payrolls. Further energy sector job losses occurred with consolidation in the industry. Amoco, for example, closed its New Orleans office after being acquired by British Petroleum.

Despite the rebound in prices and concurrent increase in the number of operating oil rigs in 1999 and 2000, the recovery in exploration and development jobs has been offset by continued losses of administrative jobs. Although gasoline prices are currently high and will likely be high in the near future, oil industry employment may continue to decline[1] as cost-cutting and consolidation in the industry continue. As a result, weakness in the oil and gas sector will likely continue to hamper Louisiana's employment growth.

Banks and Thrifts Report Stable Earnings Performance, but Margin Pressures Are Likely to Resume

Aggregate earnings performance at the Region's banks and thrifts in the first quarter of 2000 changed little from the prior year. Net interest margins (NIMs), which had fallen steadily over the prior two years, improved slightly in the first quarter of 2000, as did returns on assets.

CHART 1



[1] According to John S. Herold Inc., an energy consulting firm, oil industry employment is expected to decline 6 percent each year through 2008.

Automobile Sector Outlook Dims

The automobile-manufacturing sector is a major contributor to the Memphis Region's economy. Kentucky and **Tennessee** are ranked fifth and sixth, respectively, in the nation in total motor vehicle employment. Major automobile producers such as Ford, Nissan, Saturn, and Toyota as well as numerous parts suppliers are located in these two states. Direct employment in the automobile sector totals 73,000, with 1,400 new jobs added in 1999 on strong automobile sales. Double-digit automobile sales growth may be vulnerable, however, as demand is likely to weaken as a result of rising interest rates, high gasoline prices, and a slackening national economy.

Light trucks have grown in importance. Sales of light trucks, which include trucks, minivans, and sports utility vehicles (SUVs), eclipsed those of passenger cars in the 1990s as consumer buying preferences changed. Low interest rates and falling gasoline prices throughout most of the late 1990s allowed automobile buyers to indulge their tastes for larger vehicles. Strong demand for SUVs in particular helped to offset sometimes sluggish car sales. At Ford, for example, SUVs represented almost 20 percent of all vehicles sold in 1999, up from just 5 percent in 1990.

The trend to light trucks is strongly evidenced in the Region's automobile production. The Ford plant in **Louisville,** Kentucky, produces trucks and Explorer SUVs. It also is the only production facility for Ford's largest SUV, the Excursion. Nissan began production of its SUV, the Xterra, at its **Smyrna,** Tennessee, plant in 1999. Saturn is currently retooling its **Spring Hill,** Tennessee, plant to begin production of an SUV in 2001.

Because of the high profit margins for light trucks, competition in this market segment, as well as in the automobile industry in general, is growing. Chrysler, Ford, and General Motors (GM) lost nearly 3 percent of the domestic market to foreign competitors in 1999 and are expected to lose more with the announcements by foreign automobile manufacturers of new domestic capital investments totaling over $2 billion. Foreign automobile manufacturers are expected to flood the U.S. market with more than 500,000 more minivans, trucks, and SUVs annually over the next three years. This increased production by foreign manufacturers at a time of potentially waning consumer demand could result in a domestic oversupply and may eventually lead to layoffs in the sector.

Automobile sales are slowing. National automobile production and sales have been increasing over the past four years but are now slowing. In May 2000, total sales of U.S. cars and light trucks declined by 2 percent from the previous year, the first drop since August 1998.[2] In response, automobile producers have reduced production slightly from 1999's record pace to minimize growing inventories. Even so, Chrysler, Ford, and GM have reported higher truck inventories. As previously discussed, the recent popularity of trucks, SUVs, and minivans is strengthening competition in this market segment, with light truck production projected to expand in the second half of 2000.[3]

Some regional producers continue to transition to new products. Nissan Motor Corporation struggled throughout the 1990s, but sales are improving with the introduction of the new SUV Xterra in 1999, produced at its Smyrna, Tennessee, plant. Nissan also revealed plans to build a new full-size truck at the plant and expand current production facilities. In an attempt to diversify its product mix and penetrate the SUV market, Saturn and parent company GM are investing $1.5 billion in the production of a new SUV in 2001. The retooling for SUV production at a time when SUV sales could be hampered by interest rate hikes, high fuel prices, and more intense competition may present additional challenges for the company.

Conclusion. While the automobile sector remains healthy, initial signs of weakening have emerged. Analysts suggest that higher interest rates could slow vehicle demand with a 6- to 12-month lag, and that such effects could be felt next year.[4] The effects on automobile producers in the Memphis Region may be more pronounced because of exposure in the light truck market segment, particularly SUVs. Higher gasoline prices could hurt SUV sales because they are much less fuel efficient than smaller vehicles. In addition, higher interest rates could disproportionately affect SUV sales because of these vehicles' higher purchase price. Ford recently announced a 25 percent reduction in production of its largest SUV, the Excursion, through 2001 in the face of intense competition and lower than expected consumer demand.

Harry W. John, Regional Economist
Nicole Janda, Research Assistant

[2] The decline in 1998 was largely attributable to a strike by GM autoworkers, resulting in revenue losses of over $3 billion and almost eight weeks of halted production. The strike affected over 200,000 workers and thousands of independent parts suppliers and resulted in a decline of domestic production for the second and third quarters of 1998.

[3] Phillippi, Joseph. July 17, 2000. *Auto Trends.* Paine Webber Research Note.

[4] JP Morgan. May 19, 2000. *Monthly Auto Review: May Industry Update.*

One factor contributing to the recent improvement in NIMs is the acceleration in the long-term trend of rising loan-to-asset levels (see Table 2). NIMs typically increase as banks and thrifts shift assets from securities portfolios and other asset categories to loans, which often offer higher yields. While loan-to-asset levels have climbed steadily at the Region's insured financial institutions since the mid-1990s, the increase from the first quarter of 1999 to the first quarter of 2000 was particularly sharp. Even within loan portfolios, recent growth has been concentrated in construction and commercial real estate loans. Despite the shift toward higher-yielding, and traditionally higher-risk, assets in recent quarters, NIMs have declined or have shown only slight improvement. With loan demand reportedly softening,[5] insured financial institutions may find generating additional loan growth increasingly difficult. Further shifts into loans during a period of softening demand could reduce yields because of rising competition or a loosening of credit standards.

Another factor that benefited NIMs in recent quarters was a widening of yield curve spreads. Banks and thrifts in the Memphis Region, like insured financial institutions nationwide, have historically reported improved NIMs during periods of widening yield curve spreads and declining NIMs during periods of narrowing spreads. The spread between one-year and ten-year Treasury bonds extended from 20 basis points at the beginning of 1999 to 80 basis points by midyear 1999. However, in the first half of 2000, spreads narrowed again. At the end of May 2000, the spread between the one-year and ten-year Treasury bonds was only 11 basis points. As a result, bank NIMs may again be pressured from the effects of a flat yield curve.

Margins also may be compressed as balance sheets reprice to the current rate environment. Banks and thrifts in the Region remain liability sensitive; in other words, liabilities are likely to reprice more rapidly than assets. As a result, all other things being equal, rising interest rates can be expected to affect NIMs adversely. The ***Memphis Regional Outlook,*** first quarter 2000, described how changes in balance sheet composition during the late 1990s, primarily a lengthening of asset maturities and greater reliance on wholesale funding sources, may have contributed to an even greater sensitivity of community bank earnings to rising interest rates.

Table 2

Aggregate Memphis Region Earnings Performance Changes Little despite Growth in Loan Portfolio

	1Q00	1Q99
Return on Assets	1.20	1.21
Net Interest Margin	4.13	4.07
Loans/Assets	65.3	61.9

Source: Banks and Thrift Call Reports

Noninterest Income Sources for Insured Financial Institutions Also Are Affected by Interest Rate Changes

In addition to pressuring NIMs, recent rate changes may affect noninterest income adversely at many insured financial institutions. While the growing importance of fee income represents some level of diversification of revenue sources, many of these fees, like NIMs, are responsive to changes in interest rates or other financial markets. Large segments of noninterest income are generated by mortgage banking, investment banking, and retail brokerage activity, which remain sensitive to volatile financial markets. Mortgage banking, in particular, is affected by interest rate changes.

Earnings at the Region's large banks, those with assets of $1 billion or more, have been affected by swings in noninterest income levels in 2000 because of financial market volatility. These large institutions reported considerable growth in noninterest income sources throughout the 1990s. In the first quarter of 2000, however, noninterest income levels at these institutions dropped as a share of gross revenue.[6] Higher rates since June 1999 have led to significant reductions in mortgage loan originations and related fee income at many financial institutions. One highly publicized example was First Tennessee National Corporation. In the first quarter of 2000, the company announced lower than expected quarterly earnings and warned of lower year-end results because of the negative effect of rising interest rates on the company's mortgage operations.

Robert L. Burns, Senior Financial Analyst
Harry W. John, Regional Economist
F. Miguel Hasty, Financial Analyst

[5] As noted in recent Federal Reserve Board *Senior Loan Officer Opinion Survey on Bank Lending Practices* and Beige Book reports.

[6] Gross revenue is defined as net interest income and noninterest income. Noninterest income as share of gross revenue fell to 34.3 percent in the first quarter of 2000 from 36.6 percent a year earlier.

Risk in Construction Lending May Rise with Interest Rates

- **Residential real estate activity is slowing in the nation and the Region. Recent trends in home price appreciation suggest some weakening in the Region's housing markets relative to the nation's.**

- **Commercial real estate markets in the Region remain active, but the pace of new construction is moderating. Vacancy rates in some market segments are rising.**

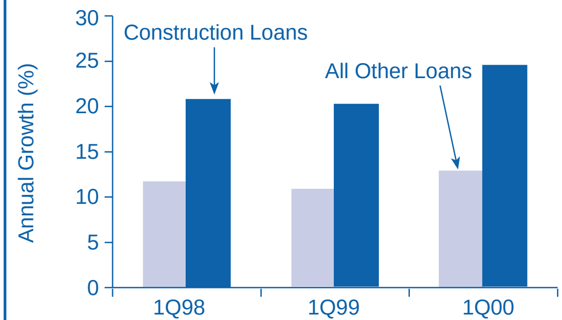
- **Construction and development lending exposure at insured financial institutions is growing rapidly. With demand moderating for both commercial and residential properties, construction loan credit quality may weaken.**

Real estate markets in the Memphis Region are in transition. Population and employment growth and increasing income and wealth levels, along with low interest rates, contributed to booming residential development in the late 1990s. Likewise, a strong economy and expanding labor markets fueled growth in commercial real estate. Although overall construction activity in the Region remains fairly robust by historical standards, development is slowing as interest rates have risen and demand for homes is waning.

Even as activity moderates, many banks and thrifts in the Memphis Region continue to grow construction loan portfolios aggressively. Construction loans[7] constituted the fastest-growing segment of loan portfolios at community banks (those with total assets of less than $1 billion) over the preceding three years. During this period, strong annual loan portfolio growth, averaging 11.5 percent, has been eclipsed by a 21.5 percent annual increase in construction loan portfolios. Furthermore, growth in construction loans for the 12-month period ending March 31, 2000, a period including nine months of rising interest rates and slowing real estate development, was higher than in either of the two preceding years (see Chart 2).

CHART 2

Strong Construction Loan Growth Reported at Community Banks in the Memphis Region



Note: Community banks are those with less than $1 billion in total assets. Growth rates are calculated on a merger-adjusted basis.
Source: Bank Call Reports

Residential Markets Are Cooling

Nationally, housing markets and residential construction activity are slowing in response to rising interest rates. For the second quarter of 2000, the average loan commitment interest rate on a 30-year fixed-rate mortgage was 8.32 percent, up 110 basis points from the same period in 1999 and the highest level reported since the first quarter of 1995. With the sharp rise in mortgage interest rates, new home sales have dipped in recent months. In response, housing construction starts have declined even more sharply, reaching their lowest level in more than two years as of June 2000.[8] The volume of single-family housing permits, a leading indicator of housing construction, also fell in June for the fifth consecutive month.

Consistent with the nationwide slowdown in housing markets, single-family permits in the Memphis Region declined by 11.0 percent in the second quarter of 2000, compared with growth of 6.7 percent during the same

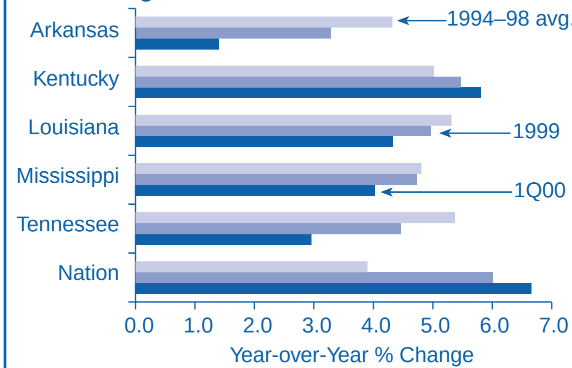
[7] As reported on bank call reports, construction loans include both residential and commercial development.

[8] Nationally, single-family housing starts in May dropped 5.4 percent from April and were 3.4 percent below levels reported in May 1999, according to the Bureau of the Census. Starts declined a further 3 percent in June and were 1 percent below levels reported in June 1999, the beginning of the current round of Federal Reserve interest rate hikes.

period in 1999. Single-family permits were lower in every state in the Region. **Mississippi** posted the largest reversal, as single-family permits fell by over 16 percent compared with growth of nearly 15 percent during the same period a year ago. Many of the Region's metropolitan areas are experiencing similar declines in real estate activity (see Table 3), in stark contrast to strong gains in permitting activity in 1999. While the decline in permitting is consistent with slowing home sales and growing inventories of unsold homes in many metropolitan areas, home construction activity in the mid-South remains strong by historical standards. To some extent the slowdown in activity reported in early 2000 represents a retreat from record levels reached in many parts of the Region in 1999 to lower but still high levels of construction.

CHART 3

Home Price Appreciation in Region, unlike the Nation, Slows



Source: Office of Federal Housing Enterprise

Home price appreciation in the Region moderated recently although it remained strong at the national level, suggesting weakening local markets compared with national conditions. Appreciation in median home sales prices has slowed dramatically in every state in the Region except Kentucky (see Chart 3). Home prices in the Region increased considerably faster than those in the nation from 1994 to 1998, but began to slow in 1999, even as appreciation escalated nationally. This divergence between the Region and the nation widened further in the first quarter of 2000. Trends in the Region may indicate some combination of overbuilding by developers, growing inventories of homes available for sale, or slowing demand.

Historically, residential real estate construction has been vulnerable to oversupply following periods of rapid expansion in the sector. With the long economic expansion and, until recently, strong growth in residential construction, many new developers, builders, and contractors were attracted to the residential sector. Some new market participants may have only limited experience and financial resources. Also, some experienced builders may have become overly reliant on previous market strength and may now be overextended on speculative developments. With rising interest rates and weakening demand, property buyers are likely to be more selective. Builders concentrated in specific price ranges, such as those involved in higher-priced speculative home construction or those concentrated in particular geographic areas, may be affected more adversely.

TABLE 3

Single-Family Building Permits in the Region Fall			
	2Q00	2Q99	Change (%)
Baton Rouge, LA	640	850	–24.7
Biloxi-Gulfport, MS	1,054	1,205	–12.5
Jackson, MS	1,100	1,355	–19.5
Lexington, KY	1,703	1,697	0.4
Little Rock, AR	1,178	1,184	–0.5
Louisville, KY	2,794	3,239	–13.7
Memphis, TN	3,338	4,089	–18.4
Nashville, TN	4,768	5,653	–15.7
New Orleans, LA	1,574	1,810	–13.0
Region	36,571	41,207	–11.3
United States	615,928	638,405	–3.5

Source: FDIC Real Estate Data System

As home sales in these market segments could slow dramatically, builders may find themselves with higher levels of unsold inventories and may have to absorb higher interest expenses to develop and carry the property. This situation would likely lead to concessions to induce sales, and prices could decline.

Commercial Construction Continues to Grow, albeit More Slowly

In contrast to a 4.2 percent decline in commercial construction starts nationally, Memphis Region commercial construction starts increased 2.2 percent in 1999, according to ***F.W. Dodge.*** Although this growth rate may appear modest, it builds upon a sharp 26.7 percent jump in commercial starts in 1998. In early 2000, the volume of planned commercial real estate projects in the Region continued to climb, suggesting the potential for increased development in the future. Growth in commercial real estate planning was concentrated in a few markets, primarily **Little Rock,** Louisville, and **Nashville.**

The ***Memphis Regional Outlook,*** first quarter 1999, discussed extensively the potential for supply and demand imbalances in specific metropolitan real estate markets in the Region. Concerns were raised about high development levels in Nashville and a potential short-term rise in vacancies in the Memphis industrial market. Since that issue was published, vacancy rates have climbed for Nashville's office, retail, and industrial market segments while the city's burgeoning hotel sector struggles with excess capacity. Memphis has reported rising industrial segment vacancy rates, but the longer-term outlook for the segment remains positive, given the city's expanding distribution industry. New Orleans has reported somewhat higher retail vacancy rates than in the past.

Commercial real estate markets are likely to face additional challenges as a result of changing economic conditions. The viability of commercial projects is a function of the cost of development, financing expenses, and obtainable rental income. Higher interest rates lead to higher financing expenses. Also, the potential for slowing national and regional economies could impair future rental income growth. As a result, new commercial developments may become less economically viable and lead to increased risk to lenders. For additional information on challenges facing commercial real estate, see the "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" article in this issue. Further discussion of the deterioration in Nashville's commercial real estate market can be found on page 12.

Exposure to Construction and Development Lending Rises

Construction lending represents a disproportionately large share of recent loan growth at Memphis Region community banks, accounting for almost 10 percent of loan growth over the preceding three years.[9] As a result, exposure levels at these banks have risen from an average of 2.8 percent of total assets[10] on March 31, 1997, to 4.0 percent on March 31, 2000, slightly above national levels.

Community banks are now more concentrated in construction and development lending than their larger counterparts. While large banks, those with more than $1 billion in total assets, have historically been involved heavily in construction lending, the average exposure of large banks at the end of first quarter 2000 is considerably lower than levels reported from 1985 to 1990 (see Chart 4, next page). In contrast, community banks are reporting much greater exposure to construction lending than in prior periods. Concentration levels reported by community banks at the end of the first quarter of 2000 are almost double those reported by these banks immediately prior to the 1990–91 recession.

Not surprisingly, exposure is highest among the 255 community banks headquartered in metropolitan areas (Table 4, next page). Construction loan portfolios at these banks, as at their large bank counterparts, likely include a mix of commercial and residential development. However, portfolios at metropolitan community

[9] Construction loans comprised an average 4.8 percent of total loans at Memphis Region community banks on March 31, 1997, while construction loan growth during the following three years comprised 9.4 percent of total loan growth. At many banks, particularly those in metropolitan areas, construction loan growth represented an even higher level of total loan growth.

[10] Construction loan exposure in this article is measured as a percentage of total assets. While overall loan portfolios also have grown as a percentage of total assets, construction loan exposure is rising sharply relative to both assets and loans. Average aggregate construction loan exposure at the Region's community banks grew from 4.7 percent of total loans on March 31, 1997, to 6.2 percent of total loans on March 31, 2000.

Table 4

Construction Exposure Is Greatest in Community Banks in MSAs		
	Construction loans as % of assets	
Banks	1Q90	1Q00
Large Banks	4.1	3.6
Community Banks	1.8	4.0
In MSA	2.6	5.7
Outside MSA	1.1	2.9

MSA=metropolitan statistical area
Source: Bank Call Reports

banks may contain higher inherent risk than portfolios at large banks, as community bank portfolios are often limited to one market and therefore may be less geographically diverse.

The number of banks reporting high levels of construction loan exposure has likewise increased. Among the Region's community banks headquartered in metropolitan areas, 116 banks, or 45 percent, report construction loan exposure equivalent to 5 percent or more of total assets. The only area of the nation with a higher share of metropolitan community banks reporting such high exposure levels is the West Coast. Furthermore, 47 of the Region's community banks headquartered in metropolitan areas reported construction loan exposure greater than 10 percent of total assets.

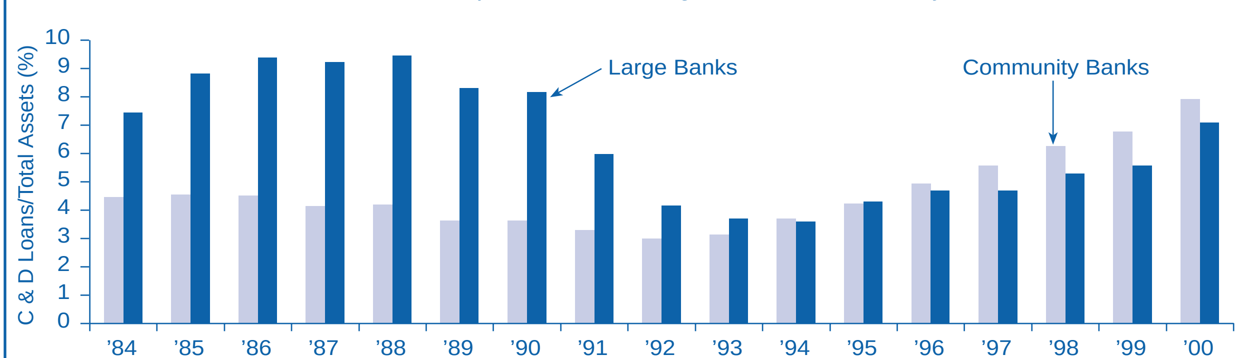
Among community banks in metropolitan areas, concentrations in construction and development loans are highest in institutions with less than $250 million in total assets. Some of these smaller institutions may not have the same level of employee resources as larger banks to oversee loan origination and loan administration functions should local real estate market conditions deteriorate. In addition, several of these small banks are recently chartered institutions that have yet to weather an economic downturn.

Banks in certain metropolitan areas have considerably greater exposure to changing real estate market conditions (see Table 5, page 11). Community banks in **Baton Rouge, Memphis,** and Nashville report average aggregate construction loan exposure well above the average for all metropolitan statistical areas in both the Region and nation. Aggregate exposure at banks headquartered in the Memphis metropolitan area is the third highest among all metropolitan areas nationwide, behind only Atlanta and Portland. Twelve banks headquartered in Memphis report construction loan exposure equivalent to 10 percent or more of total assets.

Reported Credit Quality Remains Strong, but Risks in Construction Lending Are Higher

Although slight deterioration has occurred recently, construction loan credit quality among the Region's banks remains favorable.[11] Also, construction credit underwrit-

Chart 4



C & D = construction and development
Source: Bank and Thrift Call Reports, first quarter data

[11] At the end of the first quarter of 2000, past-due construction loans represented 2.08 percent of total construction loans, up from 1.86 percent in the first quarter of 1999. Construction and development loan losses in recent years remain low but have steadily climbed from 0.04 percent of average construction loans in 1997 to 0.12 percent in 1999.

Table 5

Construction Loan Exposure Is High in Baton Rouge, Memphis, and Nashville

Location	Construction loans as % of assets		
	1Q98	1Q99	1Q00
MSAs Nationwide	3.8	4.3	5.0
MSAs Region-Wide	4.4	4.9	5.7
Baton Rouge, LA	3.2	5.2	9.0
Memphis, TN	8.0	10.1	12.3
Nashville, TN	6.3	7.6	8.9

MSA=metropolitan statistical area
Note: Community banks are those with less than $1 billion in total assets.
Source: Bank Call Reports

ing standards are considered stronger than in prior periods of robust real estate activity, such as that preceding the 1980s real estate crisis. One common theme for both periods, however, is intense competition among lenders in the Region. Construction loans typically represent an opportunity for higher yields than do many other traditional loan types, making them attractive for institutions seeking to bolster flagging net interest margins.

Construction lending also generally is considered the most complex and labor-intensive type of lending performed by most community banks and can represent the highest degree of risk. Prudent management must evaluate credit standards continuously and adjust to changing economic and market conditions. Management also must be prepared to anticipate changing conditions in order to manage risk exposure effectively. Although asset quality indicators remain strong, the high volume of recent construction loan originations and growing exposure at community banks during a period of generally slowing real estate markets are cause for some concern. Strong underwriting standards and portfolio administration practices need to be maintained to guard against the potential for weakening credit quality in the future.

Robert Burns, Senior Financial Analyst
Harry John, Regional Economist

Focus on Nashville's Commercial Real Estate Markets

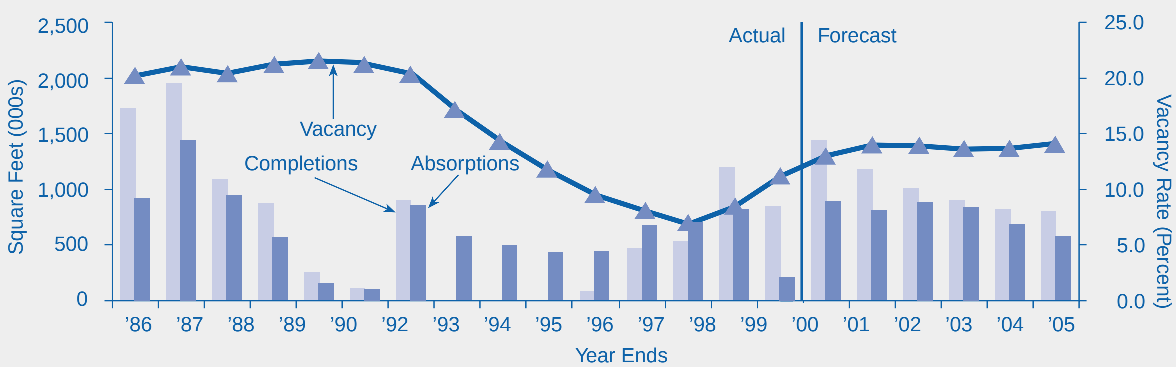
Although overall economic conditions remain positive, Nashville's employment growth has dropped sharply during the previous two years and is currently well below the national average. With a low 2.3 percent unemployment rate reported at the end of May 2000, labor market tightness is a primary factor constraining employment growth. Net in-migration has also slowed dramatically based on estimates by Regional Financial Associates, dropping from 18,300 in 1994 to an estimated 9,500 in 1999 as labor markets in surrounding areas have flourished, reducing incentives for migration to Nashville.

Despite a moderating economy, Nashville reported the highest level of commercial real estate construction starts in 1999 since the previous cyclical peak in 1988. Recent construction is driven by development in the office and retail sectors. With slowing office employment growth and considerable office completions in recent years, Nashville's office vacancy rate climbed from 6.9 percent in 1997, well below the national average, to 11.2 percent at year-end 1999, above the national average. A further vacancy rate increase is reported in ***CB Torto Wheaton's*** unaudited first quarter 2000 report to 12.7 percent. In addition to rising vacancies, Nashville reported a 2.7 percent decline in rent levels from 1998 to 1999. Even with rising vacancies and declining rents, high office construction activity is continuing.

Community bank exposure to commercial real estate markets has increased sharply in recent years. This is particularly true for construction and development lending, which now represents an average of 10 percent of total assets at community banks and thrifts headquartered in Nashville. During the 12-month period ended March 31, 2000, commercial real estate loans at area community banks and thrifts grew by 36 percent, compared with 14.7 percent growth in all other loan types.

Robert L.Burns, Senior Financial Analyst

Nashville Office: Completions, Absorptions, and Vacancy Rate



Source: Torto Wheaton Research

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.

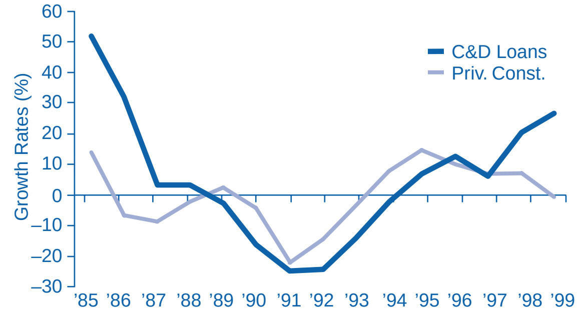
While the availability of market-based sources of capital has helped to facilitate growth in construction during this expansion, the financial market turmoil of late 1998 cast a cloud over the CMBS market that has yet to lift fully. Significant events in the global capital markets in 1997 and 1998, including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

[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

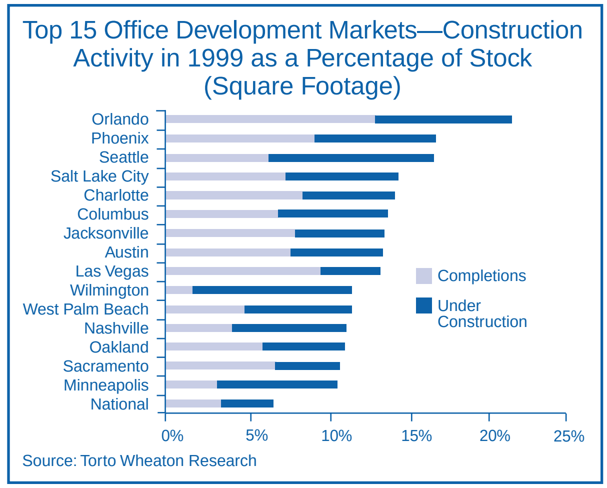


Chart 3

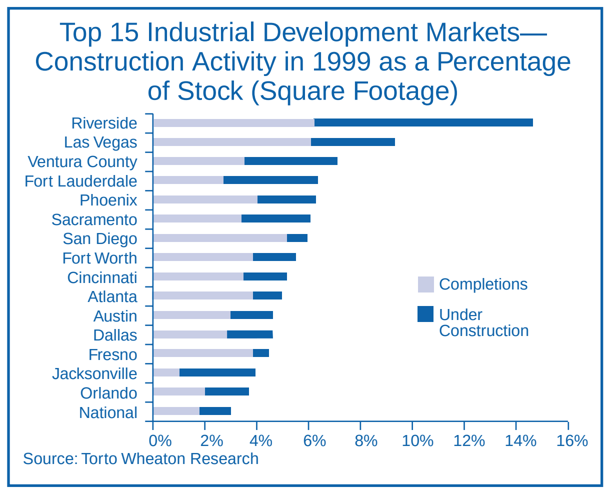
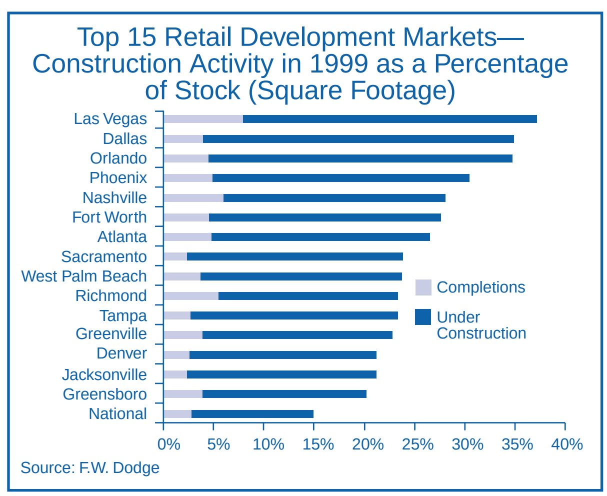


Chart 4



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-

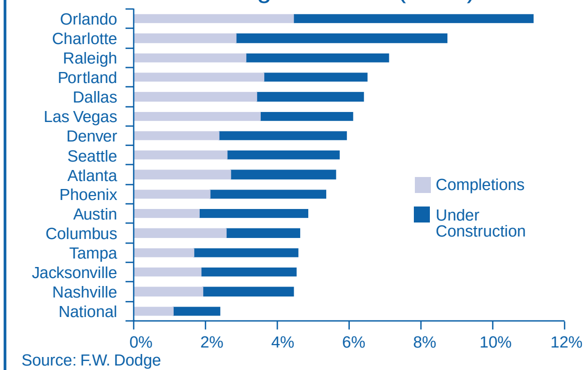
[11] Community banks are FDIC-insured institutions with assets less than $1 billion.

[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.

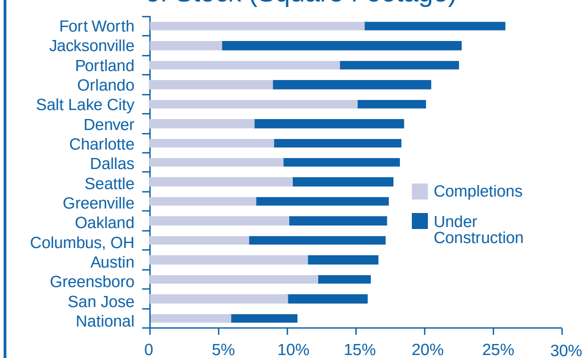
CHART 5



Top 15 Multifamily Development Markets— Construction Activity in 1999 as a Percentage of Stock (Units)

Source: F.W. Dodge

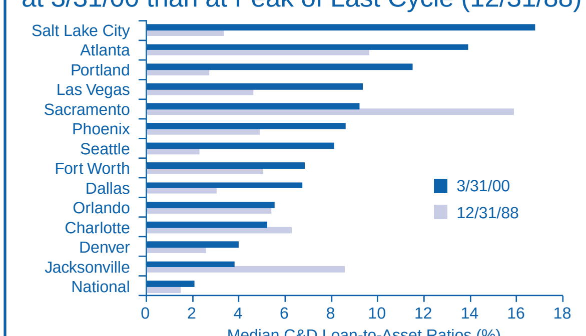
CHART 6



Top 15 Hotel Development Markets— Construction Activity in 1999 as a Percentage of Stock (Square Footage)

Source: F.W. Dodge

CHART 7



Most of the At-Risk Markets' Community Banks Have Higher Median C&D Loan-to-Asset Ratios at 3/31/00 than at Peak of Last Cycle (12/31/88)

C&D = construction and development
Source: Bank and Thrift Call Reports (Research Information System)

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

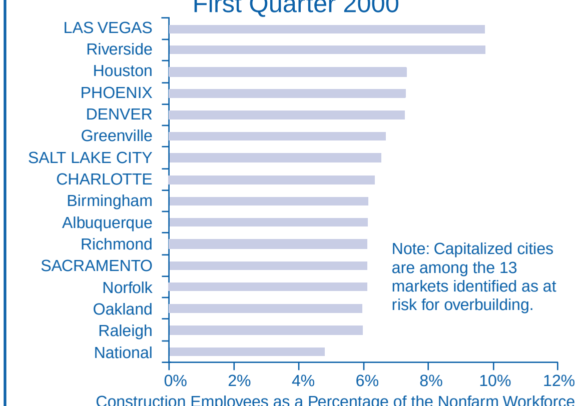
Newly constructed, speculative space competes directly for tenants against already-built and vacant space. To assess at-risk markets fully, it is useful to compare the levels of construction activity for each metropolitan area's property sector against its associated vacancy levels.[15]

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

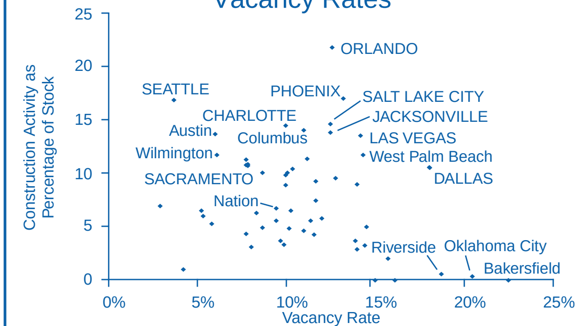
Many of the 13 At-Risk Markets Are among the Nation's Metropolitan Statistical Areas Having the Highest Construction Employment Levels as of First Quarter 2000



Source: Bureau of Labor Statistics (Haver Analytics)

CHART 9

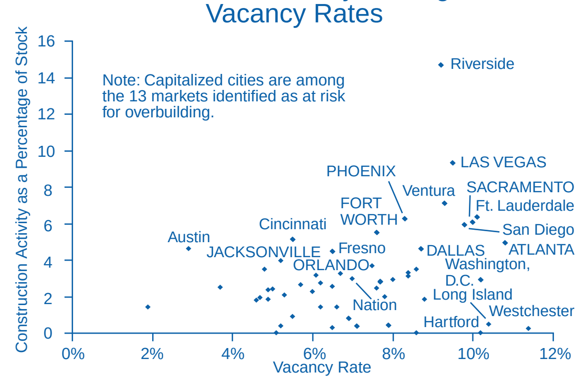
Many of the 13 At-Risk Markets Report High Office Construction Activity and High Office Vacancy Rates



Note: Capitalized cities are among the 13 markets identified as at risk for overbuilding.
Source: Torto Wheaton Research

CHART 10

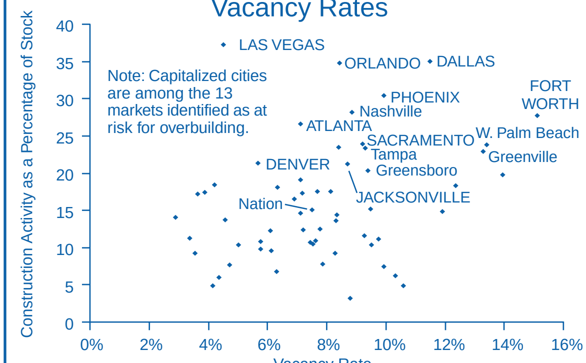
Many of the 13 At-Risk Markets Report High Industrial Construction Activity and High Industrial Vacancy Rates



Source: Torto Wheaton Research

CHART 11

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



Source: F.W. Dodge

[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]

[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

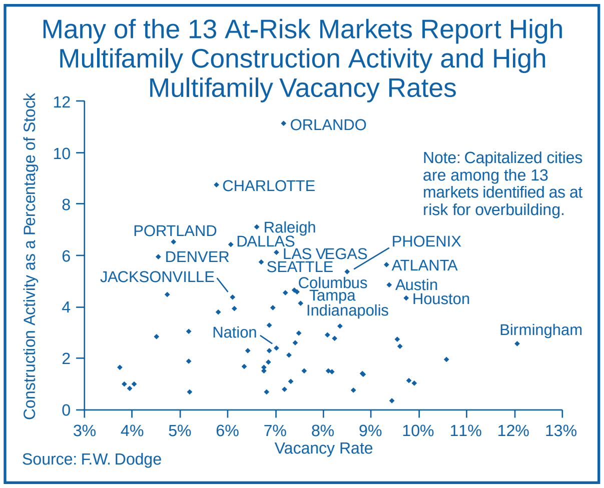
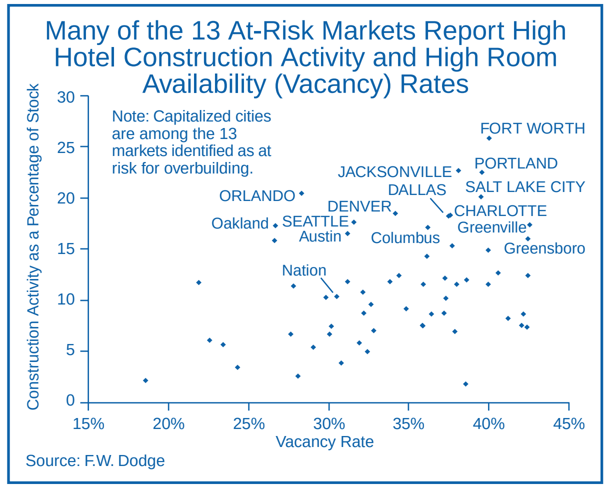


Chart 13



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.

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.

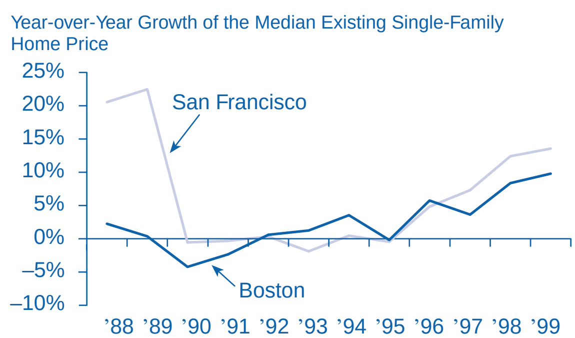
Home Prices in Some Local Markets Are Soaring

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).

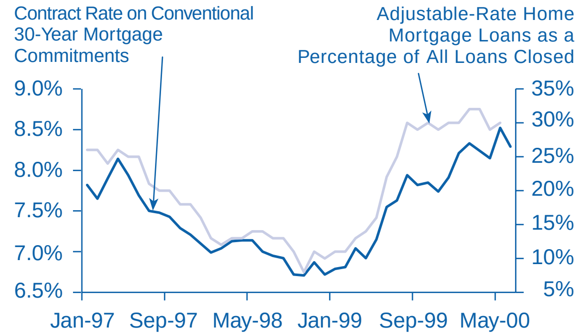
Nonetheless, as interest rates have risen, overall activity in the single-family housing market has slowed noticeably. After reaching an annualized rate of 1.4 million units in December 1999, monthly starts of single-family homes have declined by more than 15 percent to 1.2 million units in June 2000. 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

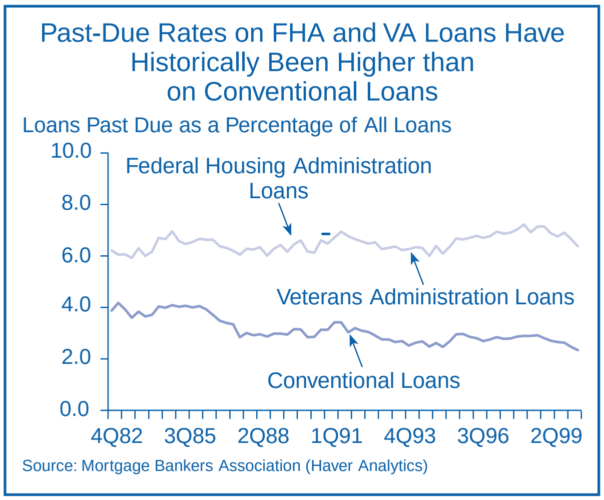
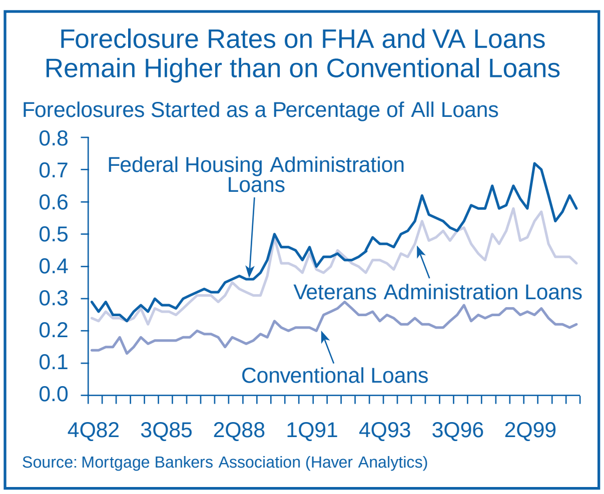


Chart 4

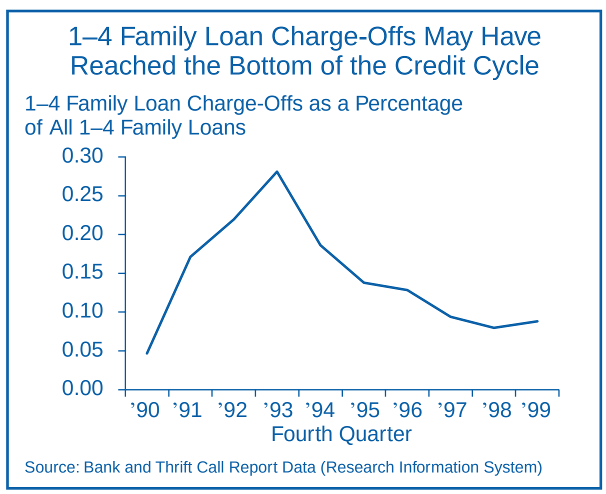


A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving submarket residential real estate problems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

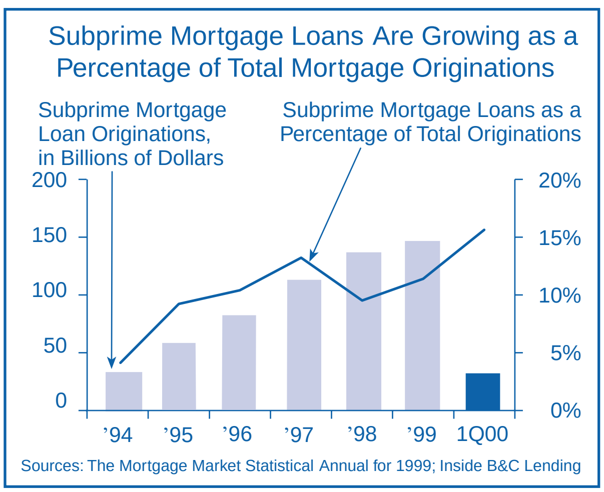
[9] See also Kathy R. Kalser and Debra L. Novak. **"Subprime Lending: A Time for Caution."** ***Regional Outlook,*** third quarter 1997; http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf.

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



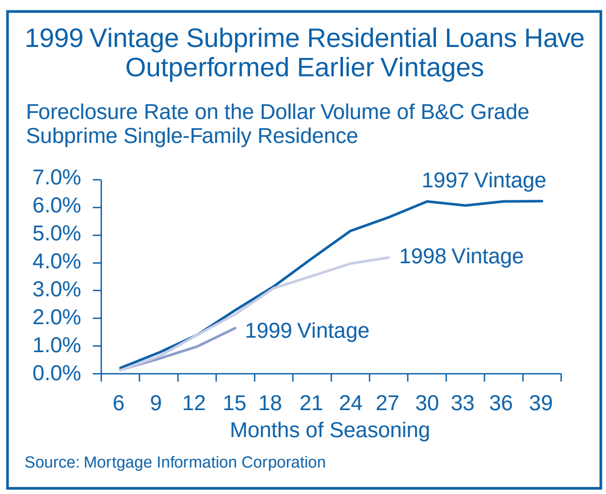
Conclusion

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



[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