Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FIRST QUARTER 1999

FDIC
NEW YORK
REGION

DIVISION OF
INSURANCE

KATHY R. KALSER,
REGIONAL MANAGER

NORMAN GERTNER,
REGIONAL ECONOMIST

KAREN A. WIGDER,
SENIOR FINANCIAL
ANALYST

ALEXANDER J.G.
GILCHRIST,
ECONOMIC ANALYST

In Focus This Quarter

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

By Diane Ellis

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

By Steven Burton

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

By Steven E. Cunningham, Ronald L. Spieker

Regional Perspectives

◆ ***Region's Economic and Banking Conditions***—**The Region's economy continues to expand at a moderate pace. Banks report healthy financial conditions, although most money center banks reported a decline in third-quarter performance because of turmoil in the global capital markets.** *See page 25.*

◆ ***Commercial Real Estate Markets Remain Healthy***—**Commercial real estate markets in the Region remain generally subdued compared with other markets across the nation. However, some areas are showing signs of increased activity. Philadelphia and Baltimore are experiencing heightened office construction; office rents are rising in Manhattan; and Wilmington's office market is tightening.** *See page 27.*

◆ ***Puerto Rico Recovers from Hurricane Georges***—**Hurricane Georges caused widespread devastation throughout Puerto Rico in September 1998. With federal aid, however, the island is rebuilding.** *See page 30.*

By Norman Gertner, Karen A. Wigder, Mark Otero

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation 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/publish/regout. For more information or to provide comments or suggestions about the New York Region's ***Regional Outlook,*** please call Kathy Kalser at (212) 704-1308 or send an e-mail to *kkalser@fdic.gov.*

Chairman	Donna Tanoue
Director, Division of Insurance	Arthur J. Murton
Executive Editor	George E. French
Editors	Lynn A. Nejezchleb Maureen E. Sweeney
Publications Manager	Teresa J. Franks

The National Edition of the Regional Outlook is now available

To the Reader:

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

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

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

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

Sincerely,

George French
Executive Editor

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

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

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

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

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

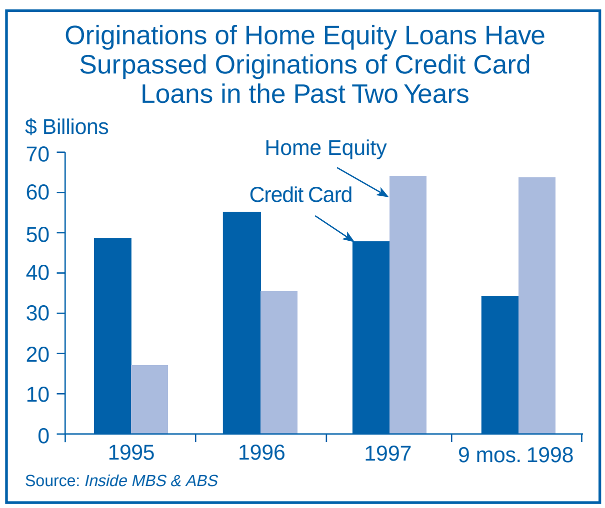
Just a few years ago, it would have been difficult to imagine a mainstream lender writing a home equity loan in excess of the equity that the consumer had in his or her home. However, intense competition and declining profit margins in traditional home equity lending have lenders looking to boost volume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

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

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

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

CHART 1



HLTV Loans Are Hybrid Loans

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

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

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

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

Typical HLTV Borrower Characteristics

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

Typical HLTV Loan Characteristics

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

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

Underwriting of HLTV Loans Emphasizes the Borrower's Credit Quality

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

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

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

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

TABLE 1

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

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

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

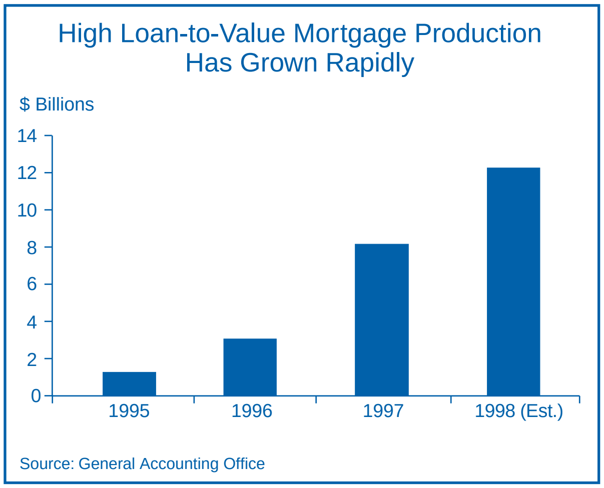
Whatever the label given to the quality of borrowers, they typically have a large amount of high-cost revolving debt, and converting this debt into a second lien on their home is an attractive alternative. They also might have some degree of poor credit performance. Table 1 shows the underwriting criteria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

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

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

Nonbank, specialty finance companies presently dominate the HLTV market, and their easy access to capital

CHART 2



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

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

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

Market Turmoil Hit HLTV Specialty Lenders Hard

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

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

HLTV Lending Presents Unique Risks to Home Equity Lenders

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

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

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

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

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

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

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

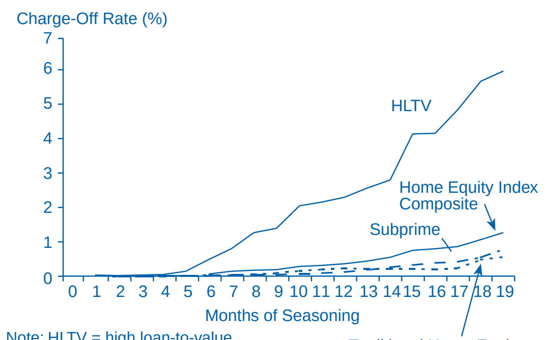
- **Long-term exposure.** Consumer loans typically have been made on a short-term basis; however, HLTV loans are made for terms up to 30 years. Therefore, the credit quality on an HLTV loan is more vulnerable to catastrophic events such as borrower job loss, illness, or divorce. Furthermore, the term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

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

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

CHART 3

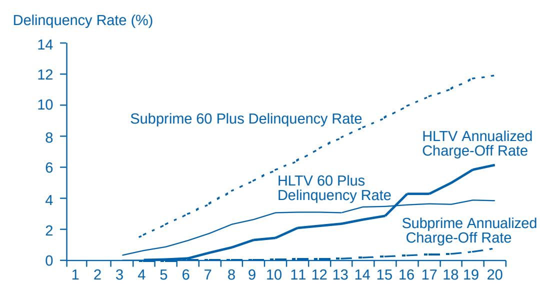
Charge-Offs Are Rising More Rapidly on HLTV Loans Than for Any Other Type of Home Equity Loan (1996 and 1997 Origination Years); ...



Note: HLTV = high loan-to-value
Source: Moody's Investor Services

CHART 4

...However, Delinquency Rates on HLTV Loans Are Lower Than on Subprime Loans Because Loans Are Charged Off Sooner (1996 and 1997 Origination Years)



Note: HLTV = high loan-to-value
Source: Moody's Investor Services

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

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

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

Insured Depository Institution Involvement in HLTV Lending Is Increasing

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

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

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

Insured Depository Institutions Are Subject to Real Estate Lending Standards

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

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

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

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

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

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

Conclusion

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

Diane Ellis, Senior Financial Analyst

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

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

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

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

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

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

Why Do Markets Become Overbuilt?

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

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

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

the failure to consider competitors' planned development activities.

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

Ranking the Risks of Overbuilding

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

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

Most Active Construction Markets

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

Comparing Construction Activity with Vacancy Rates

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

Chart 1

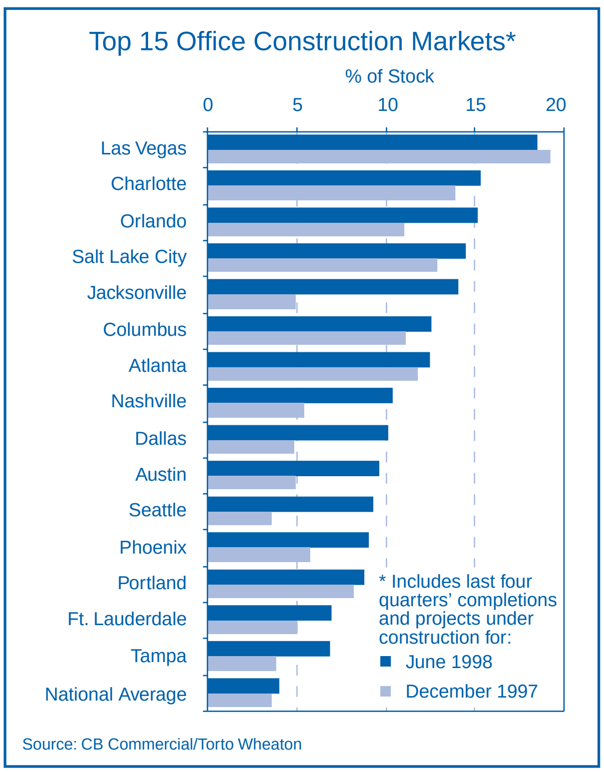


CHART 2

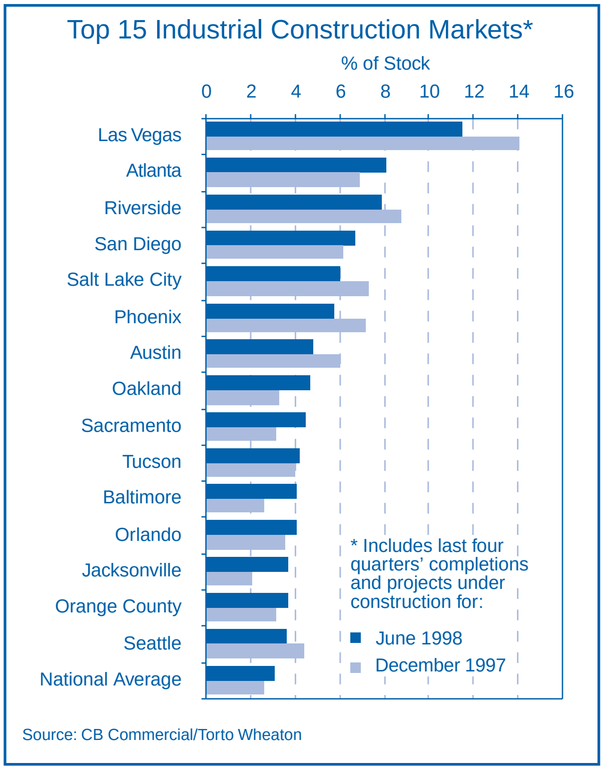


CHART 3

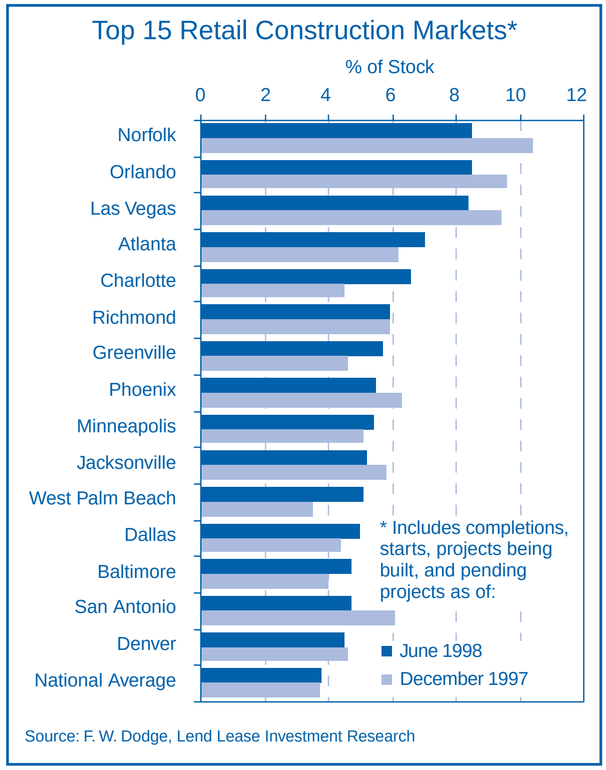


CHART 4

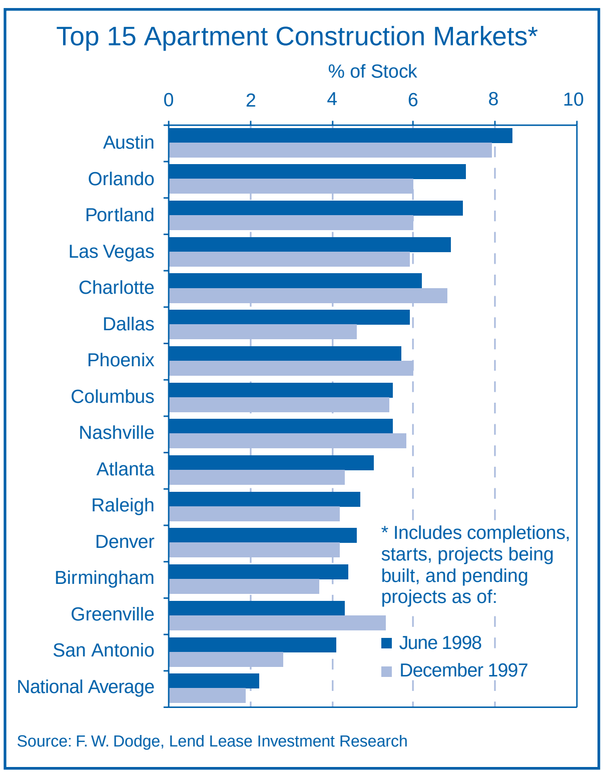


CHART 5

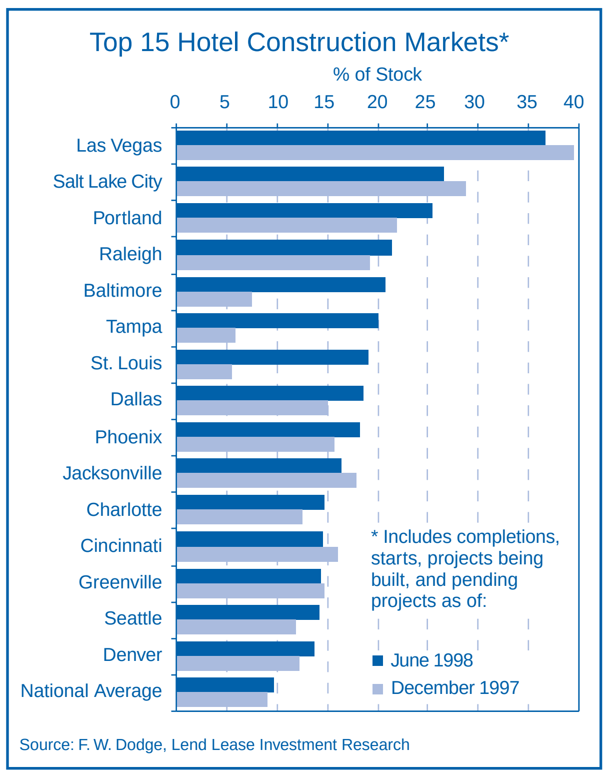


Chart 6

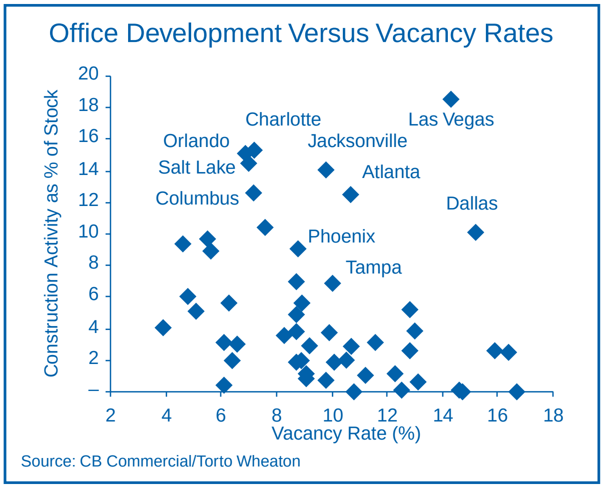
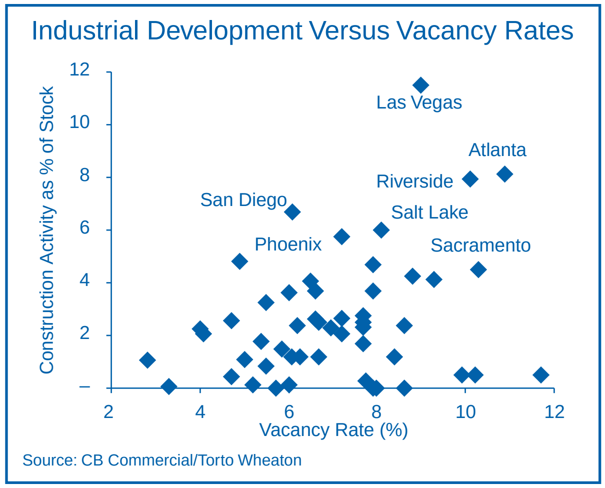


Chart 7



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

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

Analyst Outlooks for Commercial Real Estate Advocate Caution

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

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

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

[4] CB Commercial/Torto Wheaton Research, *The Office Outlook, The Industrial Outlook,* and *The Retail Outlook,* Fall 1998.

[5] Wheat First Union, *Industry Report: Quarterly Apartment Review,* October 21, 1998.

[6] Smith Travel Research, *Smith Travel Research Announces 1998 September and Third Quarter U.S. Lodging Industry Reports,* www.str-online.com/news/releasedir/pr981104_3rdgtr.html.

[7] F. W. Dodge, *Real Estate Analysis and Planning Service: 2nd Quarter 1998.*

[8] These markets are Salt Lake City, Columbus, Austin, Nashville, Charlotte, Orlando, Las Vegas, Baltimore, Atlanta, Dallas, Phoenix, Philadelphia, Indianapolis, Chicago, Sacramento, Miami, and Houston (Lehman Brothers, *Commercial REIT Research: Eye on Office Markets,* October 1998).

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

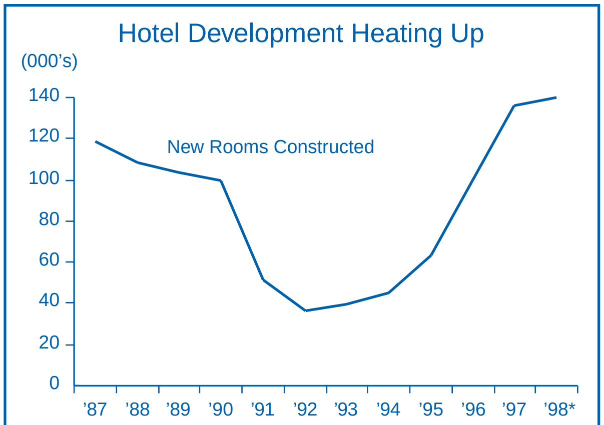
Economic Conditions May Temper Commercial Real Estate Demand

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

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

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

CHART 8



* September 1998 annualized
Source: Smith Travel Research

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

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

Markets Most Vulnerable to Overbuilding

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

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

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

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

Table 1

Markets Most Vulnerable to Overbuilding: Summary of Trends and Expectations

	1H97 to 1H98 Vacancy Rates	Construction Activity ('95 to 1H98)	Employment Growth Trends	Net-Migration Trends	Projected Vacancy Rate Trends
Las Vegas	↗	↗	↘	→	↗
Atlanta	↗	↗	↘	↘	↗
Nashville	↗	↗	↘	↘	↗
Salt Lake City	↗	↗	↘	↘	↗
Charlotte	→	↗	↘	→	↗
Portland	↗	↗	↘	↘	↗
Phoenix	↘	↗	↘	↘	↗
Dallas	↗	↗	↘	↗	↗
Orlando	→	↗	→	↗	↗

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

Las Vegas

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

Atlanta

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

Nashville

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

Salt Lake City

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

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

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

Charlotte

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

Portland

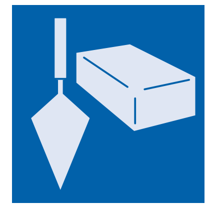
Portland has the third most active hotel and apartment development in the nation, with ratios of construction activity to current space of 25 percent and 7 percent, respectively. The area's office market is also expanding rapidly. Portland's development has been driven largely by in-migration and job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

Phoenix

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

Dallas

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



Orlando

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

Credit Availability Affects the Pace of Commercial Development

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

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

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

Summary

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

Steven Burton, Senior Banking Analyst

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

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

Recent Trends in Syndicated Lending

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

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

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

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

Syndicated Lending Overview

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

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

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

Competitive Trends in the Syndicated Loan Market

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

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

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

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

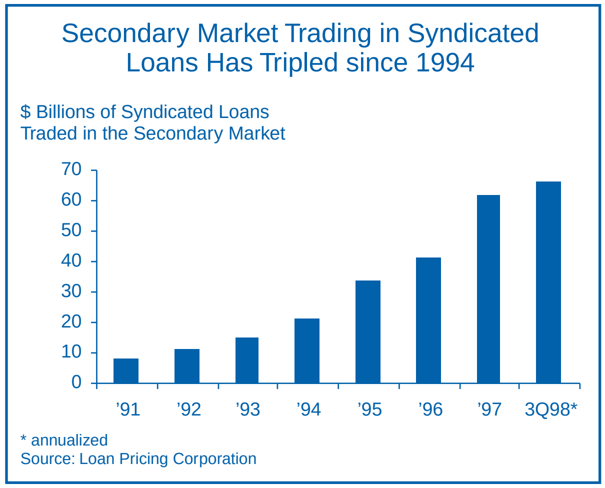
Syndicated Loan Liquidity

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

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

Independent credit ratings of bank loans were initiated in 1995 when "several years of rapid development in the syndicated bank loan market generated a critical mass of interest in the credit characteristics of these instruments."[6] ***Standard and Poor's, Moody's, Duff and Phelps,*** and ***Fitch/IBCA*** are now actively involved in rating bank loans. Through 1997, Standard and Poor's and Moody's combined rated $677 billion in loans. As rating activity increases access to and availability of standardized analysis and research for bank loans, including market analysis, ratings criteria, and historical loss recovery rates, investors are becoming more comfortable with loans as a distinct asset class. Moreover, independent loan ratings allow investors to value a company's loans relative to its other rated loans or bonds.

CHART 1



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

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

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

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

CHART 2

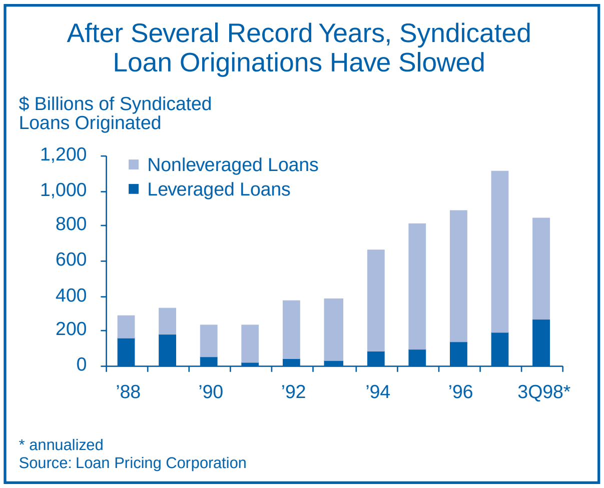
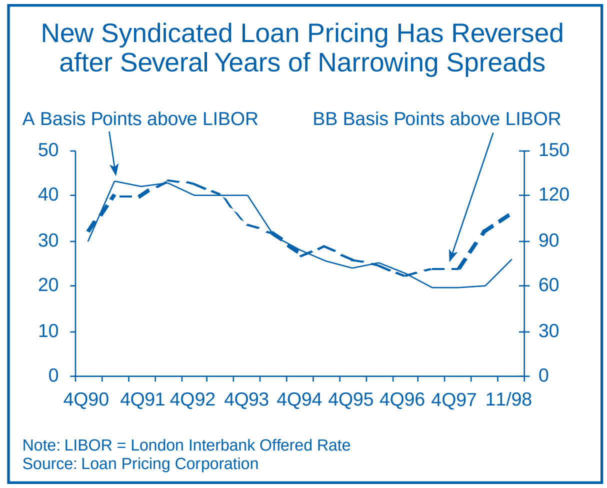


CHART 3



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

One-Stop Financial Providers

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

Historical Perspective on Syndicated Loan Underwriting Trends

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

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

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

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

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

CHART 4

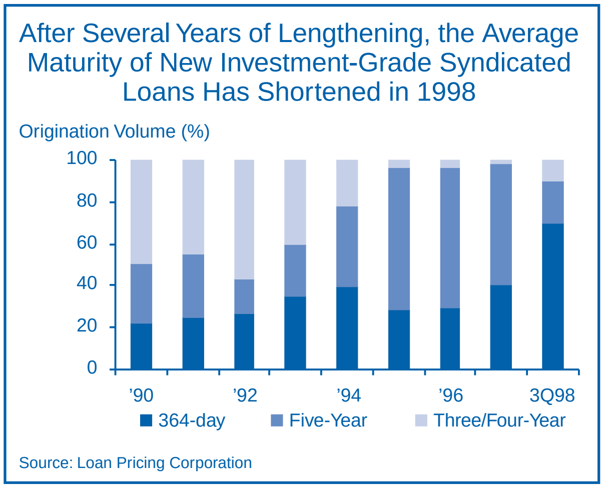
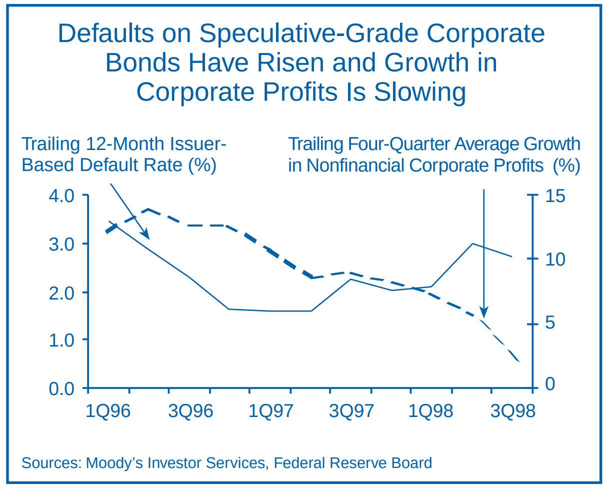


CHART 5



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

Recent Underwriting Developments

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

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

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

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

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

CHART 6

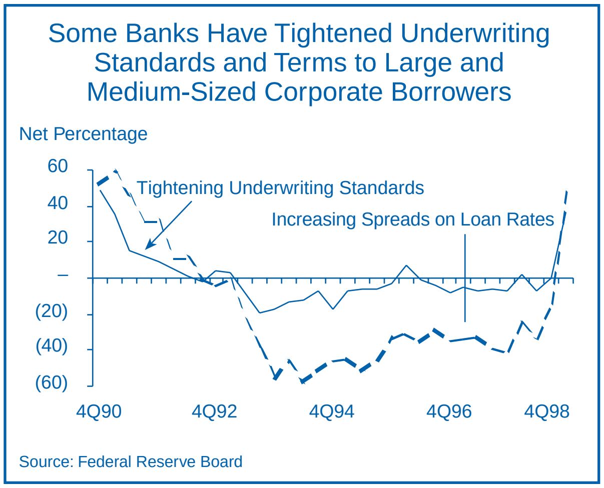
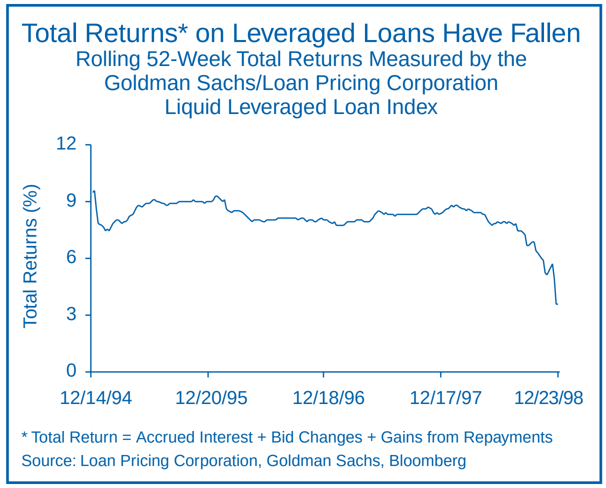


CHART 7



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

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

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

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

Implications for Insured Institutions

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

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

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

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

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

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

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

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

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

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

Regional Perspectives

- **The New York Region's economy continues to grow. Prospects for significantly slower growth seem to have abated as the stock market rebounded in late 1998.**

- **The Region's banks continue to post solid financial results; however, most money center banks reported a significant decline in third-quarter performance because of turmoil in global capital markets.**

- **Commercial real estate markets in the Region remain generally subdued compared with other markets across the nation. However, Philadelphia and Baltimore are experiencing heightened office construction; office rents are rising in Manhattan as vacancy rates decline; and Wilmington's office market is tightening.**

- **Hurricane Georges caused widespread devastation throughout Puerto Rico. With federal aid, however, the island is rebuilding.**

Region's Economic and Banking Conditions

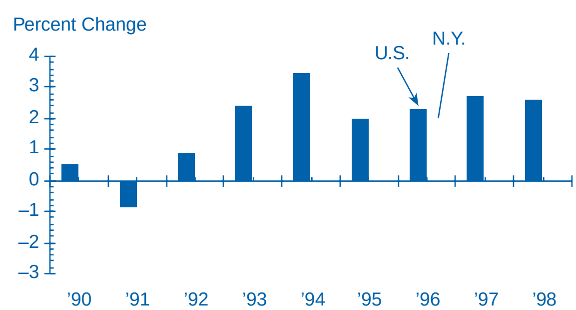
Region's Economy Continues to Expand

The New York Region's economy continues to expand at a moderate but sustained pace. Most areas of the Region are experiencing job growth and low unemployment. In the first three quarters of 1998, the Region added 290,000 new jobs, an increase of 1.4 percent over the same period one year earlier. Yet, as has been the case for the past several years, the Region's payroll employment growth rate is still only about one-half the nation's rate (see Chart 1). **Delaware** remains the fastest growing state in the Region, with employment growth ranging between 3 and 4 percent on a year-over-year basis during the past two years. Delaware's unemployment rate, at 3.5 percent, is the lowest of any of the Region's states and is almost a point below the national rate. **New Jersey** and **Pennsylvania** have reported employment growth in the 1 to 2 percent range over the past two years. Unemployment rates in these two states are comparable to the national rate. Employment growth also has improved in **New York**, the Region's largest state economy. Job growth, which had been very slow to improve in the early-to-mid-1990s, rose 1.6 percent in the third quarter. In addition, unemployment rates, which reached a high of 8.8 percent in the third quarter of 1992, fell to 5.4 percent in the third quarter of 1998. Most analysts believe that New York has finally recovered from the recession of the early 1990s.

Maryland, in contrast to the Region's other states, is experiencing slowing employment growth, and the Commonwealth of **Puerto Rico** has declining employment. In Maryland, job growth has slipped from more than 2 percent in 1997 to 1.2 percent annually over the first nine months of 1998. In addition, Maryland's unemployment rate has been declining. Slower job growth and declining unemployment could suggest that the state's economy is facing labor force constraints. Many companies, especially the large number of new technology and computer-related firms located in the state, have reported difficulty in attracting qualified workers. Puerto Rico has been losing jobs over the past year, particularly in manufacturing and business services, causing the unemployment rate to rise. Many analysts believe that the phaseout of Section 936 of the I.R.S. code, which provided significant tax incentives to U.S. companies operating on the island, has cost Puerto Rico capital and jobs (see New York's ***Regional***

CHART 1

Job Growth in the Region Remains About Half the National Rate



Source: Bureau of Labor Statistics. 1998 is for the first three quarters only.

Outlook, first quarter 1997). During the first nine months of 1998, payroll employment dropped 2.3 percent. If this trend persists, Puerto Rico will post its first yearly job loss since 1991.

Economic crises in Southeast Asia and Russia and their contagion effects continue to harm the U.S. economy and that of the Region. Currency devaluations and weakened demand from abroad are taking a toll on American manufacturers who export to Asia and other emerging markets. Trade statistics through October 1998[1] show that manufactured exports from the New York Region to the world declined slightly year over year. By contrast, exports from the rest of the nation were basically flat. New York and Maryland have been the most negatively affected. Exports in the chemical, metal, computer, and food industries from the Region were among those that showed the largest declines, consistent with national trends. With the possible threat of an economic crisis in Latin America, the Region's exporters could be harmed further. In 1997, the Region exported $15 billion in merchandise to Latin American countries, almost 14 percent of the Region's total exports, compared with $26 billion to Asia. A continuing decline in exports to Asia or a decline in exports to Latin America would hurt the Region's economy in the coming quarters.

Turmoil abroad and in the capital markets has prompted lenders to become somewhat more risk averse. Tighter credit standards among banks may slow economic growth. A recent ***Federal Reserve*** survey[2] of bank lending practices found that "a large share of participants indicated that they had firmed standards and terms on loans to large and middle-market businesses and on commercial real estate loans." The primary mechanism for this tightening was increased loan spreads rather than a tightening of structural terms. The Federal Reserve survey also noted that some banks have tightened standards and terms on small business loans. Respondents said that demand for business loans had increased, as credit in the capital markets has become less available and more expensive for enterprises such as hedge funds, emerging market countries, real estate syndications, and highly leveraged corporations.

[1] U.S. Census Bureau, "Origin of Movement of U.S. Exports of Merchandise by State by SIC-based Groupings," October 1997–1998.

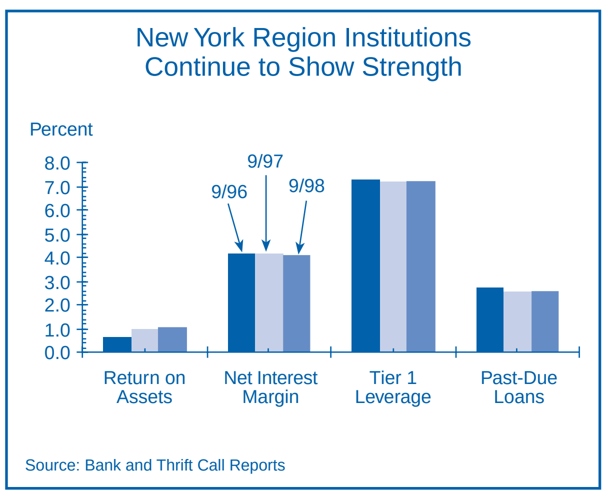
[2] Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices," November 1998. This survey polled 54 large banks in the United States.

Banking Conditions Remain Healthy Overall

The Region's banks and thrifts reported generally healthy financial conditions in the third quarter of 1998 (see Chart 2). The Region's average return on assets (ROA) ratio was 1.03 percent, about the same as a year earlier. The average net interest margin (NIM), which fell to 4.05 percent in the third quarter from 4.19 percent a year earlier, continued to narrow as a result of a flat yield curve (see New York's ***Regional Outlook***, second quarter 1998). However, the yield curve steepened somewhat in the fourth quarter, suggesting the NIM will stabilize or possibly widen in the next few quarters. Reported capital ratios remain strong, rising slightly in the third quarter and reversing the slow downward trend over the past several quarters. Aggregate past-due ratios continue to decline as well, reflecting improvement in residential and commercial real estate loan portfolios. Credit card portfolios remain the primary area of weakness. Nonperforming credit card loans as a percentage of total credit card loans seem to have leveled off at a little over 5 percent, despite slightly higher charge-off levels. Although some banks have tightened underwriting standards in response to higher delinquencies, the weakness in credit card loans is likely to continue in the near future.

The Region's 548 community banks (those with total assets of less than $250 million) continue to report weaker earnings performance, on average, than their larger counterparts. The average ROA among this group was 0.84 percent as of September 30, 1998, almost 50 basis points below the ROA for institutions with assets greater than $250 million. The difference is even more pronounced for banks with assets less than $100 million, which report an average ROA of 0.65

CHART 2



percent. Higher operating costs and lower levels of fee income generally hinder the earnings performance of smaller banks. Efficiency ratios, which measure effectiveness in generating revenue, also are much better for the larger institutions. Smaller institutions thus incur significantly higher costs in order to earn the same revenue as their larger counterparts. See New York's ***Regional Outlook***, fourth quarter 1998, for a discussion of potential risks facing smaller financial institutions in today's competitive environment.

Global Turmoil Poses Risks to Money Center Banks

Some major money center banks in the Region have reported a significant reduction in earnings as a result of the global market turmoil that began in late 1997 and continued throughout 1998. In the first quarter of 1998, significant charge-offs were taken as a result of the Asian financial crisis. Many large banks reported additional credit charge-offs and trading losses in the third quarter resulting from the economic collapse of Russia. Continuing sluggishness in the global economy and the risk of contagion, particularly among the nations of Latin America, could affect money center and large regional banks even further. Latin America, specifically Brazil, already has shown signs of weakness. Brazil reported that its economy contracted by 1.5 percent in the third quarter of 1998, fueling fears that the country will fall into a recession. Although the International Monetary Fund provided a massive $41 billion aid package, the full effect of the aid is not assured. Money center and other large U.S. banks have greater exposure to Brazil than to any other emerging nation. Aggregate outstanding cross-border exposure among these banks to Brazil totaled $22.7 billion[3] as of June 30, 1998.

Global market turmoil also is affecting the large banks' fee-generating businesses. Revenues from corporate activities at the money center banks, such as underwriting and advisory services, are falling as volatility in global markets leads to a slowdown in demand. Many analysts feel that corporate finance opportunities may be severely limited over the next several quarters, reducing fee income and negatively affecting the bottom line of these institutions.

[3] Federal Financial Institutions Examination Council, "Statistical Release," Country Exposure Lending Survey, as of June 30, 1998.

Commercial Real Estate Markets Remain Healthy

Most commercial real estate (CRE) markets in the Region remain fairly subdued compared with other markets in the United States. An analysis by ***Legg Mason Wood Walker***,[4] using property cycle charts that summarize the real estate cycle of a particular market, shows little supply and demand stress in the Region's office markets (see Chart 3, next page). There are a few markets, however, where office construction activity has been increasing and rents have been rising as a result of stronger demand.

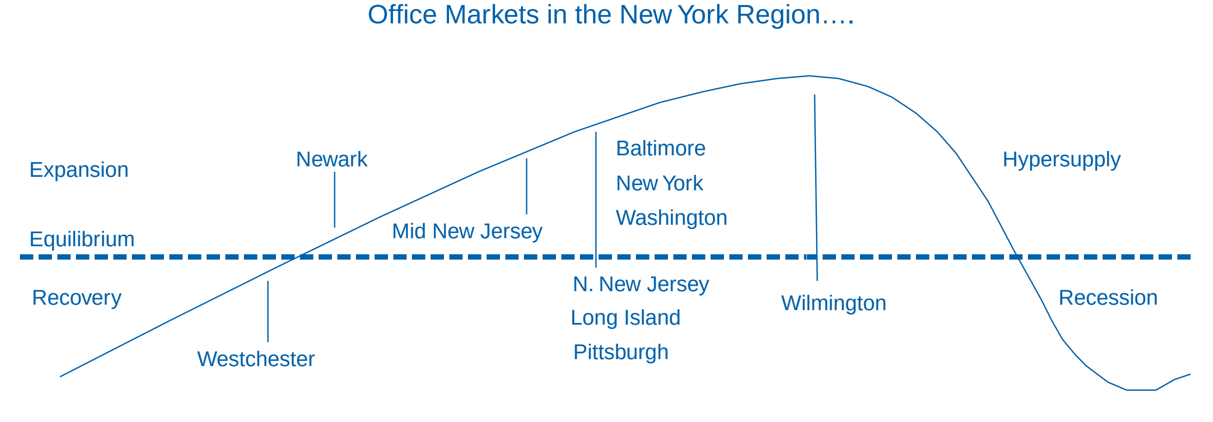
Trends in the **Philadelphia** area's office market suggest that overbuilding may be possible in the next few years. Through only the second quarter of 1998, office construction starts surged to 2.2 million square feet, surpassing annual levels since 1992. This growth in office construction is taking place against a backdrop of minimal growth in office employment. Further, the recent acquisition of two of the city's largest employers may lead to more vacant office space in the near future. ***CB Commercial/Torto Wheaton Research (CBC)***[5] projects that the office vacancy rate for the metropolitan statistical area (MSA) will reach nearly 13 percent in two years and will rise further in the future (see Chart 4, next page). According to ***Regional Financial Associates (RFA)***, the city's high wage tax and generally high business costs discourage firms from locating in the central business district. As a result, many companies are relocating to the suburbs. Vacancy rates dropped to 8 percent in the suburbs in the second quarter of 1998, in contrast to the city's 15.1 percent vacancy rate.

An analysis of local bank trends suggests that Philadelphia's community financial institutions have been maintaining a steady level of exposure to CRE and construction loans. Philadelphia's 56 local community

[4] Glen R. Mueller, Legg Mason Wood Walker, "Real Estate Market Cycle Analysis," second quarter 1998.

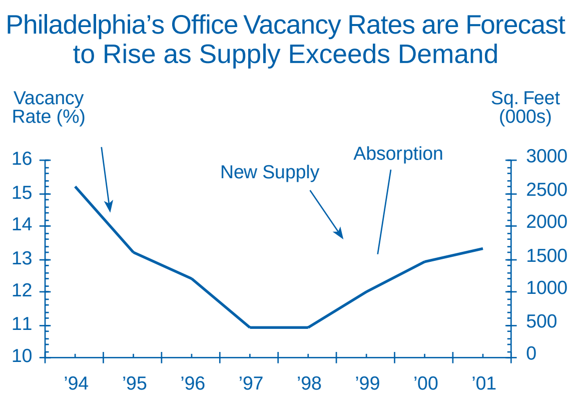
[5] CB Commercial/Torto Wheaton Research, "Fall 1998 Office Outlook."

CHART 3



Source: Legg Mason Wood Walker: Real Estate Market Cycle Analysis, Second Quarter, 1998

CHART 4



Source: Torto Wheaton Research

Market Cycle Definitions

(as shown in Chart 3)

Recovery—The market is in a state of oversupply from previous new construction or lack of demand. Vacancy rates hit their peak. As the bottom is passed, demand starts to rise.

Expansion—Demand increases, creating a need for additional space. Vacancy rates fall and rents rise rapidly. Cost-feasible rents stimulate new construction.

Hypersupply—Supply growth begins to exceed demand. This phase is not immediately recognized as vacancy rates reach their lowest points and the market is still strong. Demand eventually falls and new construction slows.

Recession—Supply clearly outstrips demand. Rents fall. The depth of the cycle is determined by the difference between supply growth and demand. The cycle eventually reaches bottom as new construction ceases.

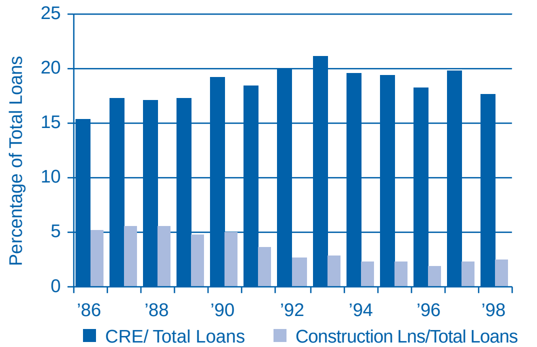
banks[6] reported average exposure to CRE loans as a percentage of total loans equal to 18 percent as of September 30, 1998. This is the same level as reported in 1991 and is only slightly above levels from ten years ago. Exposure to construction loans has declined by half from its high a decade ago (see Chart 5, next page).

In the **Baltimore** area, office construction was up by about 79 percent in the first half of 1998 over the first half of 1997. Driving the surge in office construction is an almost ten-year low in vacancy rates. According to RFA, there have been modest gains in office employment since 1993, a trend that is expected to continue. A growing brokerage and investment industry has boosted demand for office space. Baltimore's economy also has benefited from an increase in port activity. The port has a competitive advantage because of its excellent railroad connections to the Midwest. **Annapolis, Ellicott City,** and **Columbia, Maryland,** have particu-

[6] "Local community banks" refers to financial institutions headquartered in the metropolitan statistical area (MSA) with total assets less than $250 million. These institutions were analyzed because their trade area is more likely to be limited to the specified MSA and therefore should provide a clearer picture of market conditions.

CHART 5

Philadelphia's Community* Banks' Commercial Real Estate (CRE) Lending Is Stable



Data as of September 30.
Source: Bank and Thrift Call Reports

* Banks with total assets < $250 million

larly strong office markets. Much of the office construction boom is focused in the suburbs and is considered speculative. The boom in the suburbs has hurt downtown properties. Vacancy rates are still as high as 12.2 percent in Baltimore's downtown district, and the outlook remains uncertain. A recent ***Lehman Brothers'*** report[7] places Baltimore on a list of markets in a "danger zone." Central Baltimore continues to suffer from high business costs, low population growth, and federal employment cutbacks.

The **Baltimore-Washington, DC**, area also is showing some signs of excess industrial space, particularly warehouse space, caused in part by a surge in construction. The addition of about 3 million square feet of new industrial space in 1997 pushed vacancy rates to 22.5 percent in the Baltimore central business district and to 10.4 percent in the suburbs. This increase in vacancy rates caused rental rates to fall 5 percent. CBC projects over 4.8 million square feet of new industrial space to be completed between 1998 and 1999, which is expected to further push up vacancy rates in that market segment.

Stronger tourism, driven by the new Ravens stadium, Disney's Port Discovery, Camden Yards, and the National Aquarium, has ignited hotel building in downtown Baltimore. Four new large hotel projects are currently in the planning stages. If completed, they may saturate the market with the addition of more than 2,000 rooms, an increase of 40 percent over the current room inventory, which would likely drive down occupancy rates.

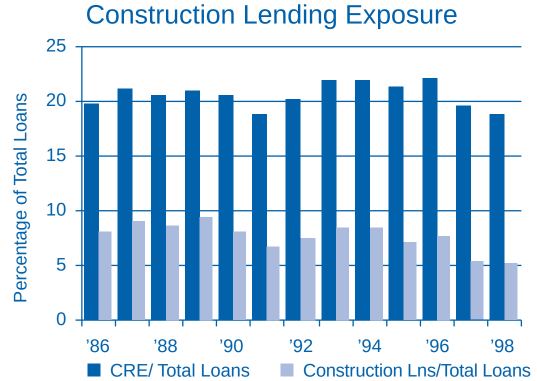
An analysis of local bank trends in Baltimore shows that the MSA's community financial institutions have slightly less exposure to CRE and construction loans than in the past. Baltimore's 60 local community banks reported a decline by almost half in the level of construction loans as a percentage of total loans in the past decade. Average exposure to CRE loans has been relatively steady over that period, but has declined slightly in the past few years (see Chart 6).

In **New York City,** the Region's largest commercial real estate market, a strong economy and the lack of major new office construction projects over the past several years have driven vacancy rates to more than a ten-year low, while office rents have skyrocketed. Moreover, commercial construction starts and investments may slow even further, given that financing has become more difficult to obtain. In the first half of 1998, total commercial construction starts declined by almost 25 percent over the same period last year. Office construction declined dramatically by over 70 percent in the metropolitan area during the first half of 1998 versus 1997. A tightening of credit standards has forced buyers and developers to walk away from deals that they might have financed just six months ago. *A sustained period of declining profitability in the securities industry could push up vacancy rates; however, few economists are forecasting a repeat of market conditions of the late 1980s and early 1990s because of the current tightness in the commercial real estate market.*

Wilmington, one of the fastest growing cities in the Region, has experienced declining vacancy rates throughout the 1990s. Office vacancy rates stood at

CHART 6

Baltimore's Community* Banks Have Less Construction Lending Exposure



Data as of September 30.
Source: Bank and Thrift Call Reports

* Banks with total assets < $250 million

[7] Lehman Brothers, "Eye on Office Markets," October 5, 1998.

6.3 percent in the second quarter of 1998, in marked contrast to the 24 percent vacancy rate in 1991. The limited number of new office building completions over the past several years, plus the area's strong economy, has contributed to the tightening of office vacancy rates. CBC, however, forecasts additional completions and a rise in vacancy rates beginning in 1999 and continuing into the next decade.

Other markets in the Region, such as **Long Island, Westchester County,** upstate **New York,** northern **New Jersey,** and **Pittsburgh,** also show tightening vacancy rates and some new office construction. However, because of the relative lack of new construction and development projects, analysts do not expect these real estate markets to be as vulnerable to an economic downturn as they were in the late 1980s and early 1990s.

Puerto Rico Recovers from Hurricane Georges

Puerto Rico is recovering from heavy damage caused by Hurricane Georges in September 1998. ***Caribbean Business***[8] estimates that the total amount invested in rebuilding the island's infrastructure could reach $6.5 billion in 1998. Damages are significantly higher than those sustained after Hurricane Hugo, which cost the insurance companies between $700 and $800 million in 1989. Because only 30 to 40 percent of homeowners have any kind of hurricane insurance coverage, Puerto Ricans are relying on the ***Federal Emergency Management Agency*** (FEMA), the ***National Flood Insurance Program,*** and the ***Small Business Administration*** to provide the majority of the funds required to rebuild devastated neighborhoods throughout the island (see Table 1).

TABLE 1

Federal Aid Helps Restore Puerto Rico's Economy (in millions of dollars)

Insurance companies	1,500
National Flood Insurance Program	1,430
Federal Emergency Management Agency	1,400
Small Business Administration	1,200
Banks	400
Department of Housing and Urban Development	360
Department of Agriculture	85
Municipalities	70
Central government	30
Department of Transportation	25
Total local and federal aid	6,500

Source: Caribbean Business

The manufacturing sector, which produces about 40 percent of the island's gross product, was showing signs of weakness before Hurricane Georges struck. During the first eight months of 1998, the manufacturing sector already had declined by 8,000 jobs year over year, or about 5 percent. This decline follows losses in the previous two years. The virtual shutdown of the manufacturing sector in the days after the hurricane cost the economy an estimated $230 million daily. Analysts believe that running plants at effective capacity, however, will make up for the temporary loss in production. Fortunately, the hurricane caused only limited structural damage to the physical operations of the major manufacturing companies.

According to Puerto Rico's ***Department of Agriculture***, total losses in the agriculture sector could reach $300 million. Over 55 percent of the island's coffee and 90 percent of the plantain and banana crops were destroyed. It could take 12 to 15 months for replacement crops to be cultivated for the marketplace. Dairy and poultry farmers suffered major losses from livestock and equipment damage. The diminished supply of foodstuff caused significant price increases and widespread shortages of some products. Inflationary pressures in this sector of the economy may continue over the short term; however, price increases may be constrained as the government allows the import of cheaper dairy and poultry products. Another concern is that many of Puerto Rico's 31,000 farm workers are out of work until the land can be recultivated.

The hurricane and its aftermath temporarily crippled tourism, a key economic driver of the Puerto Rican economy. Travel agencies, tour operators, and guides experienced a significant drop-off in business in the

[8] *Caribbean Business,* "Christmas Rush—Will Your Business Be Ready?" October 8, 1998; "The Worst Hurricane in 70 Years Hits Puerto Rico," October 1, 1998. These articles contain the statistics used in the remainder of this section.

second half of 1998. However, industry experts believe that the tourism industry will be ready for the travel season of 1998 to 1999 because hotels, beaches, and golf courses sustained minimal damage.

The retail sector experienced losses estimated at $647 million from unrealized sales and services over five days. Analysts disagree, however, on the long-term effect that the hurricane will have on retailers. Some argue that the interruption of business activities will be negative for the economy. Other analysts believe that once the federal relief funds are absorbed into the economy, the retail sector should see an increase in spending on furniture, home appliances, and home improvement products. Moreover, consumers will continue to purchase necessary food staples, clothing, and gasoline, thereby partially offsetting the retail sector's losses.

The net effect of Hurricane Georges will depend on the amount of economic aid received through federal agencies, relief efforts, and insurance companies. The aftermath of the hurricane could actually push up Puerto Rico's gross domestic product because of the increased spending associated with rebuilding the island's economy, as happened after the devastation of Hurricane Hugo in 1989. Nonetheless, banks may face some consumer credit quality problems if consumers experience financial difficulties as a result of uninsured losses.

Norman Gertner, Regional Economist
Karen A. Wigder, Senior Financial Analyst
Mark Otero, Research Analyst

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