Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 2000

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Regional Perspectives

◆ *Region's Economic Conditions*—Buoyed by a strong economy, employment levels continued to rise as the Region entered the new millennium. Although the nation added jobs more quickly over the same period, several areas of the Region are experiencing tighter labor markets than the nation. *See page 3.*

◆ *The Region's Banking Conditions*—The Region's insured institutions reported sound financial conditions in the first quarter of 2000. Nevertheless, because of higher interest rates and competition for core deposits, more of the Region's institutions showed signs of strained liquidity. *See page 5.*

◆ *The Region's Commercial Real Estate (CRE) Markets Appear Better Positioned than a Decade Ago*—In contrast to the late 1980s, most of the Region's office markets are experiencing stable or declining office vacancy rates and limited new construction. While the Region's banks reported sound CRE credit quality, the percentage of banks that have a concentration in CRE loans has increased, exceeding levels reached prior to the recession of the early 1990s. *See page 7.*

By the New York Region Staff

In Focus This Quarter

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

By Thomas A. Murray, Senior Financial Analyst

◆ *Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate*—Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios. *See page 21.*

By Alan Deaton, Financial Economist

DIVISION OF INSURANCE

KATHY R. KALSER, REGIONAL MANAGER

ROBERT DICHIARA, FINANCIAL ANALYST

NORMAN GERTNER, REGIONAL ECONOMIST

ALEXANDER J.G. GILCHRIST, ECONOMIC ANALYST

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Regional Perspectives

- **The Region's strong economy has stimulated job growth and reduced unemployment in most metropolitan areas. Upstate New York and the central cities of Baltimore and Philadelphia, which lagged the Region in the 1990s, have shown recent employment gains.**
- **The Region's insured institutions reported sound financial conditions at the end of the first quarter of 2000. Large banks benefited from increased noninterest income, while small banks reported higher net interest margins. However, commercial and industrial loan portfolios in the Region's insured financial institutions showed modest signs of credit quality deterioration.**
- **More of the Region's banks showed signs of strained liquidity, reporting securities depreciation and deposit outflow. Banks may opt to raise deposit rates or increase borrowings to offset deposit outflow, rather than incur securities losses. As the dynamics of funding alternatives change, so, too, should assumptions underlying banks' risk management tools.**
- **In contrast to the late 1980s, the Region's office markets are experiencing stable or declining vacancy rates and limited new construction. The proportion of the Region's banks that specialize in commercial real estate loans, however, has increased and exceeds levels reached prior to the last recession.**

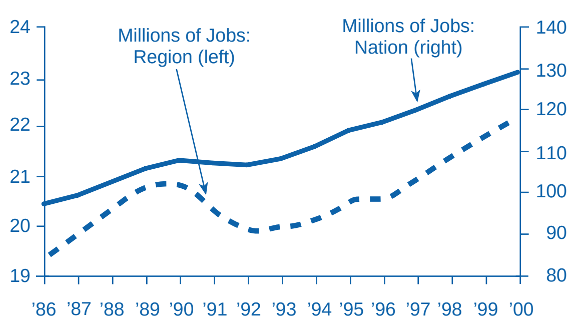
Region's Economic and Banking Conditions

Job Growth and Declining Unemployment Continue in 2000

Buoyed by a strong economy, employment levels continued to rise as the Region entered the new millennium. Between the first quarters of 1999 and 2000, approximately 373,000 new jobs were created, an increase of 1.7 percent. The Region now has surpassed by a considerable margin the employment peak attained prior to the recession of the early 1990s (see Chart 1). Although the nation added jobs more quickly over the same period, at 2.3 percent, several areas in the Region are experiencing tighter labor markets than the nation. Many of these areas, particularly suburban counties surrounding major cities, experienced unemployment rates below 3.5 percent, approximately one point below the national average of 4.4 percent during the first quarter of 2000 (see Map 1).[1] Rural counties in northern and western

CHART 1

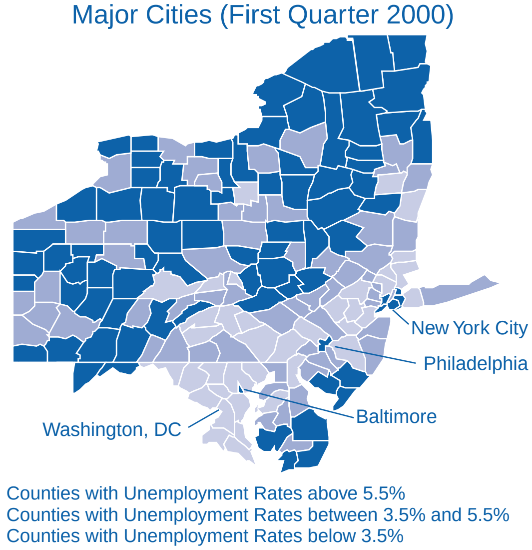
Job Levels Have Exceeded the Peak Prior to the Last Recession



Note: Data represent first quarter employment levels.
Source: Bureau of Labor Statistics

MAP 1

Tight Labor Market Conditions Surround Region's Major Cities (First Quarter 2000)



Source: Bureau of Labor Statistics

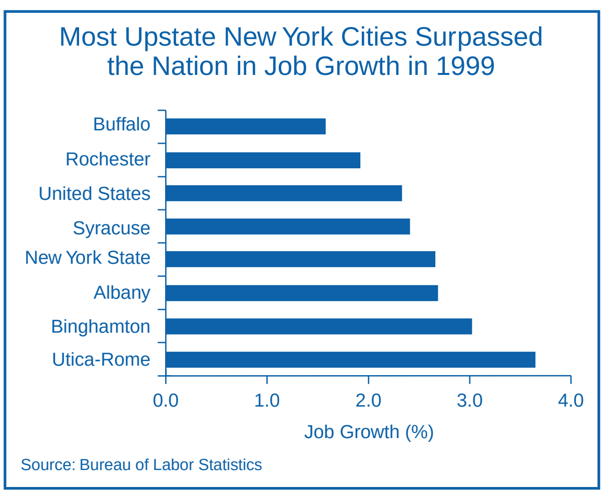
[1] For purposes of comparison, county and national unemployment rates are not seasonally adjusted.

New York and western **Pennsylvania** are experiencing significantly higher rates of unemployment. Nonetheless, many of these areas have been experiencing renewed demand for employees.

The good news is that the robust economy has extended to some of the Region's smaller cities, whose workforces had been growing more slowly (or declining) compared with those of the nation. After lagging behind the national and state averages for most of the 1990s, many of the small to midsize cities in upstate New York, including **Albany, Binghamton, Syracuse,** and **Utica-Rome,** added jobs at a faster pace than the nation in 1999 (see Chart 2). Employment gains in the business service, trade, and financial sectors have boosted job levels in these cities. While the rate of employment growth in some of these areas slowed in first quarter 2000, the growth rate remains above that of the mid-1990s, which was a period of slow or even negative job growth. In the mid-1990s, cutbacks in manufacturing jobs, particularly in the textile, apparel, chemical, and auto-manufacturing industries, hurt some of these local economies. Although manufacturing-industry declines have continued, the rate of decline has slowed, and recent manufacturing job losses have been offset by job gains in other sectors.

Employment growth rates in **Baltimore** and **Philadelphia,** which had been lagging behind other parts of the Region, also are improving. For most of the 1990s, the central cities of Baltimore and Philadelphia had been losing jobs. Between 1989 and 1997, Baltimore lost almost 70,000 jobs, or 15 percent of its workforce, and employment levels in Philadelphia dropped by 94,000 jobs, or 12 percent. Over the past two years, however, these central cities have posted modest job gains. In 1999, employment growth in Baltimore increased less than 1 percent. Between the first quarters of 1999 and 2000, however, the employment level in Baltimore rose 3.5 percent, the largest quarterly gain since 1984. Employment has been helped by growth in the construction industry, which rose almost 17 percent in 1999, in part reflecting new office and hotel construction. In Philadelphia, employment levels also have been improving modestly since 1998. Slow declines in manufacturing employment have been offset by gains in retail trade and social and educational services. The outlook is for modest job growth in these two cities, because of high business costs, sluggish population growth, and limited in-migration.[2]

Chart 2



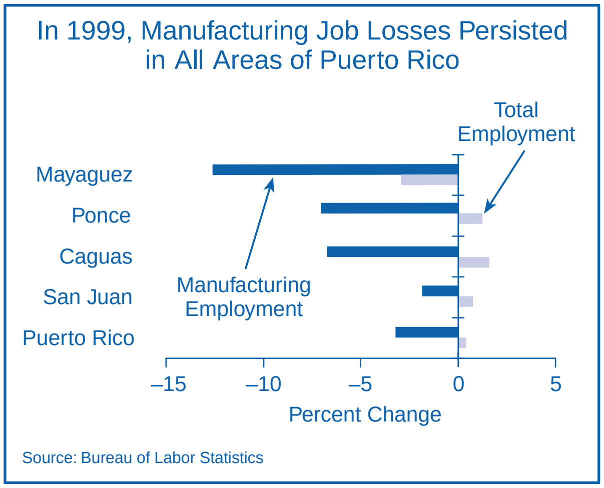
Job Growth Sluggish in Puerto Rico

Puerto Rico has lagged the nation and the Region in job growth. Since 1998, employment growth has been under 1 percent per year, and first quarter 2000 year-over-year results showed a slight decline. The phase-out of Section 936 of the federal tax code, which provided substantial federal tax benefits to U.S. manufacturers based in Puerto Rico, has hurt the island's manufacturing sector, which has lost jobs over the past four years. While new tax incentives implemented by the Puerto Rican government are designed to stem the outflow of manufacturing jobs, Puerto Rico continues to face stiff competition for manufacturing jobs from other countries, such as Mexico, that have lower labor costs.

In **San Juan,** job gains in the construction, telecommunications, business, and social service industries have partially offset losses in manufacturing jobs and cutbacks in government employment. San Juan, which represents almost two-thirds of the island's total workforce, has fared better than other parts of Puerto Rico, because its economy is more diverse and relies on tourism and service-based jobs more than other parts of the island. San Juan's manufacturing industry accounts for 11 percent of its total economic activity, significantly less than other metropolitan areas, where manufacturing can account for about one-third of total economic activity.[3] As a result, the adverse effect of the loss of Section 936 tax incentives has been more limited on the island's major city. Other metropolitan areas, however, have felt the loss of Section 936 more keenly (see Chart 3). In

[2] Forecast is by ***Regional Financial Associates.***
[3] Analysis provided by ***Regional Financial Associates.***

CHART 3



Ponce, for example, manufacturing employment has dropped every year since 1994. In **Mayaguez,** manufacturing employment dropped more than 12 percent in 1999, and sharp losses continued during the first quarter of 2000. Losses in the apparel and food-processing industries accounted for much of the decline.

Region's Institutions Report Healthy Conditions, but Funding Pressures Continue

The New York Region's insured institutions[4] reported sound financial conditions in the first quarter of 2000, exhibiting higher levels of profitability, favorable credit quality, and stable capital ratios (see Table 1). While the average return on assets improved for the Region's

TABLE 1

THE REGION'S BANKS REPORT IMPROVED PROFITABILITY AND SOUND CREDIT QUALITY

	ALL INSTITUTIONS*			ASSETS GREATER THAN $10 BILLION*			ASSETS LESS THAN $10 BILLION, GREATER THAN $500 MILLION*			ASSETS LESS THAN $500 MILLION*		
	MAR '00	MAR '99	MAR '98	MAR '00	MAR '99	MAR '98	MAR '00	MAR '99	MAR '98	MAR '00	MAR '99	MAR '98
RETURN ON ASSETS (ROA)	1.00	0.99	1.07	1.21	1.16	1.09	1.19	1.17	1.18	0.95	0.94	1.04
NET INTEREST MARGIN (NIM)	3.90	3.81	3.99	3.35	3.42	3.53	3.60	3.59	3.73	4.01	3.88	4.06
NONINTEREST INCOME/AEA	1.07	1.12	1.04	2.41	2.30	1.96	1.39	1.21	1.23	0.93	1.05	0.96
NONINTEREST EXPENSE/AEA	3.24	3.28	3.25	3.33	3.49	3.44	2.94	2.81	2.95	3.33	3.39	3.33
EFFICIENCY RATIO	64.12	65.27	63.86	54.05	56.09	60.67	56.32	56.64	56.53	66.80	67.80	65.78
CORE DEPOSITS/ ASSETS	67.73	69.61	71.00	42.34	43.26	47.56	59.40	59.79	61.60	71.09	73.01	74.03
NONCORE FUNDING/ASSETS	20.67	18.28	16.83	45.17	44.80	40.77	30.01	28.54	26.68	17.04	14.76	13.67
PAST-DUE RATIO	1.06	1.22	1.37	1.11	1.09	1.12	1.03	1.18	1.30	1.06	1.24	1.39
NET CHARGE-OFF RATE	0.09	0.10	0.10	0.10	0.12	0.12	0.05	0.06	0.08	0.03	0.03	0.04
TIER 1 LEVERAGE RATIO	10.52	10.50	10.60	7.14	6.51	6.58	8.93	9.32	9.13	11.11	10.94	11.09
TIER 1 RISK-BASED CAPITAL RATIO	19.39	20.44	22.35	10.26	10.01	9.59	15.20	16.18	16.51	20.96	21.88	24.19

* DATA EXCLUDE INSTITUTIONS IN OPERATION FEWER THAN THREE YEARS, CREDIT CARD BANKS, AND FIVE SPECIAL-PURPOSE INSTITUTIONS.
AEA = AVERAGE EARNING ASSETS
EFFICIENCY RATIO = NONINTEREST EXPENSE DIVIDED BY THE SUM OF NET INTEREST INCOME AND NONINTEREST INCOME
PAST-DUE RATIO = LOANS PAST DUE 90 DAYS OR MORE PLUS NONACCRUAL LOANS DIVIDED BY GROSS LOANS
SOURCE: BANK AND THRIFT CALL REPORTS

[4] Excludes banks in operation fewer than three years, credit card banks, and five special-purpose banks.

large, medium, and small institutions compared with the first quarter of 1999, factors contributing to improved profitability differed based on asset size. In the first quarter of 2000, higher noninterest income reported by the Region's large banks (those with total assets greater than $10 billion) and medium-sized institutions (those with assets between $500 million and $10 billion) offset the effect on earnings of a lower average net interest margin (NIM). The average NIM for these institutions declined because the increase in funding costs exceeded an improvement in the average asset yield. In contrast, the Region's small banks (those with assets less than $500 million) reported a higher average NIM and lower noninterest income compared with one year ago.

As short-term interest rates rose during the first quarter, banks reported higher average asset yields. However, the Region's smaller banks did not experience as great an increase in interest expense as did larger banks. The Region's large and medium-sized institutions' funding costs increased an average of 29 basis points and 33 basis points, respectively, while small banks' average funding costs rose by 13 basis points in the first quarter of 2000. Small banks benefited from a higher proportion of core deposits to assets on average, as rates on core deposits typically lag increases in market interest rates. Competition for core deposits, however, could reduce small banks' competitive advantage over time. While the Region's small banks are much less reliant on noncore funding than larger banks, noncore funding as a percentage of assets increased over year-ago levels, continuing a long-term trend. As the proportion of noncore deposits to assets increases, institutions that historically have relied on core deposits may become more sensitive to changes in interest rates, because pricing on noncore funding tends to be less stable and more sensitive to changes in market interest rates. Furthermore, as competition for core deposits intensifies, rates on core deposits may need to track market interest rates more closely, thereby reducing an institution's ability to benefit from lagged increases on core deposit rates. In fact, according to the ***2000 American Bankers Association Community Bank Competitiveness Survey,*** more banks have changed deposit pricing strategies in response to funding pressures; 42 percent of community banks reported more aggressive deposit pricing in 2000, compared with only 24 percent in 1999.[5] (For more information on changes in bank funding strategies, see ***"Banks' Funding Sources Shift," Regional Outlook,*** Third Quarter 1999.)

Except for commercial and industrial (C&I) loans, the average past-due ratio declined for all loan categories in first quarter 2000 compared with the same periods in 1999 and 1998. After peaking in the early 1990s, the Region's average C&I past-due and charge-off ratios improved, reaching decade-low rates of 1.7 and 0.09 percent, respectively, in the first quarter of 1997. Since then, however, these ratios have gradually risen, reaching 2.03 percent and 0.16 percent in the first quarter of this year. Although higher than three years ago, these ratios remain below the average past-due ratio of 7.37 percent and average charge-off rate of 0.52 percent reported by the Region's banks following the recession of the early 1990s.

Trends in the Region's asset quality measures were consistent with findings from recent national underwriting surveys. Surveys conducted by the ***Federal Deposit Insurance Corporation***[6] and the ***Federal Reserve Board***[7] identified generally stable or improved underwriting policies as more banks tightened C&I loan underwriting, perhaps in response to recent weakening credit quality measures. The surveys, however, also cited signs of relaxed underwriting on residential mortgages as the demand for mortgages softened.

Securities Depreciation and Liquidity Demands May Affect Bank Funding Strategies

Rising interest rates in the second half of 1999 and the first quarter of 2000 have resulted in a decline in the value of the Region's banks' investment portfolios. As of March 31, 2000, the Region's commercial institutions[8] reported average depreciation in investment portfolios of 9.62 percent of equity capital, compared with average appreciation of 3.13 percent as of December 31, 1998. The decline was widespread, as the number of the Region's commercial banks that reported depreciation in investment portfolios increased between December 31, 1998 and March 31, 2000. Furthermore, the number

[5] American Bankers Association. February 2000. *ABA Competitiveness Survey Shows Community Bankers' Concerns for Funding, Employee Recruitment and Technology Issues.*

[6] Federal Deposit Insurance Corporation. March 2000. *Report on Underwriting Practices. October 1999 through March 2000.*

[7] Federal Reserve Board. May 2000. *Senior Loan Officer Opinion Survey on Bank Lending Practices.*

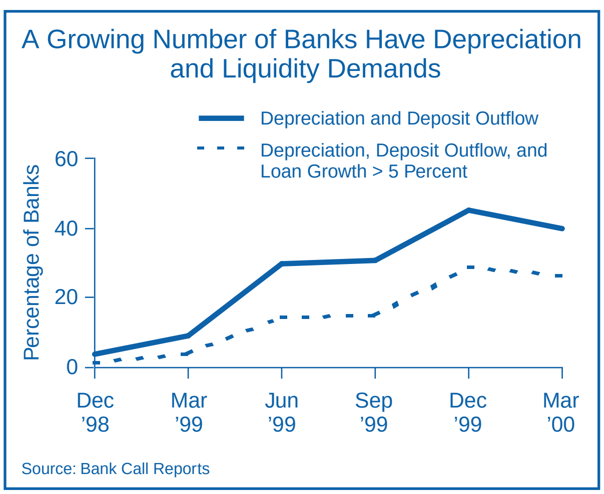
[8] Excludes banks in operation fewer than three years, credit card banks, and five special-purpose institutions. Also excludes thrift institutions, which do not report securities appreciation and depreciation.

of institutions reporting depreciation in excess of 10 percent of capital increased from five as of December 31, 1998, to 216 as of March 31, 2000. Most of these banks were small and medium-sized institutions. For additional information on securities depreciation, see ***"Rising Interest Rates Could Pose Risk to the Region's Insured Institutions" Regional Outlook,*** Second Quarter 2000.

During periods of declining interest rates, as fixed-income securities increase in value, institutions can supplement liquidity by divesting securities at a gain, thereby providing funds and augmenting profits. In a rising interest rate environment, however, security sales more likely will result in a loss. Although banks may elect not to divest securities at a loss when liquidity needs are modest, nevertheless, more of the Region's banks reported deposit outflow[9] and investment portfolio depreciation in first quarter 2000 than in fourth quarter 1998 (Chart 4). As of March 31, 2000, 235 of the Region's commercial banks had deposit outflow and securities depreciation, and 89 of these banks reported depreciation in excess of 10 percent of capital. In contrast, only 24 commercial banks reported deposit outflow and securities depreciation as of December 31, 1998, and only three of these banks reported depreciation greater than 10 percent of capital.

Loan demand also can strain an institution's liquidity, particularly if it is concurrent with deposit outflow and investment portfolio depreciation. In fact, the number of the Region's commercial banks that reported a combination of securities depreciation, deposit outflow, and yearly loan growth of greater than 5 percent is on the rise. Of the 155 institutions that met these criteria as of March 31, 2000, 61 reported securities depreciation in excess of 10 percent of equity capital. In contrast, as of December 31, 1998, only 10 commercial banks met these criteria, and no institutions reported depreciation greater than 10 percent of capital.

CHART 4



[9] Deposit outflow is defined as annual deposit growth of less than 4 percent to account for accrued interest on deposits.

Implications

While increased liquidity demands coupled with higher levels of securities depreciation do not necessarily mean that a bank will resort to selling securities at a loss to meet liquidity demands, they are important factors to consider in formulating an institution's funding strategy. Depending on the degree of depreciation and liquidity needs, banks may prefer to use alternative methods to offset deposit outflow while funding loan demand. Institutions may prefer to counter deposit outflow by offering more competitive rates on deposit accounts or by increasing noncore funding, in lieu of liquidating securities at a loss. Nevertheless, a number of the Region's institutions recently reported the sale of securities at a loss as part of balance sheet restructuring programs.

Furthermore, as alternative funding options are considered, assumptions used in banks' asset/liability management (ALM) models should reflect changes in market conditions, core deposit behavior, and funding strategies. ALM models typically rely on assumptions concerning deposit rates, repricing frequency, and retention. As the dynamics of funding alternatives change, so, too, should assumptions underlying banks' risk management tools.

The Region's Office Markets Are Robust, but Unlike the Late 1980s, Overbuilding Is Less of a Concern

The Region is experiencing strong demand for office space, and vacancy rates are at the lowest levels in the past decade (see Table 2, next page). Moreover, the Region's commercial real estate (CRE) markets are not experiencing the overbuilding that was characteristic of the early 1990s. In Manhattan, for example, the largest office market in the nation, office vacancy rates stood at 3.8 percent in the fourth quarter of 1999, the lowest level of the decade. Rents in many Class A properties surpassed $50 per square foot, and certain top-tier properties were renting for $100 per square foot. Limited new construction and soaring rents in Manhattan have

Table 2

Region's Office Vacancy Rates Have Declined during the 1990s (%)			
Metro Area	1990	1995	1999
Baltimore	17.6	13.9	8.1
Long Island	22.5	13.8	7.8
Northern New Jersey	22.5	16.2	8.5
New York City	15.2	14.9	4.6
Philadelphia	16.8	13.0	10.3
Washington, D.C.	16.6	9.6	5.7
Westchester County	23.9	22.4	18.4
Wilmington	NA	13.1	4.8
United States	18.9	14.1	9.5

Data represent fourth quarter of the year.
NA = not available
Source: CB Commercial/Torto Wheaton Research

prompted many companies to move to the shores of the Hudson River in **New Jersey,** which offer more attractive lease terms and lower rental rates. As a testament to the tight office market and surging rental rates in **New York City,** many Manhattan tenants also are moving into newly renovated Class B space.

Office markets in New Jersey have benefited from spillover demand from New York City as well as the state's strong economy. As in Manhattan, demand for space in northern New Jersey exceeded supply in 1999, as vacancy rates declined and rents increased in the majority of submarkets. Vacancy rates climbed, however, in some areas including the **Wayne/Patterson** market.[10] Demand for space has resulted in new construction. In fact, according to ***Torto Wheaton Research,***[11] new office space constructed in 1999 equaled almost 140 percent of all space added between 1993 and 1998. This new supply, however, pales by comparison to the amount of office space added in the late 1980s. Furthermore, despite the additional space, the office vacancy rate for the northern New Jersey area declined in 1999. Northern New Jersey's economy is closely linked to that of Manhattan, so any softness in the financial sector could weaken this market. Consolidations in the pharmaceutical industry, a major employer in the state, also could affect several real estate submarkets.

Office market conditions in the Region's second largest office market, **Washington, D.C.,** also showed signs of tightening. A ***Grubb & Ellis*** report[12] noted that Washington, D.C., which, except for New York City, has more office buildings than any other central city in the nation, has benefited from a strong regional economy fueled by sizable increases in computer software, telecommunications, and biotechnology employment. Reflecting surging demand for space, vacancy rates in the Washington, D.C., metropolitan area averaged 5.6 percent during 1999, the lowest level since the early 1980s. To help meet the demand, approximately 7.2 million square feet of new office space was added in 1999, with 1.5 million square feet of new office space going to the downtown inventory. Although this was the largest amount of office space added in a single year since 1990, it remained well below the amount built during the 1980s. According to the Grubb & Ellis report, virtually all of the new construction has been or will be absorbed into the market place, and as a result, office vacancy rates are expected to remain tight. As in New York, demand for office space has spilled over to subpremium space. According to ***Studley Report & Spacedata,***[13] vacancy rates in Class B and C space declined from 8.1 percent in the fourth quarter of 1999 to 7.6 percent in the first quarter of 2000, and rental rates for Class B and C space rose almost 4 percent.

Strong office employment also has contributed to the tightening of office vacancy rates in the Baltimore and Philadelphia metropolitan areas. Stimulated by start-up high-tech, telecommunication, and biotech companies, vacancy rates are the lowest in more than 15 years. Although the suburban areas of these cities have benefited from the surging economy more than the central business districts, recent job gains in the central cities have pushed down vacancy rates there as well. Forecasts for 2000 by ***Landauer Real Estate Counselors, Inc.*** (Landauer),[14] suggest that absorption will exceed new supply in those metropolitan areas.

Declining vacancy rates are found not only in the Region's major metropolitan areas, but also in many of the smaller or midsized cities. The Landauer report described demand for office space in **Annapolis, Maryland,** in 1999 as "unbelievable." There, the overall office vacancy rate was 3.7 percent, with Class A

[10] *Studley Report & Spacedata. Central and Northern New Jersey.* First quarter 2000.

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

[12] Grubb & Ellis. May 5, 2000. *Market Monitor: Metropolitan Washington, D.C.,* Issue 62.

[13] *Studley Report & Spacedata. Washington, D.C., and Metropolitan Area.* First quarter 2000.

[14] Landauer Real Estate Counselors. *2000 Comparative Statistics.*

properties at a scant 0.7 percent. Rental rates for these properties were at an all-time high at $25 per square foot. Conditions were reportedly so tight that companies were forced to locate offices in neighboring counties. In **Harrisburg,** Pennsylvania, office-market conditions were almost as tight. Demand for Class A office space was under 5 percent, and demand for Class B was 1.9 percent. Despite slowing employment growth, demand for office space was strong, particularly from financial and business service companies. According to Landauer, tight market conditions should continue throughout 2000 even with the planned addition of space. Even in **Rochester,** New York, with its relatively slower growing economy over the past few years, overall demand for office space was very strong in 1999. Class A vacancy rates in Rochester's central business district were 6.6 percent, a low for the decade. In Rochester, Landauer expects telecommunications and software companies to constitute the major growth sectors, with new technology firms actively converting old loft space to commercial use.

Are the Region's Office Markets Less Vulnerable to a Downturn than in the Late 1980s?

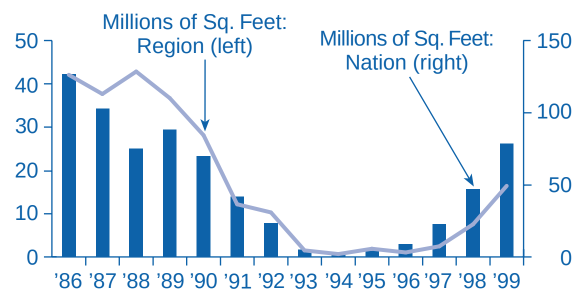
Because the Region's office markets are now so active, many analysts have been asking whether current office market conditions resemble those of the 1980s. Is there a potential for overbuilding and rising vacancy rates similar to what occurred in the beginning of the 1990s? In the 1970s, high levels of inflation stimulated a wave of speculative demand for real estate, and the commercial office sector experienced an unprecedented building boom. Among banks, concentrations of CRE loans relative to total assets substantially increased. According to an ***FDIC*** analysis,[15] from 1980 to 1990, the annual average value of new nonresidential construction was $108 billion (in 1992 dollars), up from approximately $71 billion during 1975 to 1979. During the 1980s, construction of new office space outpaced demand, as measured by absorption rates. Following a period of corporate downsizing, mergers, and consolidations, the boom collapsed in the late 1980s, leaving many real estate markets across the nation severely depressed, with high vacancy rates and falling prices and rents.

According to available data, despite the recent resurgence of office construction in the Region, the amount of new office space added during the 1990s is substantially less than the amount developed in the prior decade (see Chart 5). New office construction in the Region between 1995 and 1999 totaled only 16 percent of the construction that occurred between 1986 and 1990. More important, perhaps, while office construction has expanded during the past five years, the Region's share of new construction nationwide has declined. Between 1986 and 1990, the Region accounted for approximately 41 percent of the total new construction in the nation. Between 1994 and 1999, it accounted for only 18 percent.

An office-market risk matrix comparing the new office construction between 1995 and 1999 with construction between 1986 and 1990 indicates that the Region's CRE markets may be less vulnerable to a real estate bubble than they were in the early 1990s (see Chart 6, next page).[16] The Region's office markets appear less vulnerable to a downturn now because many of the Region's major markets, particularly New York City, **Long Island,** and **Westchester County,** experienced little or no new construction throughout the 1990s. As a result, recent demand has outstripped the supply of office space, driving down office vacancy rates. Perhaps the most important difference is that during the 1980s, large tracts of speculative office construction in the Region were coming to market, resulting in rising vacancy rates even as the economy was growing and office employ-

CHART 5

New Construction during the Present Expansion Has Not Yet Equaled the 1980s



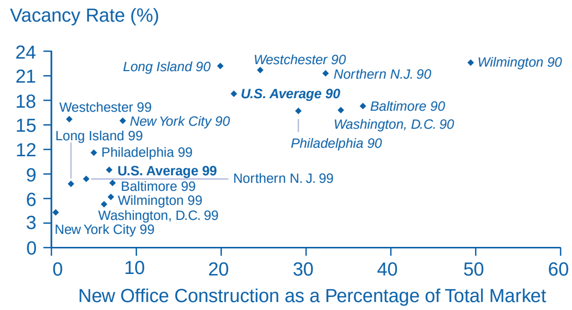
Data for the New York Region are the total of Baltimore, Northern New Jersey, Long Island, New York City, Philadelphia, Washington, D.C., Westchester County, and Wilmington, Delaware.
Source: FDIC Real Estate Data System

[15] Federal Deposit Insurance Corporation. 1997. *History of the Eighties, Lessons for the Future. An Examination of the Banking Crisis of the 1980s and Early 1990s.*

[16] For more information, see Burton, Steven K. October 1998. Ranking the Risk of Overbuilding in Commercial Real Estate Markets. *Bank Trends.* Federal Deposit Insurance Corporation, Division of Insurance.

Chart 6

Region's Cities Had More Overbuilding Risk during the Late 1980s than Today



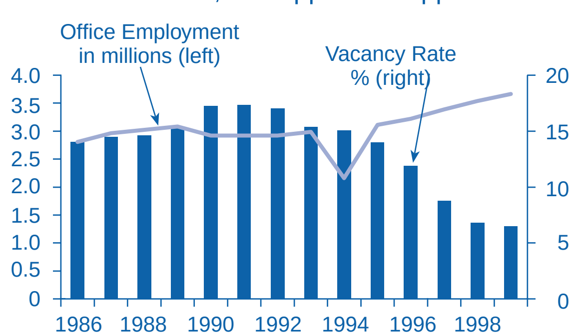
Vacancy rates as of 1990 and 1999. Existing stock as of 1990 and 1999. New stock is defined as new construction between 1986 and 1990 and 1995 and 1999.
Source: C.B. Commercial/Torto Wheaton Research

ment increasing. The recession of the early 1990s hit the Region's real estate markets harder than other parts of the nation, in part because so much new office construction was being completed just as the Region's economy started to contract and demand for space was declining (see Chart 7). In contrast, there has been limited office construction in most of the Region's office markets during this economic boom, and vacancy rates are declining in most of the Region's cities. As a result, the Region's CRE markets appear better positioned today to weather an economic downturn than they were a decade ago.

The relative lack of office construction in the Region also may be partly a result of difficulty in obtaining financing. In the early 1990s, as the glut in office space rose and loan quality deteriorated, financial institutions cut back on financing for office buildings. The so-called "credit crunch" resulted from diminished access to financing and reduced demand for CRE investments. Presently financing is available from more sources, particularly with the growth of the commercial and mortgage-backed securities and real estate investment trust markets. Nonetheless, anecdotal reports indicate that despite strong demand for office space, financing remains tight. Discussions with real estate developers suggest that more equity is required in today's market than in the 1980s. The legacy of the 1980s real estate downturn appears to be a tendency toward greater discipline and less flexibility among today's providers of capital.[17]

Chart 7

In the 1980s, Vacancy Rates Increased despite Rising Office Employment. In the 1990s, the Opposite Happened



Sources: Torto Wheaton Research and Bureau of Labor Statistics

Despite the relative health of the Region's office markets, areas of concern exist. The most notable, perhaps, is the large amount of office space being filled by high-tech and dot-com companies. A recent ***Wall Street Journal*** article[18] cited an ***Insignia/ESG*** (a real estate brokerage unit of ***Insignia Financial Group***) report that stated that high-tech tenants absorbed almost 3.9 million square feet, or about one-third of the total office space leased in New York City during the first four months of 2000. The absorption exceeded that of the city's financial sector, which leased almost 2 million square feet. Some high-tech companies have targeted previously less desirable locations that have been retrofitted to accommodate their needs, including special electrical wiring. Although demand for office space still far exceeds supply in New York City, dot-com companies are untested in their ability to weather stock market slowdowns and may face consolidation as the high-tech sector matures. Anecdotal evidence indicates that many developers are aware of the growing risks of leasing to this sector and are requiring more stringent leasing terms, such as larger deposits and more equity. However, the extent of the contribution of this new, expanding, yet volatile industry to the Region's CRE markets should be watched closely.

Growing Proportion of Region's Banks Report CRE Concentrations, but Credit Quality Is Sound

In response to renewed construction of CRE properties and perhaps in search of higher-yielding loans, the Region's banks reported that the proportion of CRE loans to total assets increased slightly in the past two

[17] Fefferman, Arthur. July 1996. *National Real Estate Investor* 38(7).
[18] Rich, Motoko. May 31, 2000. Landlords Feel Effects of Dot-Com Shakeout. *The Wall Street Journal.*

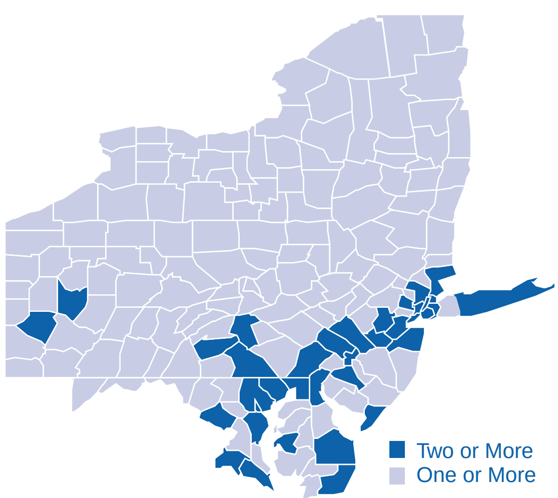
years. CRE loans represented approximately 5.9 percent of the Region's total assets as of March 31, 2000, compared with 5.3 percent two years ago. However, the proportion remains less than the 10.9 percent of assets held by the Region's insured institutions as CRE loans in first quarter 1990.

Although the aggregate proportion of CRE loans to assets has increased only slightly, the percentage of the Region's institutions that specialize in CRE lending (having more than 20 percent of total assets in CRE loans) has increased and exceeded the proportion prior to the recession in the early 1990s. In first quarter 2000, nearly 26 percent of the Region's institutions reported at least 20 percent of assets in CRE loans, compared with 19.5 percent in first quarter 1989. While small banks (those with assets less than $500 million) constituted the majority of these banks (77 percent at the end of first quarter 2000), the proportion has declined as the Region's midsized banks (those with assets between $500 million and $10 billion) have expanded their CRE presence.

Many of the Region's smaller banks that specialize in CRE lending are concentrated geographically in areas of strong economic activity from Westchester County and Long Island along the I-95 corridor to Washington, D.C., west of Philadelphia in **York,** Harrisburg, and **Pittsburgh,** and on the Delmarva Peninsula (see Map 2). In some of the Region's cities where office employment has begun to slow, small banks that specialize in CRE lending have increased their aggregate proportion of CRE loans to assets to levels above those reported prior to the last recession in 1990 to 1991. These cities include the metropolitan statistical areas of New York City, Long Island, Harrisburg, and York, Pennsylvania.

Map 2

Counties with Two or More Small CRE Banks Cluster Near Major Cities



Note: CRE = commercial real estate
Source: Bank and Thrift Call Reports

Reflecting favorable CRE conditions throughout most of the Region, the credit quality of CRE loans held by the Region's institutions has improved steadily since the last recession but may have plateaued recently. The average past-due ratio for all CRE loans in the Region has consistently improved since 1992 and was 1.8 percent as of March 31, 2000. The average CRE charge-off ratio, net of recoveries, was approximately zero prior to the last recession and is again approximately zero as of first quarter 2000. Furthermore, the distribution or range of past-due ratios on CRE loans reported by all institutions in the Region has improved steadily since the early 1990s (see Chart 8). Even among the Region's CRE banks, past-due loans and net charge-offs approximate pre-recession levels (see Chart 9, next page).

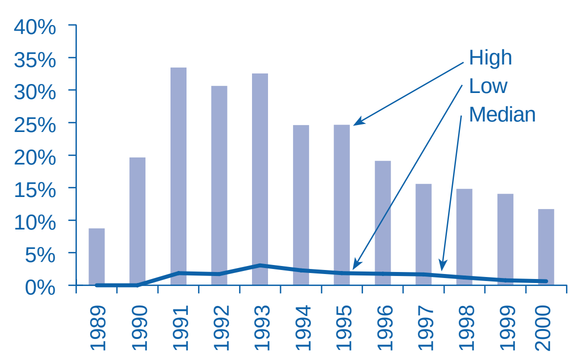
Implications

Most areas in the Region show signs of tight CRE conditions even though office construction has increased. In the recession of the early 1990s, new space was being added just as the economy slowed. Ten years later, CRE conditions are much tighter; however, many economic forecasts call for the national economy to slow, which could constrain demand for office space in local markets if companies limit expansion or contract operations.

While the Region's banks on average reported sound CRE credit quality measures in the first quarter of 2000,

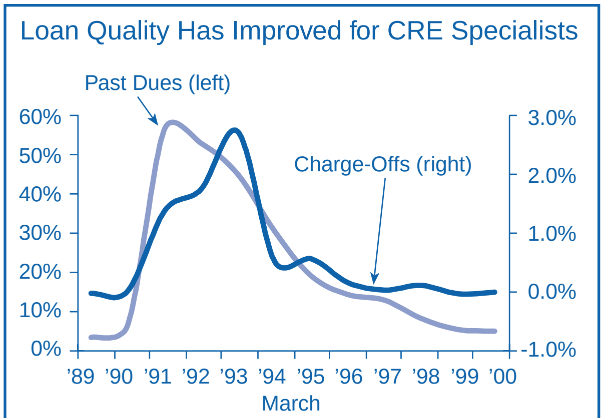
Chart 8

Range of CRE Past-Due Ratio Has Declined



Note: CRE = commercial real estate
Source: March Call Reports for all institutions in the Region less the highest and lowest 2.5 percent

CHART 9



Source: Call Reports for banks with commercial real estate (CRE) loans greater than 20% of assets

a larger share of banks than in prior years has some concentration in CRE loans. Furthermore, a recent underwriting survey noted an increased frequency of risky underwriting practices in construction lending in the six months ending March 31, 2000.[19] Relaxed underwriting in the face of a slowing economy could pose problems for construction lenders. Smaller banks with more localized exposure to CRE markets may be more susceptible to softness in local economies or problems in specific industry segments, such as the Internet or health care. Nevertheless, as banks expand CRE portfolios, they should be vigilant in monitoring economic conditions, which could affect CRE loan quality.

Kathy R. Kalser, Regional Manager
Robert DiChiara, Financial Analyst
Norman Gertner, Regional Economist
Alexander J.G. Gilchrist, Economic Analyst

[19] Federal Deposit Insurance Corporation. *Report on Underwriting Practices. October 1999 through March 2000.*

Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding

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

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

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

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

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

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

Previous Real Estate Cycles Are Well Documented

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

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

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

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

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

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

Factors Contributing to Cycle of Overbuilding in CRE

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

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

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

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

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

Recent Developments

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

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

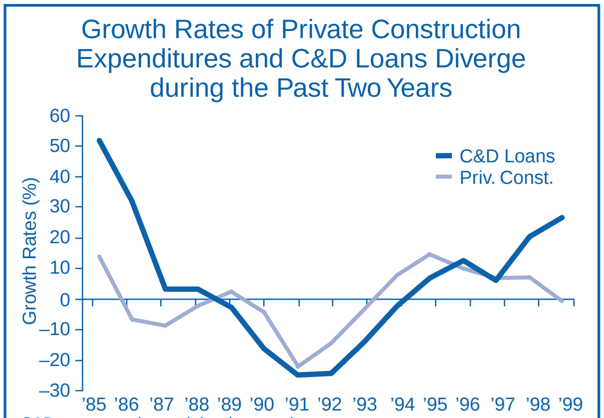
A new characteristic of the CRE industry in the current expansion has been the marked increase in capital availability through the financial markets. Annual issuance of CMBSs has grown from negligible amounts in 1990 to over $67 billion in 1999. Financing made available through REITs has been the other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

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

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

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

CHART 1



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

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

Identification of Markets at Risk for Overbuilding

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

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

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

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

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

Most Active Construction Markets

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

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

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

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

CHART 2

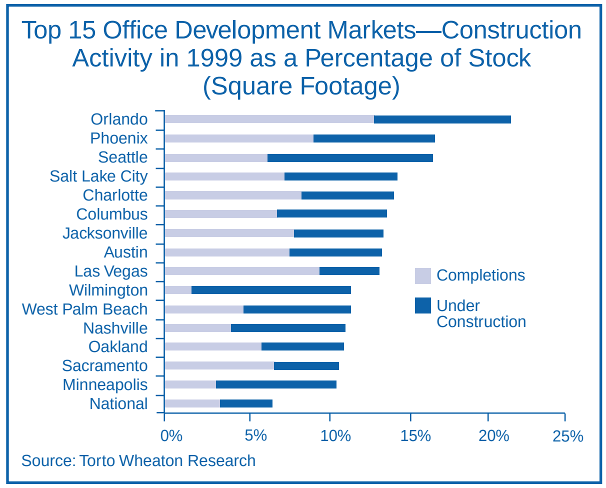


CHART 3

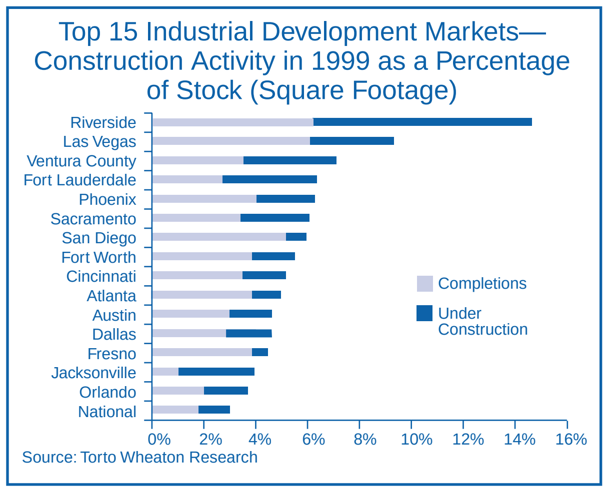
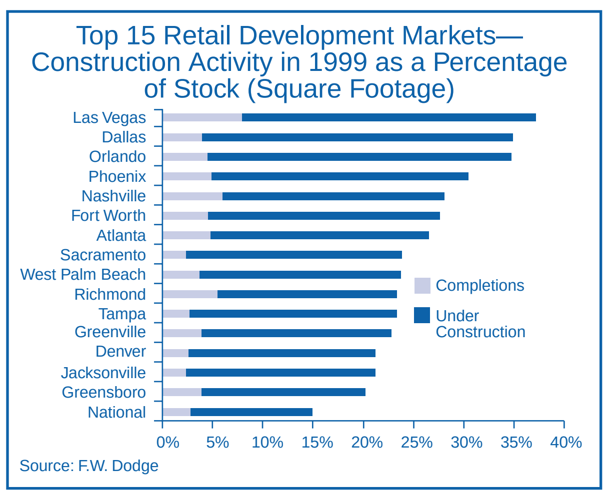


CHART 4



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

C&D Loan Concentrations

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

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

Construction Employment Concentrations

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

[11] Community banks are FDIC-insured institutions with assets less than $1 billion.
[12] For community banks that have C&D loans.
[13] Since 1992, the aggregate C&D-to-asset ratio for the nation's community banks has been higher than the C&D-to-asset ratio for institutions larger than $1 billion. This is a reversal of the condition from 1984 through 1991 when the aggregate C&D-to-asset ratio for institutions larger than $1 billion exceeded the C&D-to-asset ratio for community banks.
[14] Construction concentrations are the percentage of construction employees relative to the nonfarm workforce.

CHART 5

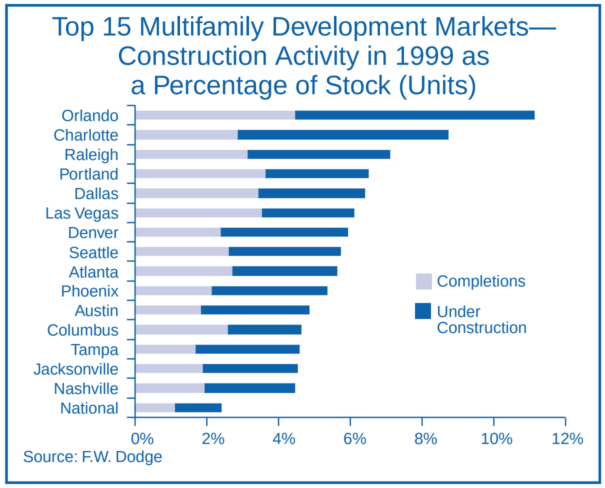


CHART 6

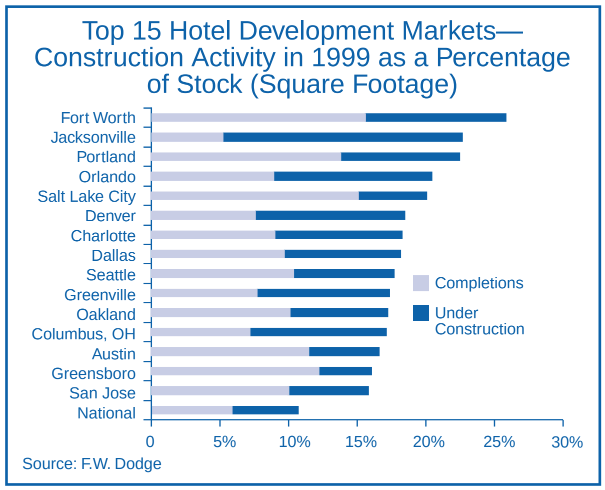
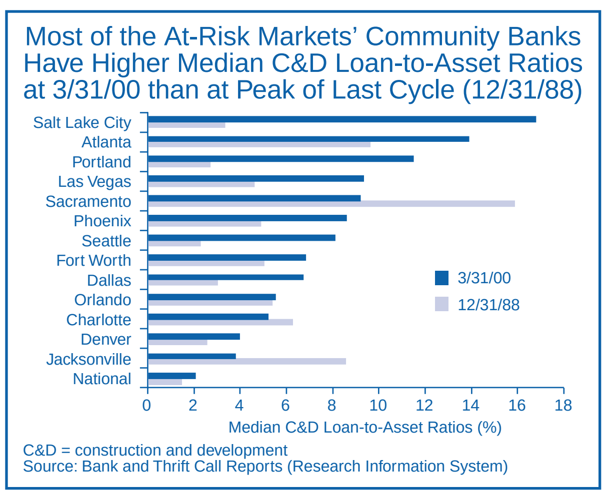


CHART 7



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

High Construction Activity and High Vacancy Levels

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

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

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

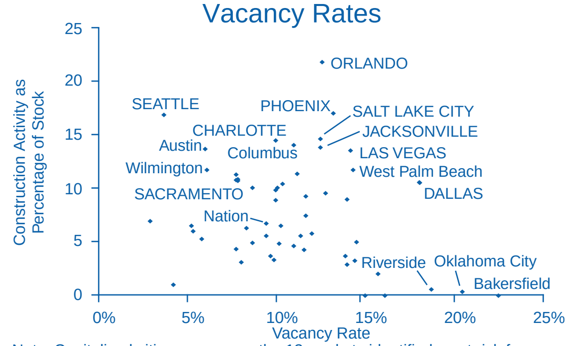
Chart 8

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

Source: Bureau of Labor Statistics (Haver Analytics)

Chart 9

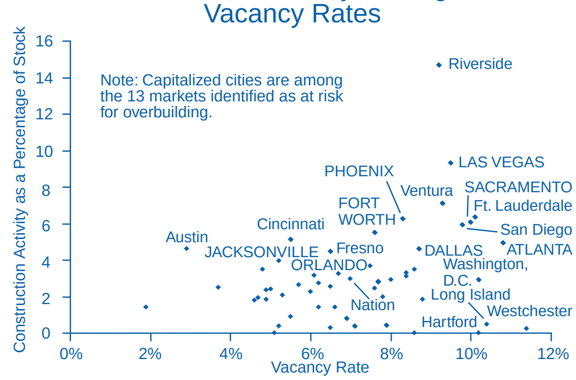
Many of the 13 At-Risk Markets Report High Office Construction Activity and High Office Vacancy Rates



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

Chart 10

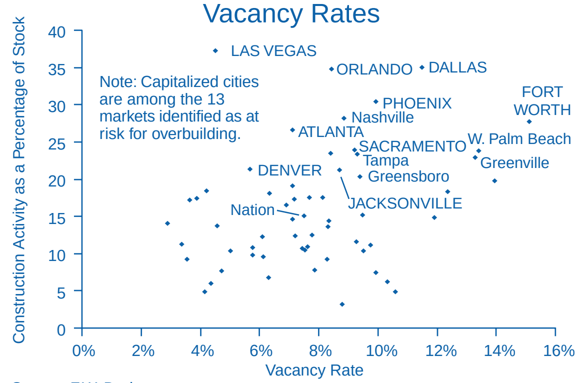
Many of the 13 At-Risk Markets Report High Industrial Construction Activity and High Industrial Vacancy Rates



Source: Torto Wheaton Research

Chart 11

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



Source: F.W. Dodge

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

What Market Analysts Are Saying

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

Office

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

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

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

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

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

Multifamily

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

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

Industrial

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

Retail

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

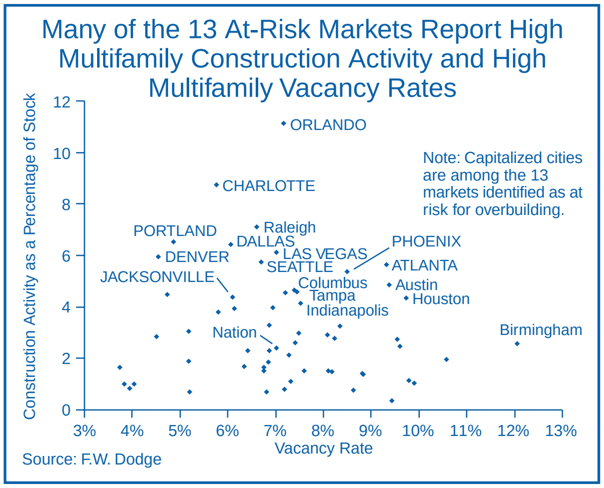
Hotel

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

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

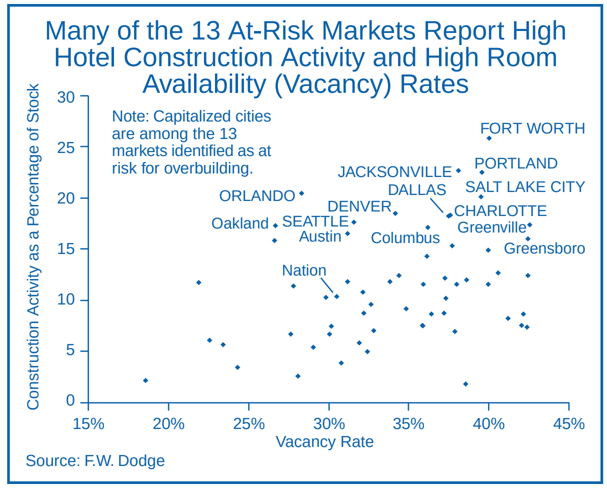
[16] Torto Wheaton Research. Spring 2000. *Office Outlook.*
[17] Thierry Perrein, Donaldson, Lufkin & Jenrette. April 2000. *DLJ REIT Corporate Handbook, "Cautious Optimism."*
[18] Urban Land Institute. *ULI 2000 Real Estate Forecast.*
[19] Templin, Neal. June 7, 2000. Economic Focus: Houston, Dallas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

CHART 12



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

CHART 13



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

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

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

Conclusion

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

Thomas A. Murray, Senior Financial Analyst

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

- **Home prices have risen rapidly in several major U.S. metropolitan areas.**

- **The credit quality of residential real estate loan portfolios traditionally has been solid.**

- **New lending programs such as subprime and high loan-to-value lending could change the historical loss experience associated with residential real estate.**

Introduction

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

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

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

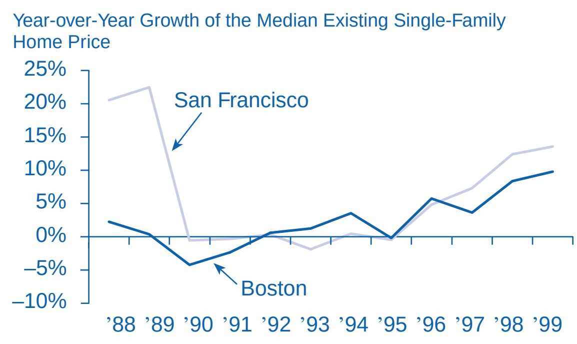
Home Prices in Some Local Markets Are Soaring

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

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

CHART 1

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



Source: National Association of Realtors (Haver Analytics)

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

Table 1

Of the 20 U.S. Cities with the Most Expensive Housing, More than Half Have a Concentration in High-Tech Employment

The shaded areas indicate markets where high-tech employees constitute at least 5 percent of the total payroll employment (see note).

Metropolitan Statistical Area Ranking by Median Home Price		Median Price of an Existing Single-Family Home March 2000	Percent Change from One Year Ago
1	San Francisco, CA	$418,600	25.0%
2	Orange County, CA	$300,800	10.3%
3	Honolulu, HI	$289,000	–2.0%
4	Boston, MA*	$255,000	8.4%
5	San Diego, CA	$251,400	16.1%
6	Bergen-Passaic, NJ	$250,200	9.8%
7	Newark, NJ	$229,500	18.8%
8	Seattle, WA	$226,100	8.3%
9	New York, NY	$221,500	14.3%
10	Nassau-Suffolk, NY	$209,200	12.8%
11	Los Angeles, CA	$202,900	5.6%
12	Middlesex, NJ	$198,500	8.6%
13	Monmouth-Ocean, NJ	$186,200	19.4%
14	Denver, CO	$181,500	12.9%
15	Washington, DC-MD-VA	$177,500	5.6%
16	Portland, OR	$166,700	0.8%
17	Chicago, IL	$166,700	0.4%
18	Lake County, IL	$162,600	–2.2%
19	Aurora-Elgin, IL	$158,200	7.5%
20	Raleigh-Durham, NC	$156,300	–4.2%
Nation		**$133,533**	**2.7%**

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

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

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

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

Favorable Economic Conditions Have Sustained Consumer Spending Patterns

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

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

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

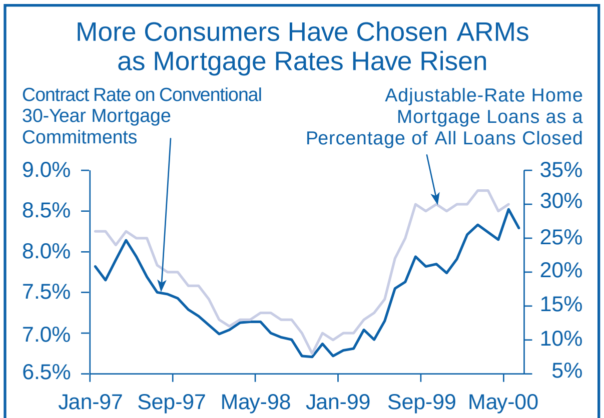
Overall Credit Quality of Residential Mortgages Has Been Solid

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

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

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

Chart 2



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

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

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

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

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

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

Chart 3

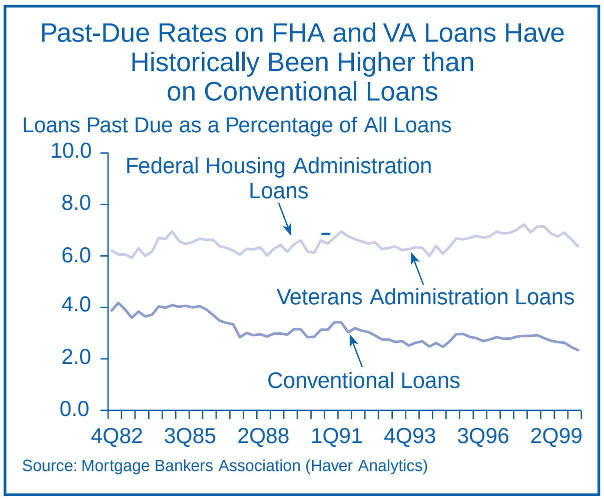
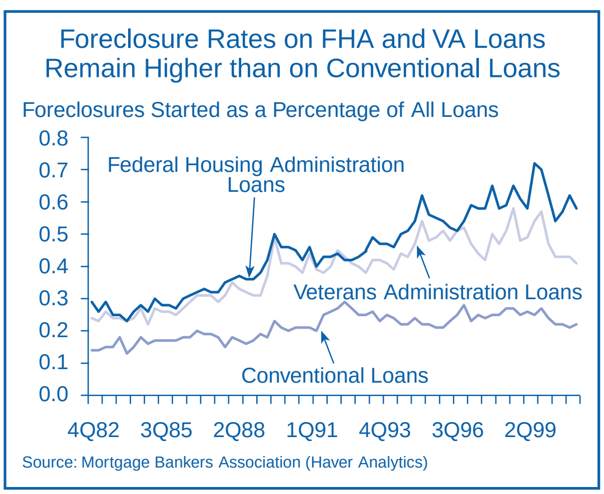


Chart 4

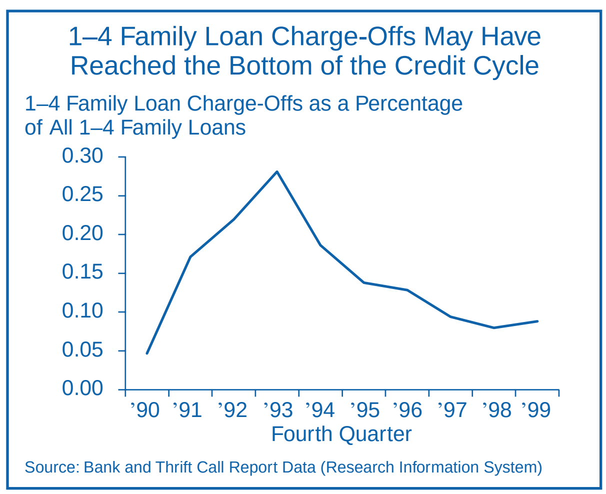


A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving submarket residential real estate problems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

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

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

Chart 5



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

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

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

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

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

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

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

Table 2

Pockets of Risk May Be Forming Where the LTV Is Highest

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

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

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

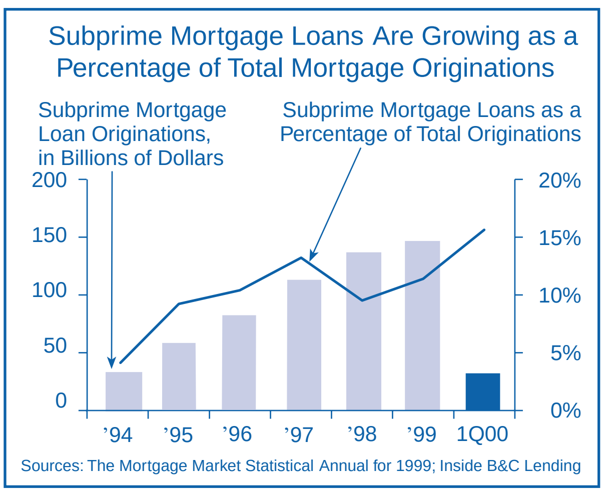
[9] See also Kathy R. Kalser and Debra L. Novak. **"Subprime Lending: A Time for Caution."** ***Regional Outlook,*** third quarter 1997; http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf.

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

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

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

CHART 6



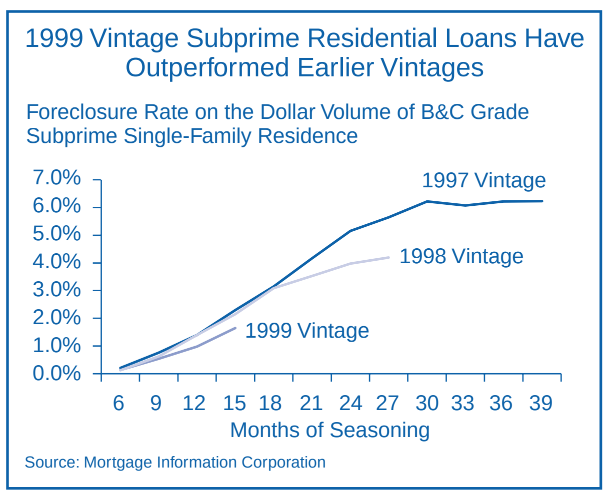
Conclusion

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

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

Alan Deaton, Financial Economist

CHART 7



[10] Subprime Mortgage Market Faces More Challenges in Second Half of Turbulent 2000. *Inside Mortgage Finance.* July 7, 2000.
[11] Mortgage Delinquency Rates Decline in Early 2000 But Industry Braces for Shift in the Wind. *Inside Mortgage Finance.* July 14, 2000.
[12] Seriously delinquent loans are defined as loans at least 90 days delinquent or in foreclosure.

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