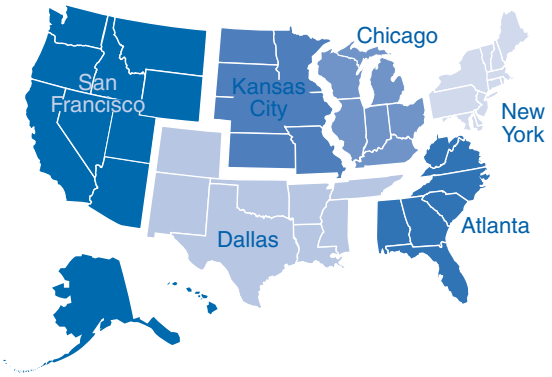
FDIC Outlook

SUMMER 2003

In Focus This Quarter



The U.S. banking industry's strong performance in the face of subpar economic growth since early 2002 is remarkable. Together, the banking and thrift industries' net income reached over $105 billion in 2002, the first time annual earnings have topped the $100 billion mark. Despite the strong performance during 2002, some issues bear watching. These include continued weakness in corporate credit quality, although conditions are generally improving as a result of aggressive bad debt workouts by large insured institutions; concerns over a protracted slump in commercial real estate markets, which might eventually lead to increased losses; subprime consumer lending, given increased household leverage and the ongoing extension of unsecured lending (especially credit card debt) to borrowers with less experience in managing credit; net interest margin compression; interest rate and funding risks related to the unusually low interest rate environment; exposure to market-sensitive, noninterest income sources; and the adequacy of internal audit and other controls against potential fraud.
See page 3.

By Richard Austin, Senior Financial Economist
Alan Puwalski, Senior Policy Analyst

Regional Perspectives

Atlanta—Revenue shortfalls and rising expenditures have contributed to deteriorating fiscal conditions among states in the Region. These developments may challenge the regional economy and pressure credit quality among insured institutions. *See page 13.*

Chicago—Concentrations in commercial real estate lending continued to rise among the Region's insured institutions as market fundamentals in the larger metropolitan statistical areas weakened. *See page 17.*

Dallas—Despite a sluggish economy, insured institutions based in the Region report favorable conditions; however, some deterioration has occurred in the consumer loan portfolio. Rising debt levels may contribute to additional weakening in credit quality. *See page 21.*

Kansas City—The number of newly chartered institutions has increased significantly in certain metropolitan areas during the past five years. These institutions performed well during the recent recession; however, continued economic weakness could pressure earnings and credit quality. *See page 25.*

New York—Many of the Region's states face budget shortfalls, which may worsen in the coming fiscal year. Job losses in the financial sector have disproportionately hurt New York City and Boston. *See page 31.*

San Francisco—The Region's travel sector remains vulnerable to a sluggish economic recovery and events abroad. Asset quality and earnings among insured institutions based in travel-dependent markets could deteriorate if weakness in this sector continues. *See page 36.*

By Staff of the Regional Operations Branch

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Economic Conditions and Emerging Risks in Banking

The U.S. economy has been growing modestly since early 2002; however, the ***Business Cycle Dating Committee of the National Bureau of Economic Research (NBER)*** said on April 10, 2003, that it needed additional time to interpret the movements of the economy last year and this year before it can officially date the economic recovery, which is believed to have begun sometime in 2002. Notwithstanding the slow growth of the economy during 2002, insured commercial banks and savings institutions registered record earnings performance. This article explains the strong performance of the banking and thrift industries through the 2001 recession and during this subsequent period of modest economic growth. It also explores areas in the banking system that are potentially vulnerable because of the narrow underpinnings of economic growth.

Industry Summary

The U.S. banking industry's strong performance in the face of modest economic growth is remarkable. While real gross domestic product (GDP) increased only 2.9 percent between fourth quarter 2001 and fourth quarter 2002, insured commercial banks and savings institutions registered record earnings performance. Together, the banking and thrift industries' net income reached over $105 billion in 2002, the first time that annual earnings have topped the $100 billion mark. While the 2001 recession contributed to higher provision expenses in 2002, low interest rates and strong fee income helped boost bank earnings to record levels.

Higher provision expenses were far outweighed by a large increase in net operating revenue. The banking and thrift industries' net operating revenue increased by almost $39 billion in 2002 over the previous year. This surge in operating revenue far outweighed the $5.1 billion increase in loan loss provisions during the year. Within operating revenue, net interest income increased by $25.2 billion, while noninterest revenue increased by $13.7 billion despite a decline in revenues associated with capital market activities.

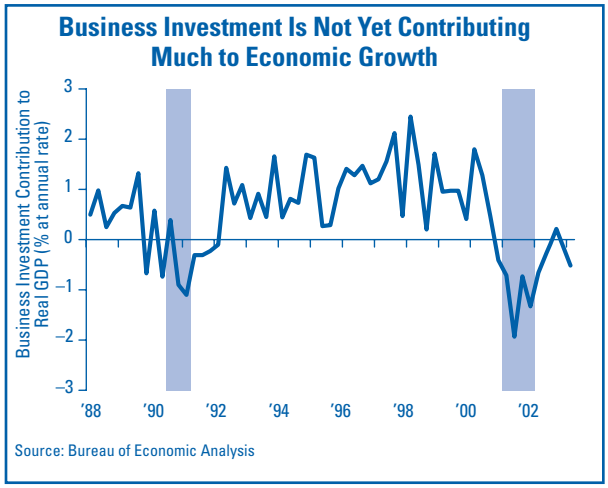
A historically steep yield curve helped boost the industry net interest margin (NIM) to a five-year high of almost 4 percent. On top of the almost 18 percent increase in operating revenue year over year, low interest rates prompted banks to take record gains of over $12 billion on the sale of securities.

A Strong Consumer and a Weak Corporate Sector

Economic growth since early 2002 has been based largely on consumer spending, which has been bolstered by gains in aggregate personal income; a widespread cashing out of home equity; lower monthly debt service as a result of mortgage refinancing and the consolidation of high-cost debt into low-cost, tax-favored mortgage debt; overall growth in consumer credit; and fiscal stimulus. In contrast, the corporate sector has shown little or no progress in expanding investment spending (see Chart 1) or employment, thus limiting its contribution to economic growth.

To date, the banking and thrift industries have largely been spared the effects of the broader corporate sector weakness for several reasons. Commendably, the industry has exercised better risk sharing and developed more diversified income sources than in previous economic downturns. Also, falling interest rates and the strength of the consumer sector have resulted in

Chart 1



a windfall for banks and thrifts through strong consumer loan growth, consumer-related fee income, and improved NIMs and income—gains that more than offset rising provision expenses. With signs that the consumer sector may be slowing, and given that deposit rates have reached a floor, the primary question hanging over financial institutions is whether record earnings performance can continue.

The outlook for industry performance will depend on resolving a number of outstanding issues, both economic and operational. The following issues could challenge continued industry strength and earnings growth:

- an uncertain or stalled transition from consumer-dependent economic growth to a broader-based recovery, including business investment;
- restructuring and continued difficulties in the corporate sector;
- vulnerabilities in certain business models conceived in a stronger economy;
- an unprecedented and challenging interest rate environment;
- corporate governance issues and associated reputational risks; and
- increasing operational risk that, in some cases, has resulted from cost cutting at the expense of important loss mitigation functions, such as internal audit.

Two Views of Recent Economic Weakness

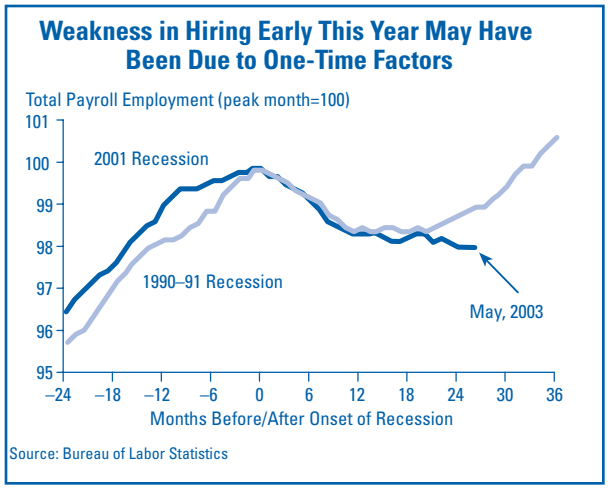
Assuming that the recovery began sometime in 2002, its unbalanced nature is not typical in U.S. economic history. Most analysts agree that for economic growth to gain momentum, a transition must take place whereby an expanding corporate business sector takes a growth leadership position, thus compensating for potentially slower gains in consumer spending. Greater vigor in business investment and inventory accumulation will be major factors in determining the vitality of U.S. economic growth—and the direction of insured institution performance—for the remainder of 2003.

Two views prevail as to why corporate sector growth remains restrained two full years after the beginning of the 2001 recession. The first view maintains that a postboom structural overhang, characterized by high corporate debt and excess capacity, will take years to unwind. The second view maintains that much of the needed corporate reform and restructuring have been completed and that transient factors—the threat of terrorism, war in Iraq, unusually severe winter weather, and, most recently, the outbreak of the severe acute respiratory syndrome (SARS) virus—caused a temporary break in hiring (see Chart 2) and investment in early 2003.

Historically, economic data have been particularly mixed around turning points, with various signals pointing in different directions. Based on the admittedly mixed evidence, and barring additional significant negative surprises, it appears likely that business hiring and investment will pick up, now that many of this year's drags on growth have passed or at least moderated. If this scenario plays out, many of the banking system's potential vulnerabilities (discussed below) will recede.

The downside risks are of two sorts. First, the corporate structural overhang may have further to run; if so, modest increases in business investment and hiring may not adequately replace faltering growth in consumer spending. Second, certain geopolitical and global economic factors may continue to weigh on business confidence, including the potential for a protracted U.S. peacekeeping, nation-building presence in Iraq; additional terrorist attacks against the United States; and an ongoing global recession—recently made worse in some parts of Asia by the SARS outbreak.

Chart 2



Banks Have Thrived in the Consumer-Driven Recovery

GDP growth in 2002 reflected the narrow, consumer-driven underpinnings of economic activity, as modest contributions to growth from housing and government last year were offset by rising imports and a weakening in exports late in the year. Despite the corporate bankruptcies, layoffs, and erosion of equity market wealth associated with the 2001 recession, consumer spending expanded in every quarter throughout the past two years. Personal consumption growth has persisted because of monetary and fiscal policies that helped, in aggregate, to offset job losses and maintain household disposable income.

Aggressive monetary policy easing by the Federal Reserve, begun in January 2001, contributed to a dramatic shift in the yield curve from inverted in 2000 to steep and upward sloping by year-end 2001, and brought short- and long-term rates down to levels not seen for 40 years. Over most of the Fed's latest easing, the month-end spread between three-month and ten-year Treasury rates averaged roughly 230 basis points. As a result, on a year-over-year basis during much of 2002, net interest margins widened among institutions of different asset sizes and banking business models (including commercial, residential, and consumer lenders). Quarterly NIMs rebounded quickly during 2001 and steadily improved until fourth quarter 2002. Over the same period, gains in net interest income, resulting largely from Federal Reserve policy, helped offset rising charge-offs at banks and thrifts.

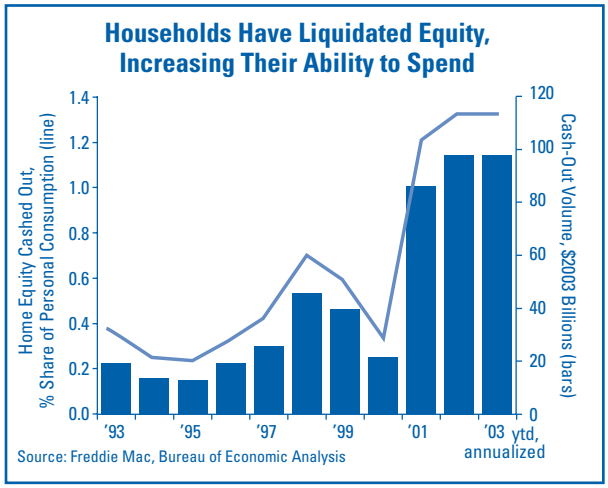
Federal Reserve policy achieved its desired effect on consumer demand, and banks benefited from the response. By taking on new debt and refinancing existing debt at more favorable rates, households were able, for the most part, to continue to service growing debt and sustain aggregate demand. Over the past two years, cash-out mortgage refinancing freed up an estimated $180 billion for consumers to either spend or save (see Chart 3). Over that period, households also took out an additional $169 billion of consumer debt, according to the Federal Reserve's flow of funds data. The growth in consumer indebtedness contributed to insured institutions adding $375 billion to consumer and mortgage lending in 2002, accounting for two-thirds of total asset growth.

Mortgage applications increased by 28 percent in 2002, from record-high levels in 2001, while refinancing activity rose by 36 percent. The booming mortgage market provided a windfall for banks and thrifts through the inflow of refinancing and mortgage origination fees. Through May 2003, mortgage rates continued to hold near historic lows, and the refinance pipeline remained full. However, analysts' opinions about the strength of refinancing activity going forward differ widely. Even if mortgage rates remain low, many of the mortgages that can be refinanced already have been. Furthermore, stagnation of home appreciation could dampen demand for cash-out refinancing, which has been both a driver of consumer demand and a support for consumer credit quality. Ongoing corporate restructuring may continue to weigh on employment growth, which also would limit gains in consumer demand.

Subprime Consumer Credit Quality Remains a Concern

The growth in bank consumer lending has not come without credit costs. Credit card charge-offs exceeded 6 percent of average balances in 2002 as personal bankruptcy filings topped 1.5 million for the first time. Despite sharply higher loan losses, credit card lenders earned a combined return on assets of 3.6 percent and a return on managed assets of 2.3 percent in 2002. Return on equity also has risen for this specialty group, despite higher capital requirements for certain securitization activities. In terms of earnings, prime consumer lending specialists, in particular, generally outperformed the rest of the industry.

Chart 3



A weak job market and a slowing in receivables growth have contributed to rising charge-offs. Rapid growth of accounts can mask deteriorating credit quality trends, because new accounts tend to have lower loss rates than seasoned accounts. A continued slowdown in the growth of credit card receivables will likely result in higher loss rates. In addition to cyclical pressures, the wider availability of consumer credit over the past decade may affect aggregate credit quality adversely.

At the FDIC consumer debt roundtable on February 28, 2003, the extension of credit to higher-risk borrowers and growth of the subprime lending industry were discussed as part of a long-term "consumer lending revolution" that is likely to result in permanently higher loss rates for many consumer lenders. While higher loss rates, in and of themselves, are not necessarily an impediment to profitability, the extent to which some lenders' credit scoring technology underpredicted losses during the recession is a concern. For subprime lenders in particular, loss rates rose more than predicted during the recession, and some lenders were not prepared for the volatility of loss rates demonstrated by the higher-risk loan pools. Even rating agencies were taken aback by the extent and velocity of portfolio deterioration at some credit card lenders.

As of year-end 2002, the FDIC identified 125 institutions as subprime lenders (with 25 percent or more of Tier 1 capital in subprime loans). These institutions held $62.8 billion in subprime assets. This level had declined from two years earlier, when 156 institutions holding $70.3 billion in subprime assets were identified. The decline, by and large, is the result of a retrenchment of activity by former subprime lenders, and this retrenchment has led to an overall decline in the number of problem banks (defined as institutions rated a 4 or 5). However, some institutions have remained committed to this business line and have replaced those that have withdrawn.

Some subprime lenders followed the consumer lending revolution to troubled bank status (defined as institutions rated a 3, 4, or 5). Although the number and assets of subprime lenders rated 3, 4, and 5 have declined since 2000, the volume of subprime assets held by troubled institutions is higher. Of the 125 institutions identified as subprime lenders, 48 are rated 3, 4, or 5, and the dollar volume of subprime assets held by these 48 troubled institutions is $26.1 billion. Two years ago, 54 subprime lenders were rated 3, 4, or 5, and they held $19.9 billion in subprime assets. The majority of the institutions currently identified as most susceptible to failure are subprime lenders.

Ongoing Risks in Consumer Lending

Several additional factors could lead to a continued rise in subprime and prime consumer charge-offs. A continued weak employment picture, unfavorable bankruptcy reform, and any decline in the "take-out financing" provided by cashed-out home equity could result in higher consumer loan charge-offs.

Credit losses aside, some consumer lending business models have been found inadequate for other reasons in staving off the market and economic challenges of the recession. Among these business models are those, such as certain home equity and credit card lenders, that relied heavily on the securitization market for funding and were, therefore, highly sensitive to pricing in this market. These institutions were unable to meet liquidity demands when access to the securitization market became more selective.[1]

Other business models relied on the generation of fees from programs such as the sale of "club" memberships, such as frequent flier programs, or credit-life insurance. Demand for these products has proved tenuous, and credit losses at these lenders are cutting more deeply into total revenue as this source of fee income fades. Finally, some business strategies have relied on third-party relationships that have given rise to significant operational risks. In some instances, these relationships have resulted in reputational and legal risks for the contracting banks; in extreme cases, they have caused significant fraud-related losses.

Credit card lenders face several challenges in the future that are not yet reflected in their performance results. Securitization costs are rising, not only because of market conditions but also as a result of increased subordination levels. The latter condition resulted from rating agencies' diminished view of the value of early amortization as a credit enhancement. Credit card lenders also face generally higher capital requirements for retained interests in securitizations because of recently enacted regulations and may face

[1] Capital market conditions recently resulted in securitization pricing for one credit card lender that some analysts estimate will cost as much as an additional $10 million over the life of the transaction because of current market selectivity.

higher requirements under the proposed Basel II capital requirements.

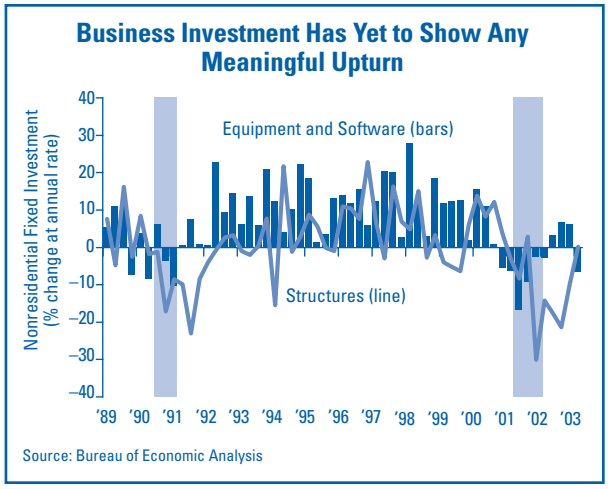
Home equity lending is emerging as another risk area in consumer lending. The FDIC has previously addressed this issue in its more egregious form—high loan-to-value lending—but the risks of other forms of home equity lending may be subtler. Lenders have a tendency to price this product very thinly because of stiff competition and the perception that home equity lending will perform similarly to other residential lending; however, they may find that borrowers behave differently when there is not as much equity at stake, even if they face a nominal threat of foreclosure. Stagnant or declining home values in certain markets may exacerbate this effect.

Continued consumer sector strength will depend on the resilience of real disposable income growth. An active mortgage refinancing market through May 2003 also bodes well for consumer liquidity, though the extent to which consumers choose to spend cashed-out equity or reductions in monthly mortgage payments remains uncertain—they may choose to retire other debt or increase saving instead. Although new tax rebates, an additional extension of unemployment benefits, and tax cuts were approved in May, monetary and fiscal stimuli may not boost consumption growth significantly during the next six months, especially if households elect to save more or retire debt, rather than increase spending. Any slowdown in consumption growth may impede the overall economy's pace, unless it is offset by another source of expanding aggregate demand.

Business Spending and Hiring Necessary to the Recovery

In contrast to the robust consumer and banking sectors, contracting corporate business investment dragged on overall U.S. economic growth throughout 2001 and most of 2002. After nearly a decade of uninterrupted sequential quarterly growth, aggregate real nonresidential investment has contracted more than 10 percent over the past two years. In this sense, the 2001 recession can be viewed primarily as a nonfinancial corporate sector recession, as opposed to the "traditional" recessions that affect consumers, financial companies, and other businesses more evenly.

Chart 4



Currently, business investment appears to be the most likely replacement for any slowdown in consumer spending. Residential investment and government spending are expected to continue growing, but probably not at the higher rates necessary to compensate for an easing in consumption growth. No improvement is foreseen in net exports; in fact, the U.S. current account deficit is likely to continue deteriorating over the near term despite the dollar's recent depreciation, as weak final demand abroad may more than offset lower dollar-denominated prices.

Although the importance of stronger growth in business investment (and hiring) is clear, there is substantial debate about when the pace of these activities will pick up. As seen in Chart 4, equipment and software investment had been recovering modestly last year but slowed in first quarter 2003. The slowdown, though, was mostly due to a drop in transportation equipment outlays; technology investment continued to grow. Meanwhile, the overall decline in business plant and structure investment seemed to stabilize by early 2003. While the recession-induced decline in capital equipment spending may be over, a return to strong growth remains elusive. Much of the needed corporate restructuring may have occurred already, but the problems of high debt loads, excess capacity, and slow revenue growth may be slow to abate.

Business Recession Has Hurt Commercial Credit Quality

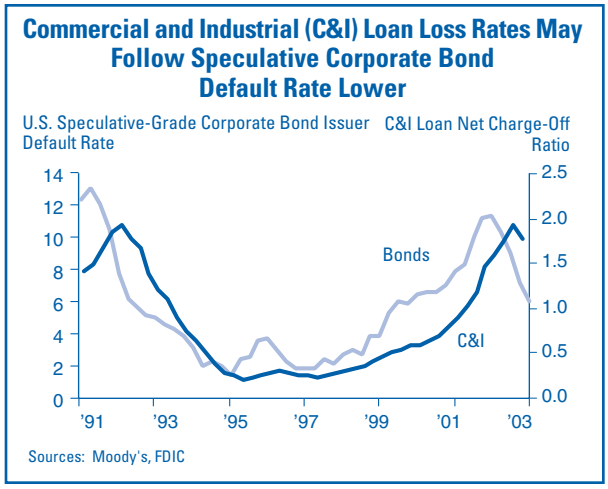
In contrast to the strong growth of consumer lending, commercial credit provided by banks and thrifts increased by only $13.8 billion in 2002. During the corporate sector shakeout that accompanied the recession, more than 78,000 businesses failed in two years. These bankruptcies contributed to 229 defaults on almost $197 billion in publicly rated bonds over the same period.

Banks, particularly large banks, have not been immune to these corporate credit trends as commercial and industrial (C&I) loss rates increased during the past few years. Loan losses have been disproportionately borne by large banks because of poor risk-selection practices during the rapid syndicated loan growth years of 1996–2000 and high-profile financial woes brought on by accounting irregularities exposed at a number of formerly investment-grade companies ("fallen angels"). Recently, the segment of the industry experiencing worsening credit quality trends has narrowed. In fact, three large banks accounted for all of the $2.1 billion increase in losses on C&I loans at FDIC-insured institutions in 2002.

Commercial Credit Problems Likely to Abate

Two trends look promising for commercial credit quality in the near term. First, C&I charge-offs declined in fourth quarter 2002 by almost 30 percent from a year ago. Second, noncurrent C&I loans (those 90 days or more past due or in nonaccrual status) fell by $1.2 billion during the quarter—the first quarterly decline in three years. A continued improvement in noncurrent C&I loans will help the industry's coverage ratio, which has been declining since 1998. C&I losses seem to follow default rates on noninvestment-grade corporate bonds, suggesting continued improvement in C&I loan quality this year (see Chart 5). The extent of the improvement in commercial credit quality will be evaluated during the 2003 Shared National Credits (SNC) Review by the three federal bank regulatory agencies. Results for the 2003 review should be available by September.

Chart 5



Credit Implications of Corporate Sector Restructuring

In addition to the rash of corporate defaults and bankruptcies during this period of restructuring, other businesses have been downsizing, reducing their workforces in response to strong domestic and foreign competition and lackluster sales growth. Reducing workforces has raised productivity levels and helped to maintain profits, but it has also idled large amounts of plants and equipment. Industrial capacity utilization tumbled precipitously from May 2000 through December 2001, falling from 83.6 percent to 74.6 percent, mostly as a result of weakness in manufacturing. Although capacity use rose somewhat in early 2002, that gain was short-lived. As a result, April 2003 overall capacity utilization of 74.4 percent was little changed from the December 2001 rate.

Reduced workforces and lower capacity utilization (as well as historically lean inventories) have implications for commercial real estate (CRE) and potential C&I loan growth. Because the recession caused demand for working capital to diminish, commercial loan demand declined also. As a result, although total loans at commercial banks have grown steadily for the past few years, the percentage of C&I loans to total loans has been declining. Historical precedent suggests that C&I loan demand will remain lackluster so long as capacity utilization remains low and corporate profit growth lacks traction.

In addition, the effects of corporate restructuring have been reverberating through the CRE markets, resulting

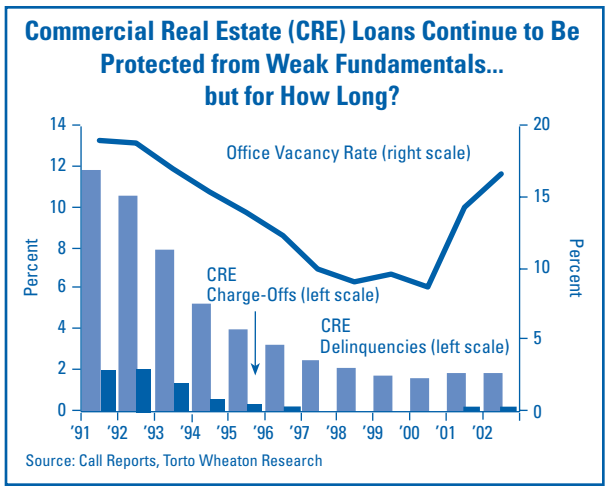
in continued upward pressure on office vacancy rates and unprecedented negative net absorption. Throughout this period of corporate restructuring, many property owners have been confronted by tenants demanding lower rents and who are scrambling to pare back holdings of office, industrial, apartment, retail, and other space. But in spite of the weaknesses in CRE market fundamentals, CRE credit quality at insured institutions has remained sound. Past-due loans and charge-offs remained at near-record lows through year-end 2002 for each of the three commercial real estate loan categories: construction and development, multifamily, and nonfarm-nonresidential (see Chart 6).

A number of factors may explain the disconnect between market fundamentals and banks' CRE credit performance. In contrast to the CRE downturn of the late 1980s and early 1990s, the current situation is due mostly to rapidly diminished demand rather than to oversupply. While many landlords have had to accept static or lower rents to remain competitive in attracting and retaining tenants, few have found this situation to be a major hindrance to net cash flow, largely because the low interest rate environment has enabled property owners to refinance existing CRE loans at lower rates.

The stronger performance of CRE loans at banks and thrifts in this cycle is due also to the fact that risk has been spread more widely through the tremendous growth in commercial mortgage-backed securities (CMBS) and real estate investment trust (REIT) activity since the last cycle. Growth in these aspects of public real estate markets has enhanced transparency and public scrutiny of CRE fundamentals. In addition, increased regulator oversight and tighter CRE lending requirements may have improved the underlying credit quality since the last cycle.

Several issues regarding commercial real estate warrant continued monitoring, however. Many properties that had been under construction are now coming on line, and for those that had leases executed during the boom period of two years ago, the full effect of the decline in market rents has yet to be felt. The cash flows generated by these newly completed properties could be considerably less than was anticipated when the original construction, or takeout, financing was arranged. Similarly, as existing leases on occupied properties come up for renewal, landlords face the prospect of tenants returning unused space or requesting rent concessions. In addition, sublease space exerts downward pressure on market rents as overextended tenants seek to exit properties by finding substitute tenants to assume their leases at less than market rents.

Chart 6



The extent to which low rates have kept weak CRE market fundamentals from affecting banks' credit quality will be tested if rates rise before the demand for space improves, and some analysts envision a corporate restructuring process that could result in just such a scenario. Corporate restructuring may continue to push the work of some firms offshore, especially labor-intensive businesses and those with minimal product shipping costs, such as software companies. This scenario could be accompanied by rising interest rates without a recovery in the demand for industrial space.

An additional concern that affects both CRE and non-real estate-related commercial lending is larger companies' lack of pricing power. The recent slow economic growth has limited the ability of larger companies, especially those that face international competition, to raise prices. A global recession and slack capacity worldwide in many industries has engendered significant disinflationary (and outright deflationary) trends in recent years. In the absence of strong revenue growth, income growth has become dependent on cost control. As a result, large companies have been seeking price reductions from other businesses down the supply chain. For example, the major auto manufacturers have recently pressed their parts and assembly suppliers for price concessions. It is likely that pricing pressures will continue to be passed down, affecting revenue at mid- and small-sized businesses. This could, in turn, affect

the credit quality of the smaller financial institutions that lend to these companies.

Other Emerging Risks in Banking

Market-Sensitive Revenues

Diversification of revenue streams has been noteworthy industrywide, with noninterest income continuing to grow as a percentage of net operating revenue. While such strategies have produced lower earnings volatility for many institutions, this has not been the case for some of the largest financial companies because of heavy reliance on market-sensitive revenues. Some institutions have experienced highly volatile earnings over the past two years, largely because of investment banking, merchant banking, and proprietary trading activities. For example, weak and volatile financial markets led to losses in private equity funds and venture capital activities totaling $1.2 billion for commercial banks during 2002. Significant declines in trading revenues were also seen last year, particularly at the seven largest banking organizations. Even trust management revenue—a former stalwart—has declined as a result of the prolonged bear market. In total, market-sensitive revenue for commercial banks declined by almost $1.7 billion from 2001 to 2002.

Interest Rate Risk

In 2002, the historically steep yield curve helped boost the industry's net interest margin to a five-year high of almost 4 percent. The significant decline in short-term rates, prompted by a series of cuts in the federal funds rate starting in January 2001, contributed to a dramatic shift in the yield curve from inverted in 2000 to steep and upward sloping by year-end 2001. A steeply upward sloping yield curve has persisted since then, although the spread between ten-year note and three-month Treasury bill yields narrowed from nearly 350 basis points in early 2002 to 234 basis points by May 20, 2003. This easing of longer maturity yields was the result of emerging concerns over the U.S. economy's near-term economic growth prospects, as well as expectations of further rate reductions by the Federal Reserve.

In addition to the generally favorable aggregate industry NIM through 2002, NIMs widened among institutions of different asset sizes and banking business models (including commercial, residential, and consumer lenders). Nevertheless, one area of concern arises in an examination of the recent trend in the industry's median NIM (that of a typical institution). This measure of NIM contracted in fourth quarter 2002 (see Chart 7).

The fourth quarter 2002 narrowing in median NIM suggests that the benefit derived from low short-term rates may have run its course and that many banks are finding significant resistance to lowering funding costs any further. The historically low level of short-term rates has led to a complex interest rate risk environment in which various banks are exposed to potentially adverse interest rate scenarios. Recent FDIC analysis has found that relationships between NIM performance and rates appeared to be stronger in past higher-rate environments, but recently that link has started to break down as rates have fallen below a certain point.

Chart 7

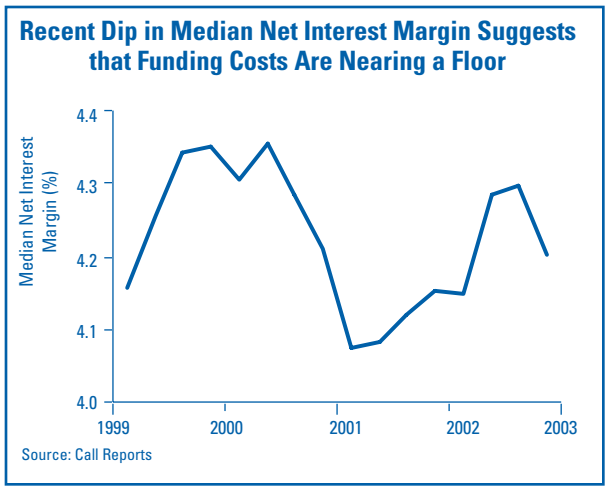
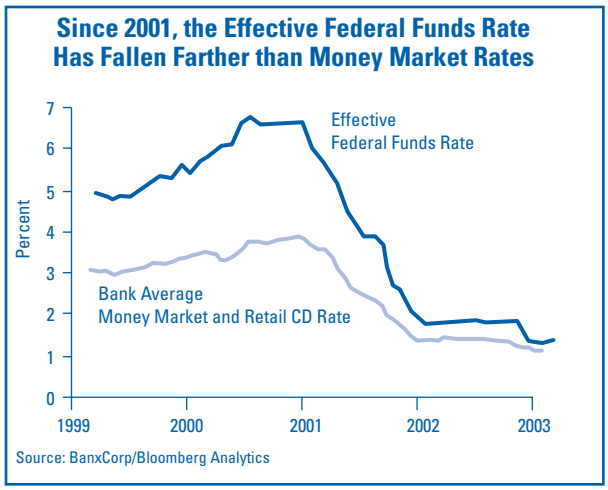


Chart 8



At this stage of the rate cycle, banks with the highest percentage of very low cost funding appear to be most at risk, from a net interest income perspective, to a falling or even stable rate environment. This is because funding that is already not rate-sensitive will not get cheaper, no matter how long low rates persist. In fact, the longer low rates persist, the more likely it is that the yield on assets of these banks will fall without an offsetting decline in funding costs. The risk of lower asset pricing was highlighted by the renewed flattening of the yield during May 2003.

Even larger banks (which, because of a higher percentage of market-based funding, reaped the benefit of low short-term rates sooner than smaller institutions) have not been immune to the magnitude of the rate decline. Large-bank assets are currently repricing downward more quickly than funding costs (see Chart 8).

As shown in Chart 8, the effective federal funds rate has declined steeply since 2001, almost to the average level of retail certificates of deposit (CDs) and bank money market rates by early 2003. (The retail CD and bank money market average rate provides a proxy for deposit costs.) As a result, new money that flows into some banks may be invested at a loss, at least initially, because the narrow spread between estimated deposit costs and the effective federal funds rate (interest paid on bank-invested overnight funds) may not cover operating expenses. Therefore, some banks face margin compression in the current low interest rate environment as higher-yielding loans and securities reprice at lower rates, while funding costs seemingly have reached a trough.

In addition, more positively sloped yield curves have historically induced some banks to take on additional risks. Banks took a record $12 billion in securities gains in 2002. If these securities were not sold to meet loan demand, replacing them with lower-yielding assets may dampen future profitability. Moreover, flush with deposits and challenged for loan growth, banks tend to reach for yield in their securities portfolios by extending maturities and, in some cases, increasing the complexity of their securities portfolio and, more recently, their liability structure.

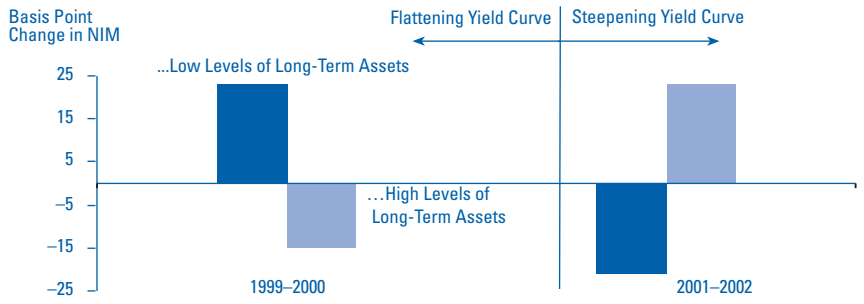
A further flattening of the yield curve could result in a greater narrowing of NIMs for banks with high concentrations of long-term assets. While measures of such concentrations have stabilized during the past few years, residential mortgage lenders continue to report higher levels of long-term assets as a result of the recent refinancing wave.

The interest rate risk positions of banks with high concentrations of long-term assets likely will result in NIM compression if short-term interest rates rise. Following the 1998 refinancing wave, some banks were left with high concentrations of long-term assets, which typically expose institutions to a rise in short-term interest rates. From mid-1999 through 2000, short-term interest rates rose relative to long-term rates (the yield curve flattened), and banks with higher concentrations of long-term assets reported weaker NIM performance than those with lower concentrations of long-term assets (see Chart 9).

From first quarter 1999 through 2000, banks with high concentrations of long-term assets reported a decline in

Chart 9

Net Interest Margin (NIM) Performance Diverged Following 1998 Refinancing Wave for Banks Holding...



Note: A high level of long-term assets is defined as a ratio of long-term assets to earning assets above the 95th percentile. A low level is defined as a ratio below the 25th percentile.
Source: Bank Call Reports

the median NIM of 15 basis points, compared with an increase of 23 basis points for banks with low levels of long-term assets. This situation reversed in 2001, as banks with high levels of long-term assets began to benefit from steepening in the yield curve. However, if short-term interest rates rise following the current refinancing wave, as they did after the 1998 wave, this group of banks again could experience greater compression in NIMs than other banks. The banks with the highest levels of long-term assets are centered in the Northeast and on the West Coast.

Reputational and Legal Risks

Certain institutions have received heightened scrutiny over their dealings with companies such as Enron and Worldcom, as well as over their past investment banking activities. The reputational damage caused by negative media coverage of these issues is difficult to measure.

However, lapses in corporate governance could result in direct losses in the form of increased legal costs, damages from investor lawsuits, and regulatory fines. According to Donald Langevoort of the Georgetown Law Center, a likely estimate of eight banks' scandal-related exposure to investor lawsuits alone is close to $20–$25 billion.[2] Any investor litigation is likely to be a protracted affair—taking years, not months—and this cost may be spread over a long period. However, according to one large-capitalization banking analyst group, noninterest expenses as a percentage of net operating revenue for the largest financial institutions was as much as 780 basis points higher in the fourth quarter of 2002 as a result of legal expenses.[3] The ultimate result could be legal costs amounting to four times more than what the largest financial companies have reserved for so far. According to some analysts, some banks may be reluctant to reserve for potential damages because they believe that a provision for lawsuits could be viewed as an invitation to sue.

In addition to legal expenses, banks may find that reputational and legal risk, and the associated uncertainty surrounding ultimate payouts, results in higher market funding costs. As news of progress or regress in lawsuits is released or even speculated about, bond spreads for the companies involved will likely become more volatile, and they may find it difficult to raise additional equity should they need it.

Internal Controls

The cost to generate each dollar of revenue at insured institutions (the efficiency ratio) declined substantially in the past decade, from almost 76 cents at year-end 1990 to almost 56 cents at the end of 2002. Some of this decline reflects benign or even positive factors, such as consolidation benefits and lower loan workout costs. However, bank supervisors are concerned that some of this improved efficiency may have come at the expense of internal controls or other important loss mitigation functions, such as internal audit. For this reason, bank supervisors have intensified review of efforts to detect and reduce suspicious activities at banks.

Increased reporting of suspicious activities, anecdotal evidence from recent Reports of Examination, and the nature of enforcement actions brought against banks in the last year suggest that bank supervisors have brought significant resources to bear on these issues. From the perspective of the deposit insurer, these are resources well-spent. Since 1997, fraudulent activity and accounting irregularities have resulted in the greatest losses to the FDIC. Of the 35 failures since 1997, 22 involved fraudulent activity or accounting irregularities. The weighted average loss rates where fraud or irregular accounting has been indicated as a significant contributing factor to the failure is 37 percent-more than twice the average loss rate for similar size institutions since 1986. These failures cost the insurance funds almost $2 billion, or 86 percent of the total cost to the funds since 1997.

Richard Austin, Senior Financial Economist

Allen Puwalski, Senior Policy Analyst

[2] Prudential Financial Research, *Lawsuits Against Banks,* January 14, 2003, p. 12.
[3] FBR Financial Services Research, *Bank & Finance Weekly,* January 15, 2003, p. 5.

Atlanta Regional Perspectives

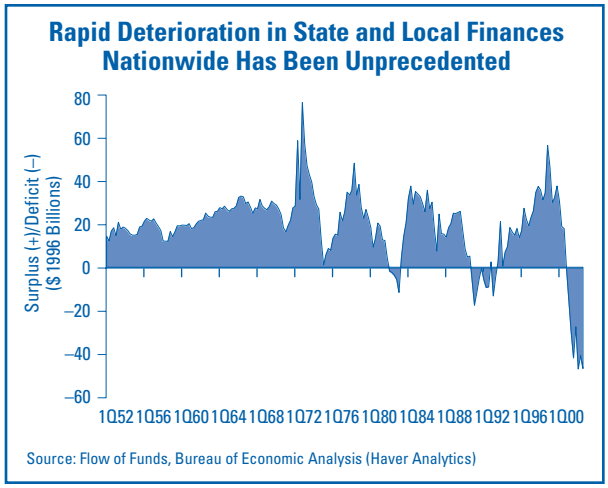
Implications of State and Local Government Budget Deficits

State and local government finances in the Atlanta Region have been affected adversely by losses in U.S. equity markets and the lingering effects of the recent recession. Declines in tax revenues, the burden of funding commitments made during the 1990s for government programs and projects, increased Medicaid costs, and the escalating costs of homeland defense have converted budget surpluses into deficits. These deficits, in combination with statutes that require states to maintain balanced budgets, have forced governments to seek ways to cut spending and boost revenues. This article analyzes the implications of such contractionary fiscal policies and discusses the potential effects of government policies in the Atlanta Region on the local banking industry.

Large State and Local Budget Deficits Have Emerged Quickly since 2001

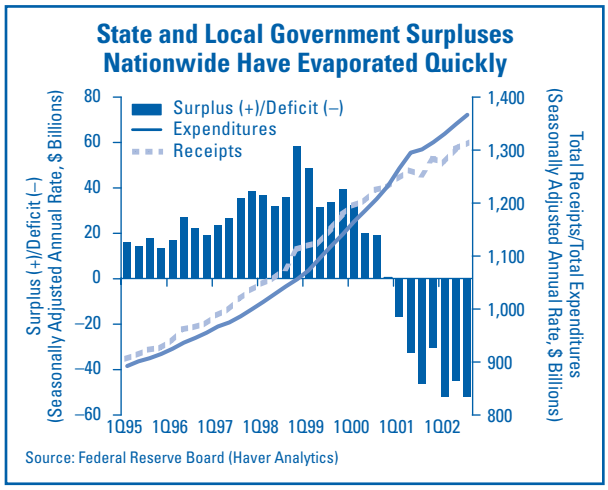
The reversal in state and local government fiscal conditions nationally has been unprecedented in terms of scale and rapidity since World War II (see Chart 1).

Chart 1



Surpluses peaked at nearly $60 billion in early 1999 as capital gains and the record-long economic expansion supported robust state and local government tax revenue increases. Program and project funding expanded, and permanent tax cuts were enacted. The piercing of the stock market bubble and the decline in economic growth from 2000 through 2001, however, significantly constrained revenue growth, while spending commitments continued to rise (see Chart 2). Other factors have also aggravated the deteriorating fiscal conditions, including the costs of homeland defense, the spiraling costs of federally mandated programs such as Medicaid, and, recently, sharp increases in energy prices. Commitments to public assistance programs, such as unemployment insurance benefits, also helped inflate expenditures. (Between 2000 and 2001, initial unemployment insurance claims rose 33 percent.) The record surpluses of the late 1990s evaporated in less than two years, and the rapid erosion in fiscal balance sheets has contributed to what many governors have described as the worst fiscal crisis for states since World War II. Even with a more robust recovery, this crisis is expected to persist into the future.[1]

Chart 2



[1] See, for example, Dennis Cauchon, "State, Local Spending Up Despite Downturn," *USA Today*, January 15, 2003, page 1A, and "U.S. Governors Say Deficits Worst in Decades, Seek Federal Aid," Todd Zeranksi, Bloomberg.com, February 22, 2003.

States Have Three Policy Options for Closing Budget Deficits

To close budget deficits, as constitutionally mandated by all states except Vermont, states are being forced to adopt, or at least consider, policies that generally fall into three categories: increasing revenues, cutting expenditures, and borrowing. Many policy options may be politically difficult to realize, however, given the continued weakness of the economic recovery.

Governments Are Seeking More Revenues

As average real year-over-year growth in total receipts in 2002 slumped to 0.2 percent—one-tenth the average of the latter half of the 1990s—state and local governments nationwide have expanded efforts to identify additional sources of revenue. As revenues are drawn from a variety of sources (see Table 1), governments have explored several options for increasing receipts while attempting to minimize the costs borne by citizens.

Government Expenditures Are Being Cut

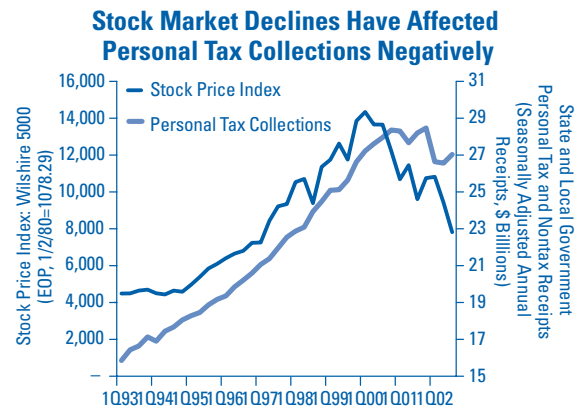
During fiscal year 2003, more than half the states cut spending, the most common way of reducing budget deficits. Despite these cuts, however, expenditures continued to increase faster than revenues. Cutting spending, like raising taxes, may be difficult during periods of sluggish growth. Transfer payments through a variety of programs account for one quarter of all state and local outlays. During downturns, public assistance programs can stabilize the economy but subsequently may entail even greater expenditures. Also, efforts to constrain spending are complicated by the increasing demands of federally mandated programs. Higher education represents one area of state government spending that has seen cuts. Governments have also explored deferring investments in infrastructure.

One of the fastest methods to cut expenditures that does not directly entail service cuts is to lay off employees. In 1999, salaries and wages accounted for nearly one-third of state and local government costs. Several states have explored staff cuts, early retirement initiatives, and wage freezes (or cuts) to pare direct expenditures.

Borrowing Is Increasingly Common

Cutting expenditures and increasing taxes have been essential budget-balancing tools during previous downturns; however, state and local governments are increasingly turning to borrowing to fill gaps. In real terms, borrowings were more than twice as high as of third quarter 2002 as year-ago levels and at the highest levels since World War II. A recent ***USA Today*** article[2] quotes Utah Deputy Treasurer Richard Ellis saying that such a policy is "like using a credit card to pay your bills." Low interest rates have helped minimize the cost of state borrowing, but weak economic conditions and heavy borrowing have affected some states' credit ratings adversely, and debt payments may be a burden on state budgets in future years.

Chart 3



Source: *Wall Street Journal,* Flow of Funds (Haver Analytics)
EOP = End of Period

Table 1

Sales Taxes Account for Largest Share of State and Local Government Revenue Nationwide

Current Receipts	Share of Total Receipts (%)
Federal Grants-in-aid	**23**
Personal Tax and Nontax Receipts	**21**
Income Taxes	16
Nontaxes	3
Other	2
Corporate Profits Tax Accruals	**3**
Indirect Business Tax and Nontax Accruals	**53**
Sales Taxes	26
Property Taxes	20
Other	7
Contributions for Social Insurance	**1**

Source: Bureau of Economic Analysis, 2002Q3

[2] Dennis Cauchon, "States Choose Debt to Fill Gaps," *USA Today,* February 26, 2003.

Reducing Deficits May Have Negative Implications for Local Economies in the Short Run

Efforts by state and local governments to close budget gaps may exacerbate the prevailing weak economic conditions. Reduced government spending and tax increases that reduce disposable personal income could adversely affect economic performance in the short run. An expected worsening in state balance sheets in fiscal year 2004 may require additional expenditure cuts and tax increases.

Contractionary fiscal policies at the state and local levels may be offset in part by the expansionary policies of the federal government; however, the increased federal expenditures may not be distributed as evenly as those made by state and local authorities. State and local government spending represents a large share of total government spending; federal efforts to stimulate the nation's economy may be less effective. Moreover, some analysts argue that recent federal tax cut proposals to spur growth may inadvertently worsen the financial condition of states.[3] States will receive, however, a one-time $20 billion transfer from the federal government as part of the recently enacted stimulus package.

Budget Deficits Exist in the Atlanta Region

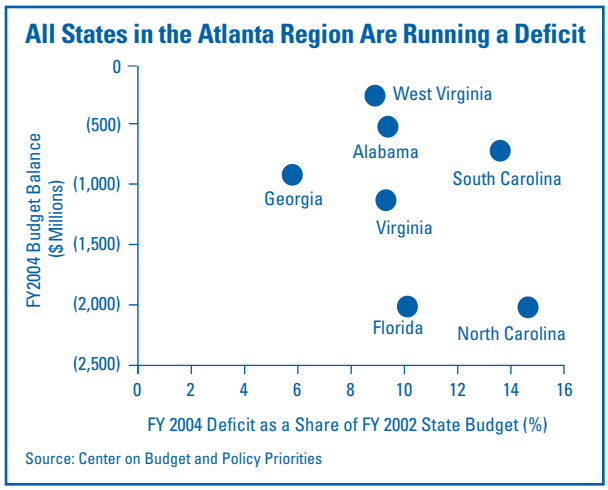
State and local governments in the Atlanta Region have not been immune to the effects of equity market declines and slower national and regional economic growth. **Florida** and **North Carolina** are projected to have the largest budget deficits in the Region at approximately $2 billion each.[4] In absolute size, however, state budget deficits in the Atlanta Region are small compared with those in larger states, such as California, Texas, and New York. Nonetheless, as a percentage of state budgets, deficits in the Region are significant, with **Alabama**, Florida, and North Carolina estimated in the double digits (see Chart 4).

Proposed government policies and actions in the Region since fiscal year 2002 have attempted to address the issue of budget deficits; so far, states have been more successful in cutting expenditures than boosting revenues. Most states, including Alabama and North and **South Carolina**, have tapped their reserve or rainy-day funds as a stopgap financing measure. Increases in "sin taxes"—particularly on tobacco products—also have been considered but have been difficult to enact in tobacco-growing states. Recently, **Georgia's** new governor proposed increases in sin taxes as a way to cut two-thirds of the state's budget deficit. In **West Virginia**, the Senate Finance Committee voted down a proposal in early 2003 to nearly double the tax on cigarettes. Many local governments have been increasing property taxes to raise revenues.

Higher education, in particular, has been a target for state funding cuts. As a result, public universities have been forced to increase tuition sharply, scale back planned expansions, and lay off faculty and staff.[5] Funding cuts could significantly hurt communities, such as **Athens**, **Charlottesville**, and **Tuscaloosa**, that are highly dependent on the economic contributions of public universities and that, until now, have been insulated from the worst effects of the recession.

Most states in the Atlanta Region have cut funding for programs such as education, economic development, and some social services, either through across-the-board spending cuts or by targeting specific programs. Layoffs have been essential to cutting expenditures in **Virginia** and North Carolina. Layoffs in government,

Chart 4



[3] Iris J. Lay, "President's Tax Proposals Would Reduce State Revenues by $64 Billion Over 10 Years," Center on Budget and Policy Priorities, February 4, 2003.

[4] Estimates of budget deficits vary widely depending on the source data. Also, as the issue of state budget deficits is evolving rapidly, revised estimates occur frequently and can change substantially. Although we considered various estimates, we relied heavily for this analysis on data from the Center on Budget and Policy Priorities.

[5] Private colleges and universities also have encountered funding difficulties as the prolonged equities market downturn has reduced the size of endowments.

as in other sectors of the economy, can affect local economic conditions adversely. Although state government employment is concentrated in urban areas, particularly state capitals, the effects of such layoffs on local economic conditions vary according to the relative importance of the government sector to the local economy. For example, **Raleigh** is home to the largest number of state government workers in the Region—63,300 workers in 2002. **Atlanta** is second, with just over 60,000, followed by **Tallahassee**, with 51,900. Even though the concentration of state government employment in the Atlanta Region is less than the national average, the shares in Raleigh and Tallahassee are nearly three and nine times the national average, respectively.[6] Thus, in the event of layoffs, some metropolitan areas may be hit harder than others.

Municipal Revenues May Be More Stable than State Revenues

The same developments that have contributed to state budget deficits may have affected metropolitan areas negatively, but fiscal conditions at local levels generally are more stable, according to a recent ***Standard & Poor's*** report,[7] because they are less likely to rely on cyclical sources of funding, such as income tax collections. Property taxes account for just over one quarter of all municipal revenue. Continued strong home sales and home price appreciation during the recent recession have bolstered this component of municipal revenue, helping to avert more serious deterioration in fiscal conditions.

Some municipalities, however, have encountered declining fiscal conditions. In Atlanta, for example, government officials dealt aggressively with a $90 million deficit in 2002 (a 20 percent budget gap) through a combination of tax hikes and layoffs. These policies proved effective as the city ended the year with a $47 million surplus. Continued economic weakness or a retrenchment in the housing market, however, could place additional burdens on municipalities such as Atlanta.

[6] This measurement is commonly referred to as the Location Quotient. See *Atlanta Regional Outlook*, first quarter 2003, for an explanation of this statistic.

[7] Karl Jacob, Michael Zinman, Robin Prunty, Jeffrey Panger, Edward McGlade, David Hitchcock, John Kenward, Jane Ridley, James Wiemken, James Breeding, Alexander Fraser, Jeanie Yarbrough, Geoffrey Buswick, Kenneth Gear, Gabriel Petek, and Ian Carroll, "Public Finance Report Card: The Largest Cities," *Standard and Poor's Ratings Direct*, February 19, 2003.

The Atlanta Region's Banking Industry Remains Strong but Should Be Watchful

State and local efforts to address budget deficits could have adverse effects on the Region's banking industry. Indirect spending cuts in the form of layoffs in areas where state government is a critical component of the local economy could weaken overall economic conditions further. As a result, credit quality could deteriorate and demand for loans could decline. Cuts in education and social service program funding also could affect credit quality negatively as consumers are forced to pay more expenses out of their own pockets. These funding cuts and tax increases could make debt service more difficult for consumers as disposable incomes decline, leading to weaker credit quality. Although Call Report data suggest that banks have weathered the recent recession remarkably well, record trends in personal bankruptcy filings, residential foreclosures, and corporate defaults, as well as the effects of contractionary state and local fiscal policies, could begin to adversely affect the performance of insured financial institutions.

Institutions in the Atlanta Region may be directly exposed to state and local government agencies through their holdings of municipal bonds (munis). According to ***Call Report*** data, commercial banks with assets less than $1 billion headquartered in Alabama, Florida, and North Carolina increased muni holdings more rapidly than the nation in 2002. Munis are not "default-free," and recent ratings downgrades for several states and municipalities illustrate the rising default risk of holding these securities.[8] Also, munis are not as liquid as Treasuries, and because of current fiscal difficulties, the market's preference for revenue bonds over general obligation issues may increase. Recent proposals to end double taxation on dividends may affect market yields of tax-exempt munis adversely as the benefits of holding equities increase. Bank management should monitor developments and trends affecting municipal borrowers' fiscal condition as well as the impact of tax policy on yields to identify risks to municipal bond holdings.

[8] Ted Hampton, "Municipal Bond Credit Rating Cuts Increase 40 Percent Moody's Says" Bloomberg.com, February 4, 2003.

Chicago Regional Perspectives

Asset Quality Deterioration May Have Peaked for Many, but Not All, Insured Institutions

Despite an economic recovery that has been in place for several quarters, delinquency trends suggest that asset quality could deteriorate further. The median past-due[1] ratio among the Region's insured institutions declined slightly during 2002, from 2.20 percent to 2.14 percent. However, during the fourth quarter, delinquencies rose yet again. In 2002, both the largest and smallest institutions reported year-over-year declines in delinquency levels, while institutions that hold between $250 million and $1 billion in total assets reported a rise in delinquencies. Despite rising delinquencies for these midsize banks, the overall past-due levels remained relatively favorable at 1.75 percent. Geographically, the highest delinquency rate in the Chicago Region is among insured institutions based in **Indiana,** where the median level was 2.47 percent, 13 basis points higher than a year ago.

While the slight improvement in overall delinquencies in 2002 is encouraging, the share of noncurrent loans did not decline. The year-over-year improvement in loans 30 to 89 days past due may indicate that overall asset quality concerns have peaked in the Region, but perhaps not for all locations or types of banks. For instance, overall past-due and noncurrent rates continue to rise among banks based in **Michigan** and Indiana. With the Region below prerecession levels of economic activity and job losses continuing, the economy may not do much to buoy asset quality in the near future. Furthermore, recent weakness in the Region's commercial real estate (CRE[2]) markets may affect overall asset quality negatively in the near term.

CRE Fundamentals Present Some Concerns

Commercial real estate fundamentals have deteriorated in the Region and across much of the nation. The recession and the sluggish economic recovery led to net job losses and diminished demand for office and industrial space. As a result, many leaseholders feel pressured to vacate or terminate leases before they expire or renegotiate lease terms. This weakening is evident in higher vacancy rates and lower rental rates for many property types in the Region's larger markets (see Table 1). With

Table 1

Commercial Real Estate Vacancy Rates Increased among the Larger Chicago Region Markets

	Percentage									
	Apartment		Office		Retail		Warehouse		Hotel	
	2002	2000	2002	2000	2002	2000	2002	2000	2002	2000
Chicago	4.1	2.5	16.6	10.5	11.7	9.2	10.4	7.3	40.2	30.9
Cincinnati	7.8	6.4	14.8	9.6	15.1	10.8	9.5	7.2	48.4	44.1
Cleveland	7.1	6.3	18.1	11.5	13.7	11.2	10.5	7.8	45.1	38.7
Columbus	8.7	7.6	17.1	10.2	14.8	9.7	13.0	9.8	43.1	36.0
Detroit	5.6	3.7	17.1	9.4	14.6	11.3	9.3	6.4	43.2	33.5
Indianapolis	9.5	8.1	17.0	12.9	15.1	10.2	10.8	6.8	44.5	39.5
Milwaukee	7.7	7.3	17.2	12.3	11.9	10.3	7.0	4.6	43.2	38.1
St. Louis	7.1	5.6	15.4	10.6	13.0	9.4	8.5	5.2	39.5	37.2

Note: Shaded = Largest increase in each submarket.
Source: Property & Portfolio Research, Inc.

[1] Past-due includes loans at least 30 days delinquent or in nonaccrual status.
[2] Commercial real estate lending includes construction and development, multifamily, and nonresidential real estate lending.

lease agreements often spanning several years, the full effects of softening CRE fundamentals can take time to emerge. When they do, lower cash flows may make debt repayment more challenging for some borrowers.

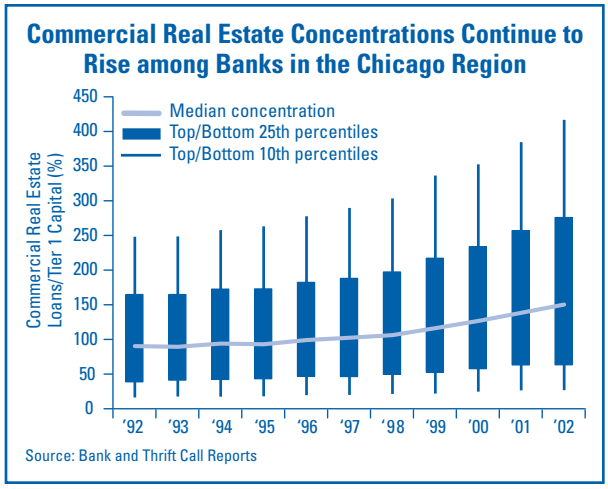
Commercial real estate is a diverse category, and economic trends affect CRE properties at different times and to different degrees. For instance, employment trends can significantly affect vacancy rates for office space. Year-over-year growth in "office employment"[3] in the Chicago Region has declined since 1997 and was virtually nonexistent during 2002. Declining employment among office-using firms in the services sector often affects net absorption of office space rather quickly, while employment trends in the finance, insurance, and real estate (FIRE) sectors affect net absorption more slowly.[4] Companies in the FIRE sectors typically have more square footage per employee and can therefore hire additional personnel without immediately needing more space. Employment in all of the Region's larger office markets[5] is deteriorating.

Profits have been erratic since 1999 and did not grow in the retail sector during third quarter 2002. Retail sales growth is not likely to accelerate substantially in coming quarters for several reasons. Recent strong levels of vehicle purchases likely are waning, job and income growth are not robust, and many consumers may defer major purchases because of concerns about employment security. In this environment, any property owner trying to let or sublease retail space likely will face ample supply on the market.

CRE Exposure Has Grown Dramatically among Insured Institutions Based in the Chicago Region during the Past Ten Years

As of December 31, 2002, the median level of CRE to Tier 1 capital among banks in the Chicago Region was 149 percent, steadily increasing during the past ten years from 89 percent (see Chart 1). The CRE concentration levels of institutions in the 90th percentile rose to a greater extent during the same

Chart 1



period, showing that much of the growth in CRE has been among institutions that already held substantial CRE exposure. Although regional exposure levels have risen dramatically, the median CRE exposure in the Chicago Region remains in line with that of the nation.

Institutions with more than $250 million in assets (21 percent of the Region's insured institutions) report a median CRE concentration to capital that exceeds 200 percent. Smaller insured institutions based in the Region tend to hold less CRE exposure.

The highest current exposures in the Region are among insured institutions based in Michigan (223 percent) and **Wisconsin** (182 percent). The **Grand Rapids,** Michigan, metropolitan statistical area (MSA) is home to institutions with the highest CRE exposure of any large MSA in the Region, with a median exposure of 410 percent of Tier 1 capital. Exposures are also relatively high among banks based in the **Ann Arbor** (337 percent), **Milwaukee** (305 percent), **Lexington** (282 percent), and **Chicago** (281 percent) MSAs.

Nonresidential Real Estate Lending Has Fueled Most of the Growth in the CRE Portfolio

The median level of nonresidential real estate lending is 106 percent of Tier 1 capital, up from 60 percent ten years ago. Increases have occurred among institutions of all sizes and among banks based in all the Region's states. Again, the smallest institutions (less than $250 million in assets) have considerably less exposure to nonresidential real estate lending.

[3] Office employment is defined here as employment in the finance, insurance, and real estate (FIRE) sectors, plus 45 percent of services employment.
[4] Winter 2003 Office Outlook, Torto Wheaton Research.
[5] Detailed information about CRE fundamentals is generally not available for the Region's smaller markets.

Multifamily residential real estate lending is a relatively small segment and has not experienced the growth evident in construction and development (C&D) and nonresidential loan segments. The current median level of multifamily real estate lending is 5 percent of Tier 1 capital, up slightly from ten years earlier.

C&D Lending Presents Additional Challenges

Although C&D lending represents a relatively small segment of the CRE portfolio, this loan category likely presents the greatest challenges to lenders. Construction lending can take many forms. The primary types of construction loans insured institutions make are unsecured front money, land development, commercial, and residential. The characteristics of each of these business lines vary; however, in all cases the properties usually achieve appraised values only after funds are advanced and improvements are made. Consequently, C&D lending is typically one of the higher-risk lending segments.

C&D lending has grown considerably among insured institutions in the Chicago Region during the past ten years. The median ratio of C&D lending to Tier 1 capital was 20 percent at year-end 2002, up from 8 percent ten years earlier. In the Region, 194 insured institutions hold concentrations that exceed 100 percent of Tier 1 capital, up from 46 insured institutions ten years ago.

Recently, C&D lending performance among banks based in the Region generally has been positive. The C&D portfolios of most of the Region's insured institutions have performed reasonably well to date. Overall, C&D underwriting appears satisfactory. However, the Federal Deposit Insurance Corporation's (FDIC's) September 2002 survey of underwriting practices noted that the proportion of banks active in construction lending that either "frequently" or "commonly" made speculative loans for residential construction projects had increased from 26 percent to 29 percent. Also, institutions that frequently or commonly failed to use realistic appraisal values increased from 12 percent to 14 percent.

Despite Increasing Concentrations and Weakening Market Fundamentals, CRE Loan Quality Remains Sound

Although CRE loan portfolios generally performed well during 2002 (see Table 2), the full effect of weakening CRE fundamentals may not have emerged yet. The median CRE past-due rate among insured institutions based in the Region was 0.92 percent as of December 31, 2002, down from 1.06 percent 12 months earlier. Nevertheless, only the Dallas Region (including the Memphis area) reported a higher overall CRE past-due rate. CRE delinquencies among banks in the Chicago Region declined, except for insured institutions holding assets between $500 million and $1 billion, which reported a slight increase.

Within the Chicago Region, CRE past-due levels and trends show some geographic variation. Insured institutions based in **Kentucky** report the highest CRE past-due rate and have experienced some deterioration in CRE loan quality. Deterioration among insured institutions based in Kentucky is concentrated in the smallest institutions (those holding less than $250 million in assets). Institutions headquartered in Indiana and Michigan also report relatively high past-due rates. However, past-dues reported by banks in Indiana have improved considerably, while institutions based in Michigan have reported some slight deterioration.

Low Interest Rates and Industry Trends Contributed to Favorable Performance of CRE Portfolios

Several factors have helped bolster CRE loan performance. Low interest rates enabled many property owners to reduce debt service requirements by refinancing. Also, even though rental rates fell in a large portion of the Region's markets, many properties remain under more favorable leases. Essentially, property owners have been able to reduce debt service requirements without experiencing the full effects of lower current rental rates. Further improvement in debt service reduction may be limited, as interest rates may not decline significantly in the near term. Revenue

Table 2

Recent Median Commercial Real Estate Delinquency Trends Varied among the Chicago Region's States

	4Q02 (%)	4Q01 (%)	4Q00 (%)	4Q99 (%)	4Q98 (%)
Chicago Region	0.92	1.06	0.36	0.24	0.36
Illinois	0.59	0.73	0.19	0.10	0.32
Indiana	1.22	1.47	0.43	0.44	0.48
Kentucky	1.28	1.13	0.82	0.43	0.68
Michigan	1.22	1.18	0.15	0.00	0.00
Ohio	0.99	1.15	0.01	0.03	0.14
Wisconsin	1.10	1.27	0.61	0.43	0.47

Source: Bank and Thrift Call Reports

streams, however, are likely to decline as leases expire. In some cases, there may be no demand for the space. Even when demand exists, the new lease rate may be less favorable to the lessor.

Also enhancing CRE loan performance among insured institutions is the prevalence of securitized CRE lending, which has helped to spread risk among several lenders. Nonbanking entities, such as real estate investment trusts and insurance companies, fund many of the larger and more complex CRE projects. Conversely, smaller CRE relationships, in which the lender is "closer" to the borrower, likely are still heavily funded by insured financial institutions.

Projects with a sufficient amount of owner equity are less likely to become nonperforming. The maximum loan-to-value limits instituted following the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) may help to minimize the number of highly leveraged CRE projects funded by insured institutions. FDICIA prompted Part 365 of the FDIC's Rules and Regulations, which requires insured institutions to establish loan-to-value policy limits of 65 percent for raw land, 80 percent for C&D, and 85 percent for 1- to 4-family residential development. While insured institutions may exceed these limits in certain instances, these regulations have provided a solid framework for operations.

And finally, the downturn in the stock market has increased the attractiveness to some investors of hard assets, such as real estate. Lower interest rates and a preference for real estate have lowered capitalization rates, supporting property values and helping to maintain equity ratios.

CRE Portfolios Will Benefit from Close Monitoring in the Current Environment

CRE property values can fluctuate significantly with changing market conditions and underlying cash flows. As a result, some consider CRE lending inherently more risky than many other loan types. In fact, historically, C&D past-due and charge-off rates have demonstrated they can reach relatively high levels among insured institutions in the Chicago Region.

CRE lending is not homogenous, and the risk characteristics may vary significantly by bank size, types of properties financed, and location of collateral. Many bankers likely have learned the lessons of the late 1980s and early 1990s. Nevertheless, given the growth in CRE exposures and the current softness in certain CRE markets, portfolio managers should continue to monitor fundamentals of local CRE markets and watch for early warning signs, which can include, but are not limited to, the following:

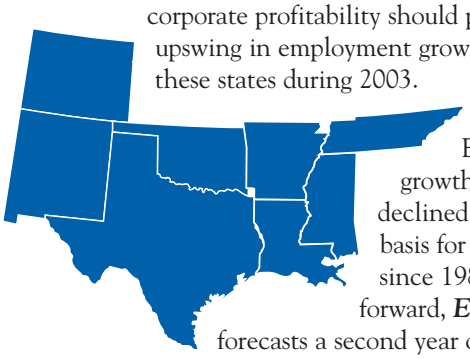
- Cash flow falling below projections in the original appraisal, often from rent concessions or sales discounts.
- Changes in concept or plan, such as a condominium project converting to an apartment project.
- Construction delays that lead to cost overruns or a renegotiation of loan terms.
- Slow leasing or lack of sustained sales activity, which could lead to protracted repayment or default.
- Construction draws that exceed the amount needed to cover construction costs and related overhead expenses.
- Property owners tapping into equity to keep payments current.

Dallas Regional Perspectives

Insured Institutions in the Region Report Favorable Banking Conditions despite a Sluggish Economy

The 2001 recession and the tepid recovery[1] have resulted in weak annual average employment growth in all states in the Dallas Region during the past two years (see Table 1).[2] Only the **New Mexico** economy has avoided recession. Strong gains in the government and services sectors have contributed to employment gains in the state. However, even though employment growth in New Mexico exceeds the national average, the growth rate slowed during 2002.

In sharp contrast, **Colorado** is the only state in the Region that remained in recession as of first quarter 2003.[3] The downturn in the high-tech sector and ongoing weakness in the financial services sector and commercial real estate markets continue to affect the Colorado and **Texas** economies adversely. However, increases in defense spending, stronger levels of business investment, higher energy prices, and improved corporate profitability should promote an upswing in employment growth rates for these states during 2003.



Employment growth in **Oklahoma** declined on an annual basis for the first time since 1987. Going forward, ***Economy.com*** forecasts a second year of declining employment for the state during 2003, as weakness in the manufacturing, wholesale trade, and transportation sectors is expected to continue to constrain the economy.

Arkansas, Louisiana, Mississippi, and **Tennessee** (states that entered recession before the national downturn) recorded a second consecutive year of employment losses during 2002. The key manufacturing sectors in these states were hurt by cheaper imports or a decline in exports as well as the national recession. In addition to a sluggish manufacturing sector, weakness in the hospitality, mining, and construction sectors adversely affected the Louisiana economy and spilled into the retail trade and services sectors. Employment in Louisiana is forecast to decline for the third consecutive year during 2003 because of poor demographics and a lack of growth industries and skilled labor.[4] However, except in Louisiana, a weakening U.S. dollar (which should contribute to higher levels of exports), improving commodity prices, and a recovery in regional tourism should improve prospects for employment growth.

Although most of the states in the Region appear poised for job gains in 2003, growth is expected to be modest. Five quarters into the U.S. recovery, the Region has yet to show positive job growth, an unfavorable comparison with what occurred during the economic recovery that began in 1991 (see Chart 1, next page). Geopolitical uncertainties, a sustained period of high energy prices, a volatile U.S. dollar, and significant state budget deficits are the greatest constraints to the Region's economic recovery.

Table 1

Employment Growth Is Expected to Be Modest during 2003 in the Dallas Region

	Average Annual Growth Rates (%)			
Area	**1995–2000**	**2001**	**2002**	**2003F**
Arkansas	1.6%	–0.4%	–0.6%	0.2%
Colorado	3.8%	0.6%	–1.9%	0.0%
Louisiana	1.6%	–0.1%	–1.0%	–0.1%
Mississippi	1.4%	–2.0%	–0.3%	0.2%
New Mexico	1.8%	1.7%	1.1%	1.3%
Oklahoma	2.5%	1.0%	–1.5%	–0.2%
Tennessee	1.8%	–1.5%	–0.8%	0.3%
Texas	3.3%	0.9%	–1.0%	0.6%
Dallas Region	2.7%	0.3%	–0.9%	0.3%
United States	2.4%	0.2%	–0.9%	0.2%

F=forecast

Sources: Bureau of Labor Statistics (actual); Economy.com (forecast: F)

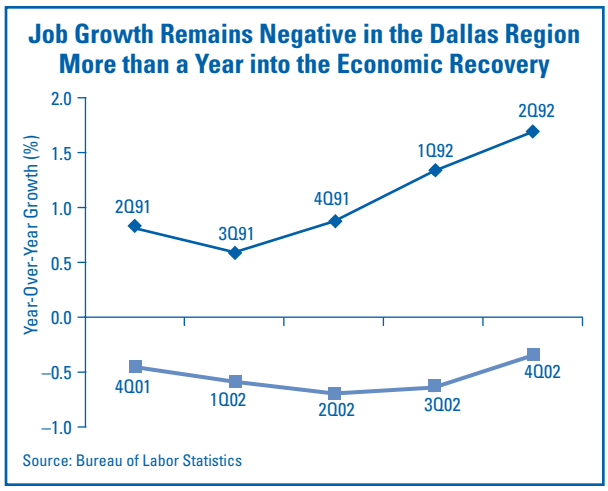
[1] For purposes of this article, the U.S. recovery is assumed to have begun in fourth quarter 2001, when real gross domestic product returned to positive growth.

[2] Newly revised payroll employment data from the U.S. Bureau of Labor Statistics revealed downward revisions for most states in the Region in 2001 and 2002, with significant revisions occurring in Louisiana, Oklahoma, and Tennessee.

[3] Economy.com, Regional Outlook forecast, February 19, 2003.

[4] Economy.com, Louisiana State Précis Report, March 2003.

Chart 1



Although economic conditions remain sluggish, insured institutions based in the Dallas Region reported favorable conditions at year-end 2002. Historically low short-term interest rates and an upward-sloping yield curve benefited banks and thrifts based in the Region as the net interest margin and average return on assets reached their highest levels in the past 20 years.[5]

A dramatic drop in the median cost of funds to record lows is one of several factors contributing to positive earnings performance.[6] Additions to provision expenses were not necessary, as past-due and charge-off rates remained moderate for all segments of the portfolio except consumer loans. Equity capital levels remain strong, as evidenced by a median leverage ratio of 9.15 percent—among the highest levels in a decade.

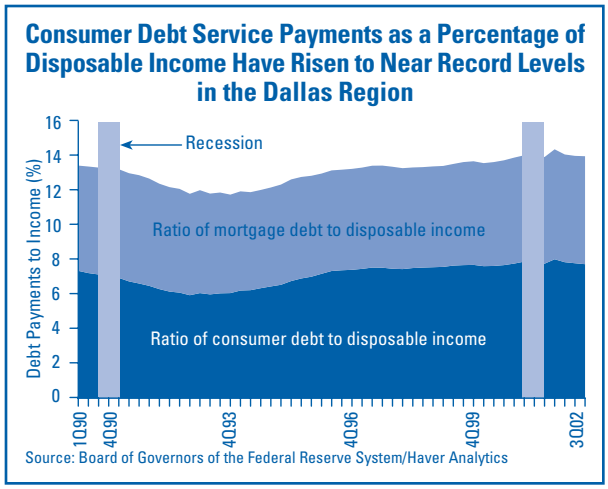
Several factors could explain the apparent disconnect between weak economic conditions and strong insured institution performance. First, merger and acquisition activity has contributed to increased geographic diversification in the loan portfolio, minimizing the level of concentration risk. Second, insured institutions have improved techniques for gathering data related to consumer and corporate borrowers, which has helped to improve credit quality. Finally, the increased use of securitization has allowed many institutions to sell loans, thereby spreading risk. Should economic weakness continue, however, insured institution performance could be affected adversely, particularly in the consumer loan portfolio.

Rising Debt Levels Coupled with Weak Economic Conditions Could Stress Consumers

Nationally, consumer debt levels grew through the recession of 2001 and have continued to grow. Aggregate household debt increased to 10.7 percent in fourth quarter 2002, the highest level since 1989.[7] Debt service levels[8] reached a historic high in fourth quarter 2001 and declined slightly in 2002 (see Chart 2).[9] The rise in debt service levels can be attributed to increased mortgage and other types of consumer borrowing.

Nationally, several factors contributed to an increase in debt service levels. The rise in home equity values contributed to a surge in cash-out refinancing activity. Similarly, historically low interest rates prompted consumers to increase borrowing for durable goods, such as automobiles and personal computers, and boosted home sales to record highs. The increasing availability of credit, facilitated by the use of credit-

Chart 2



[5] The net interest margin and return-on-assets ratio for insured institutions based in the Dallas Region were 4.35 percent and 1.42 percent, respectively, for the four quarters ending December 31, 2002.

[6] The cost of funding earning assets dropped to 2.15 percent in fourth quarter 2002, a decline of 129 basis points from a year ago.

[7] Federal Reserve Board Flow of Funds data.

[8] The debt service level, commonly referred to as debt service burden, is calculated by dividing the sum of required principal and interest payments by after-tax personal income (often referred to as disposable personal income).

[9] In contrast to the growth reflected in the Flow of Funds data, the Federal Reserve Board Survey of Consumer Finances (SCF) series indicates that consumer debt service levels declined from 14.4 percent in 1998 to 12.5 percent in 2001. The SCF calculations include income data from 2000, a period when income levels were increasing rapidly.

scoring programs, also contributed to growth in consumer debt levels.

Although many of these factors apply to the Dallas Region, this Region also has experienced a more severe economic decline than elsewhere in the nation. For example, job losses have been significant since the mid-1990s in rural areas of the Region that rely heavily on the manufacturing sector. Financial stress caused by higher debt levels and prolonged economic weakness is evident in bankruptcy filings that have risen to the highest level since the 1990–1991 recession. As of fourth quarter 2002, Tennessee, Arkansas, Mississippi, and **Oklahoma** ranked among the top ten states nationwide in per capita bankruptcy filing rates.[10]

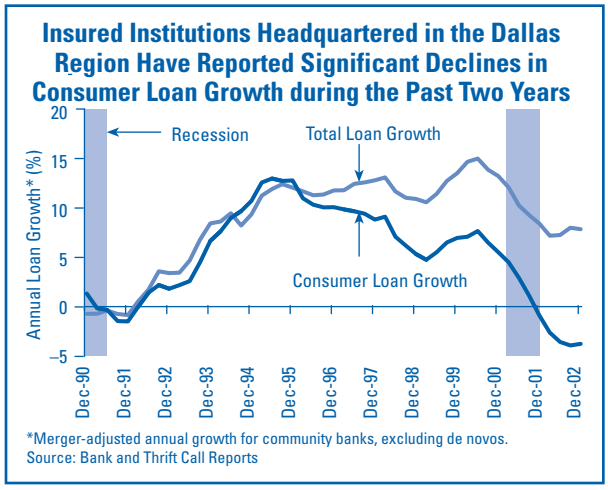
Higher debt service levels are a key contributing factor to the relatively high rate of consumer bankruptcies in the Region. Results of the ***Federal Reserve Board Survey of Consumer Finances*** show that families with incomes in the lowest two quintiles are most likely to be financially overextended.[11] This relationship is particularly relevant in the Dallas Region, because per capita income levels are among the lowest in the nation, suggesting that more consumers in this Region are more heavily indebted.[12] Furthermore, many of the manufacturing job losses have occurred in the lower-skilled and generally lower-paying jobs. Taken together, these trends make it more difficult for consumers to remain current on their debt payments.

Consumer Loan Portfolios[13] Weaken as the Regional Economy Struggles to Recover

Lingering economic weakness and debt consolidation, made possible by cash-out mortgage financing, contributed to slow consumer loan growth among insured institutions based in the Dallas Region. Consumer loan levels have steadily declined since mid-2001; this is the only segment of the portfolio that exhibited negative growth at year-end 2002 (see Chart 3). However, this decline was more than offset by an increase in residential and other loan categories.[14]

Consumer credit quality has deteriorated recently among community banks headquartered in the Dallas Region. Consumer past-due loans increased in fourth quarter 2002 to the highest levels since first quarter 1988. The median ratio of total past-due consumer loans to total consumer loans was 3.0 percent, significantly exceeding the past-due ratio for residential loans.[15] Levels of past-due consumer loans were also relatively high compared with other areas of the country, and levels varied among states in the Region. Not surprisingly, past-due levels were highest among banks and thrifts based in states that experienced the longest and deepest period of economic weakness (see Table 2, next page). Banks headquartered in rural areas of the Region may be more vulnerable to deteriorating consumer credit quality because of higher exposures[16] and weaker economic conditions. In contrast to the trend in past-due levels, the share of total loan losses attributable to consumer loans has begun to drop.

Chart 3



[10] The share of employment in the manufacturing sector in these states, except for Oklahoma, exceeds that of the nation.
[11] SCF, 2001. Families in the lowest two income quintiles reported the highest percentages of debt, with debt service burdens greater than 40 percent.
[12] Mississippi and Arkansas reported the lowest per capita personal income levels in the nation in fourth quarter 2001 (the most recent data available), followed closely by New Mexico, Louisiana, and Oklahoma.
[13] Consumer loans include loans to individuals for household, family, and other personal expenditures, excluding loans secured by mortgages on residential properties.

[14] Residential loan levels increased 5.8 percent in fourth quarter 2002 from one year ago. Conversely, consumer loan growth was minus 2.7 percent for the same period and was below growth reported for the period following the 1990–1991 recession. Nationally, consumer loan growth dropped 9.5 percent in fourth quarter 2002 from one year ago.
[15] Past-due residential loans were 2.3 percent of total residential loans in fourth quarter 2002, compared with 2.5 percent one year earlier.
[16] Consumer loans represented 8.3 percent of total assets in fourth quarter 2002 among rural banks in the Dallas Region, relatively unchanged from one year ago but higher than in the other FDIC Regions. Conversely, banks in metro areas held consumer loans at 6.5 percent of assets in fourth quarter 2002, down 100 basis points from one year ago.

However, loss rates remain high relative to other types, such as residential loans.[17] Furthermore, recent increases in past-due loan levels suggest the potential for an increase in consumer loan loss rates, particularly if the Region's employment picture remains weak for the balance of 2003.

Looking Ahead

In light of the weak economic and employment trends that are persisting in the Dallas Region, insured institution management should continue to monitor trends in the consumer loan portfolio. In addition, management should consider offering or supporting programs that will enhance financial literacy, such as the FDIC's Money Smart program.[18]

Table 2

Past-Due Levels among Insured Institutions Based in the Dallas Region Raise Concerns about Credit Quality

Area	Ratio of consumer past-due loans to total consumer loans (median %)*			4Q02 National Rank
	4Q01	3Q02	4Q02	
Arkansas	3.7	3.0	3.5	6
Colorado	1.8	1.9	2.0	30
Louisiana	3.0	2.6	3.1	7
Mississippi	5.2	3.8	4.5	1
New Mexico	2.0	1.6	1.8	31
Oklahoma	3.1	2.8	3.0	9
Tennessee	4.3	3.6	4.1	2
Texas	2.7	2.3	2.7	13
All other states	2.3	2.0	2.3	

*States with at least 10 established community banks.

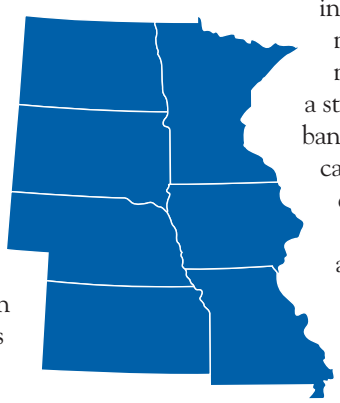
Source: Bank and Thrift Call Reports

[17] Established community institutions hold assets less than $1 billion and have been in existence for at least three years. Consumer loan losses were 39.1 percent of total loan losses in fourth quarter 2002, relatively unchanged from one year ago and slightly down from one quarter ago.

[18] The FDIC's Money Smart program enhances consumers' ability to manage their personal finances. Refer to the Consumers and Communities section of the FDIC's website at www.fdic.gov.

Kansas City Regional Perspectives

The Region's Economy Is Improving, and Banks Report Continued Strong Conditions



The Kansas City Region economy was affected adversely in 2002 by the recession. Job growth in most states, although remaining negative during fourth quarter 2002, improved by year-end. In particular, employment improved in **Nebraska**, **Minnesota,** and **South Dakota,** as laid-off employees began to be absorbed into new jobs. Employment was most robust in **Kansas,** as strength in the transportation and government sectors helped to offset losses in the telecommunications and aircraft manufacturing industries. In fact, Kansas is the only state in the Region to post positive employment growth each quarter during the past three years. On the other hand, the **Missouri** economy continues to struggle with massive layoffs in the manufacturing and retail sectors, two industries that represent a disproportionately high share of the state's employment.[1]

Overall, insured financial institutions in the Region reported sound operating results during 2002. Community banks[2] and farm banks[3] reported improved earnings in 2002 as measured by post- and pre-tax measures (see Table 1). Net interest margins were bolstered in early 2002 by a steeply sloped yield curve, which helped banks recover some of the margin losses caused by rapidly declining interest rates during 2001. Levels of past-due loans remained moderate in the aggregate at year-end 2002. However, a subset of banks is reporting elevated levels of problem loans; 11 percent of both the Region's community banks and farm banks reported past-due ratios that exceed 5 percent, a relatively high industry benchmark. Overall, capital levels increased in 2002 and remain high compared with historical levels, and loan loss reserves are stable compared with total loan and problem loan levels.

Drought Conditions Are Worsening and Adversely Affecting Insured Institution Performance

Severe drought conditions continue to affect much of the Region. Normally, drought conditions abate consid-

Table 1

Community Banks and Farm Banks in the Region Continue to Report Sound Operating Results

	Community Banks			Farm Banks		
	2002	2001	2000	2002	2001	2000
Number of Banks	1,821	1,860	1,918	1,129	1,159	1,211
Return on Assets (%)	1.28	1.16	1.24	1.27	1.12	1.21
Pretax ROA (%)	1.59	1.47	1.63	1.58	1.40	1.56
Net Interest Margin (%)	4.26	4.14	4.31	4.16	4.00	4.10
Past-Due and Nonaccrual Loan Ratio (%)	2.29	2.39	2.14	2.39	2.44	2.13
Leverage Capital Ratio (%)	10.40	10.07	10.03	10.68	10.39	10.28
Loan Loss Reserves/Loans (%)	1.42	1.42	1.41	1.52	1.50	1.51

ROA = Return on Assets

Notes: "Community banks" are defined here as commercial banks with less than $250 million in assets, excluding new banks and specialty banks.
"Farm banks" are insured financial institutions at which at least 25 percent of total loans are farm operating loans or loans secured by agricultural real estate.
Nearly all farm banks are also considered community banks.

Source: Bank and Thrift Call Reports

[1] For a deeper look into each state's economic situation, see the FDIC *State Profiles* at www.fdic.gov.
[2] "Community banks" are defined in this article as insured institutions that hold $250 million or less in assets, excluding de novo and specialty institutions. Thrifts are excluded because of dissimilarities to commercial banks.
[3] "Farm banks" are defined as insured institutions that hold at least 25 percent of total loans in farm operating loans or loans secured by agricultural real estate.

erably with precipitation during the fall and winter, but continued dry weather has contributed to deteriorating conditions (see Map 1). Although the drought was confined to the Region's western states last summer, dry conditions have now spread eastward into **Iowa** and Missouri, and Minnesota is experiencing abnormally dry conditions. Nebraska continues to be most adversely affected, with approximately two-thirds of the state experiencing at least "extreme" drought conditions. The state's corn, wheat, and soybean harvests declined approximately 20 percent from 2001 levels, and hard-hit pasturelands made it difficult for ranchers to feed herds. Farmers' strong equity positions and reliance on crop insurance appear to have mitigated much of the drought's negative effect on loan quality during 2002. However, should drought conditions continue into the summer of 2003, local economies that depend on the agricultural sector may weaken considerably.

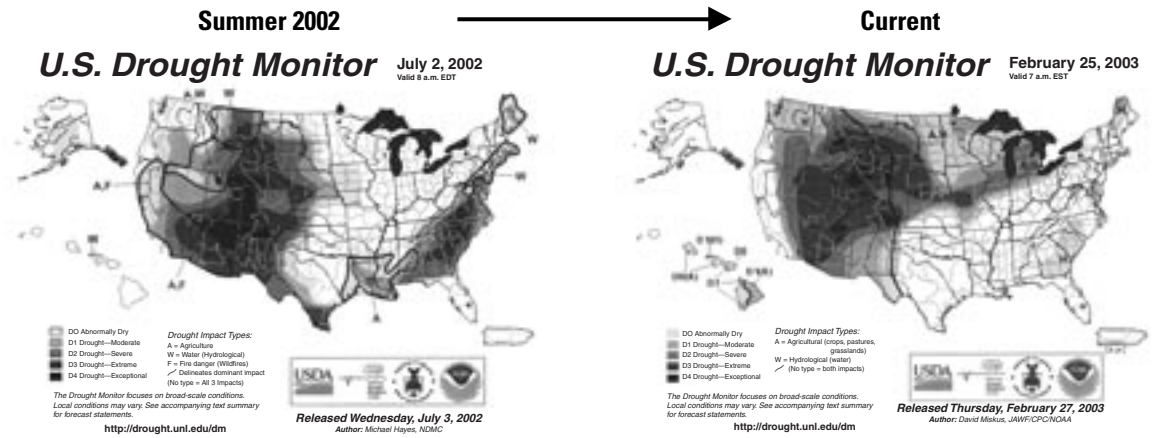
Although farm banks in the aggregate reported solid financial results during 2002, the drought has begun to affect the performance of banks in areas that have experienced a second year of drought: 53 counties in eastern Nebraska and 8 counties in the northwestern corner of Kansas. The 143 farm banks in these counties reported earnings and capital performance similar to that of other farm banks in the Region; however, the aggregate past-due ratio[4] for this group of institutions was 2.98 percent at year-end 2002, compared with 2.39 percent for all farm banks in the Region. Fifteen percent of the farm banks in counties that have experienced prolonged drought conditions reported a past-due ratio of at least 5 percent. These numbers do not reflect a significant degree of deterioration; however, should the drought continue for a third year, asset quality among these institutions could be affected significantly. In addition, asset quality among farm banks in areas that experienced a first year of drought in 2002 could deteriorate to the same extent as farm banks in second-year drought areas.

Some of the Region's Markets Are Home to a Significant Number of New Institutions

Minimal levels of new bank formation occurred in the Region in the years following the 1990–1991 recession; however, activity has surged during the past five years. New institutions now represent a sizable presence in many of the Region's metropolitan centers, and 2001 marked the first year that these institutions operated during an economic downturn. Our analysis allows us to compare current financial conditions between new and established institutions and evaluate any differences in light of a continuing fragile economy.

Map 1

Much of the Region Continues to Be Affected by Drought Conditions



[4] Defined as the sum of loans 30 to 89 days past due and in nonaccrual status, divided by total loans.

Consolidation throughout the Region Has Obscured a Growing Presence of New Institutions

Consolidation among banks and thrifts headquartered in the Region has been significant since the 1980s. Nearly one-third of the insured institutions present in the Region at the end of the last recession are no longer present; the rate of decline peaked in the mid-1990s. In the aggregate, the consolidation trend was similar between insured institutions headquartered in metropolitan statistical areas (MSAs) and nonmetropolitan areas; however, differences exist at the individual MSA level. The level of merger activity tends to obscure the fact that the Region has experienced a significant level of new bank activity during the past few years.

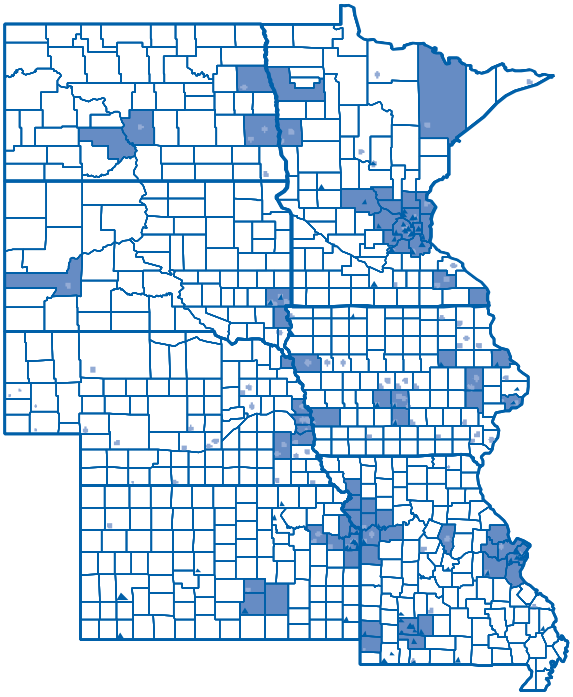
The Federal Deposit Insurance Corporation (FDIC) granted 202 new deposit insurance charters in the Region between April 1991, when the 1990–1991 recession ended, and year-end 2002. The headquarters locations of the 202 charters are shown in Map 2, which indicates that the majority of charter activity was centered in and around MSAs, in particular **Minneapolis, St. Louis, Kansas City,** and **Springfield.** Depopulation has occurred among the Region's rural areas during the past few decades; therefore, it is not surprising that new charter activity has been centered in metropolitan areas.[5]

The 125 light blue dots on Map 2 represent charters granted to institutions affiliated with multibank holding companies or otherwise controlled by a chain banking organization or other financial services company. Much of this "affiliated charter" activity appears to be targeted at new market penetration. Many of the dots are concentrated in Iowa and Nebraska, states that have relatively more restrictive branching. Thirty-eight of these 125 affiliated charters are no longer in existence, primarily because of mergers involving affiliated acquirers.

The 77 dark blue dots represent charters to institutions that have no substantive affiliation with multibank holding companies, financial services companies, or other financial institutions. These independent new institutions are less likely to be able to rely on outside expertise and support than nonindependent startups that have a close affiliation with parent or sister financial institutions or financial services companies. The remainder of this article focuses on 72 of the 77 independent new banks that remain in operation[6] and examines how the financial performance of these institutions fared in the sluggish economy.

Map 2

Independent Institutions Chartered since the 1991 Recession Are Concentrated in and around Metropolitan Areas



New Bank Entrants since 1991 Are Experiencing an Economic Slowdown for the First Time

The emergence of new banks in the Region could be problematic because newly chartered institutions historically have exhibited higher risk profiles than established institutions. Results of other regulatory studies suggest that de novo institutions are more likely

[5] Refer to the *Kansas City Regional Outlook*, first quarter 2003, for a discussion of depopulation trends.

[6] For the remainder of this article, the term "new banks" denotes active FDIC-insured institutions headquartered in the Kansas City Region that were granted charters between April 1, 1991, and December 31, 2002, and that are considered independent of any multibank holding company or any other parent or sister financial institution or financial services company. The term "new bank" includes thrift activity.

Table 2

New Bank Activity Has Been Recent and Centered in Four of the Region's Metropolitan Areas

Community	Number of Newly Chartered Institutions[1]			Total Number[2] of Institutions	Newly Chartered as Percentage of of Total
	1991 to 1996	1997 to 2002	Total		
No MSA	2	20	22	1,573	1
Minneapolis, MN	**2**	**19**	**21**	**115**	**18**
Springfield, MO	**2**	**5**	**7**	**24**	**29**
Kansas City, MO	**2**	**5**	**7**	**96**	**7**
St. Louis, MO	**1**	**5**	**6**	**54**	**11**
Des Moines, IA	1	2	3	26	12
Dubuque, IA	0	1	1	7	14
Waterloo, IA	0	1	1	7	14
Joplin, MO	0	1	1	8	13
Davenport, IA	1	0	1	11	9
St. Cloud, MN	0	1	1	21	5
Wichita, KS	0	1	1	27	4
Grand Total	11	61	72	1,969	4

[1] As of December 31, 2002, 72 out of 77 independent institutions chartered since 1991 were still in operation.

[2] Total FDIC-insured institutions as of December 31, 2002.

Source: Bank and Thrift Call Reports, Kansas City Region

to be assigned "weak"[7] examination ratings and are more likely than established institutions to fail during a recession.[8]

Historically, well-run institutions have outperformed other institutions during economic downturns. Although well-run institutions can experience problems related to poor market conditions, they generally do not fail because of an economic downturn. Additionally, management teams that have been through economic slumps benefit from firsthand knowledge of how quickly asset quality can deteriorate and how costly it can be to deal with troubled assets.

A strong majority (85 percent) of the 72 new banks were established between 1997 and 2002, and these new banks represent significant proportions of insured institutions presently headquartered in the Minneapolis, St. Louis, Kansas City, and Springfield MSAs mentioned earlier (see Table 2). Although these MSAs were hurt by the same economic trends that contributed to the national recession, they remain in better condition than the hardest-hit MSAs nationally. However, employment growth in these four MSAs has slowed, particularly in the manufacturing sector, and commercial vacancy rates have increased, reaching or exceeding historical highs set in the early 1990s.

Given these economic conditions, the following sections compare new bank performance with that of established institutions in the aforementioned MSAs. This discussion draws heavily from data shown in Table 3. Financial results generally do not stabilize until an institution has been in existence for at least three years; as a result, Table 3 includes data on the 45 new banks chartered before year-end 2000.

Earnings Lag Those of Established Institutions

Pretax return on assets (pretax ROA) ratios and net interest margins (NIMs) indicate that new bank earnings performance lags that of established institutions. In fact, almost three quarters of established institutions report higher pretax ROAs than the median level for new banks. New banks' lower margins can be explained by higher funding costs, as these institutions typically pay higher rates to attract depositors. In addition, new

[7] A "weak" examination rating is defined here as a composite Uniform Bank Rating of 3, 4, or 5.

[8] For further discussion of de novo bank performance compared to established bank performance in recessionary times, see Robert DeYoung, "Birth, Growth, and Life or Death of Newly Chartered Banks," *Economic Perspectives*, Federal Reserve Bank of Chicago, third quarter 1999, and "De Novo Banking in the Atlanta Region," *Atlanta Regional Outlook*, first quarter 2000.

Table 3

New Banks' Financial Performance Ratios Differ Considerably from Established Institutions

	New Banks	Established Institutions
Median Figures as of Year-End 2002		
Earnings		
Pretax Return on Assets	1.14	1.56
Net Interest Margin	3.83	4.38
Yield on Earning Assets	6.73	6.73
Yield on Total loans	7.18	7.66
Cost of Funds	2.77	2.32
Funding		
Tier 1 Leverage Capital Ratio	7.80	8.51
Core Deposits to Total Assets	66.69	75.98
Other Borrowings to Total Assets	8.15	3.50
Credit Risk		
Loan-to-Asset Ratio	79.34	67.14
CRE Loans to Tier 1 Capital	324.09	222.88
Past-Due and Nonaccrual Loans to Total Loans	1.08	1.65
Loan Loss Reserves to Total Loans	1.07	1.26
Net Charge-Off Ratio	0.08	0.14

New banks represent 45 of the 72 institutions shown in Table 2 that have been in existence at least three years.

Established institutions represent MSA-headquartered banks and thrifts established prior to April 1, 1991, with total assets under $1 billion, excluding specialty institutions.

Source: Bank and Thrift Call Reports, Kansas City Region

banks generally rely more on noncore deposits and other borrowings, which can be more costly than core funding.

New bank loan yields also lag those of established banks. New banks may offer rate concessions to attract loan business, thereby lowering yields. Lower yields also could be attributed, at least in part, to high-quality, low-yielding loans that "walk" to new charters with loan officers hired from established institutions. However, as a way of compensating for lower loan yields, new banks typically report higher loan-to-asset (LTA) ratios than established banks, potentially implying heightened credit risk for new banks.[9]

[9] LTA ratios were a key barometer of whether a bank would fail during the 1980s agricultural crisis. Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future. Vol I: An Examination of the Banking Crisis of the 1980s and Early 1990s,* Chapter 8. Washington, DC: FDIC, 1997. See www.fdic.gov/bank/historical/history/index.html.

Funding Levels Are Lower than Those of Established Institutions

After three years of operation, new banks typically are operating with lower levels of capital funding than established institutions. In addition, new banks rely more on noncore deposits and other borrowings. The median core deposits-to-total assets ratio of new banks is typically 9 percentage points lower than that of established institutions, and the cost of funds ratio is nearly 50 basis points higher. New banks would be expected to fare less well than established institutions, given their higher LTAs and greater reliance on noncore funds.

Credit Risk Is Higher than That of Established Institutions

The median past-due loan ratio for new banks is considerably lower that that of established banks; however, two factors suggest that new banks may take on higher levels of credit risk. First, the median LTA ratio for new banks is 12 percentage points higher than the median LTA of established institutions, and only about one quarter of all established institutions report higher LTAs than the new bank median. Since loan-to-asset ratios tend to indicate the tolerance of management for taking on additional risk, higher LTA ratios typically suggest higher credit risk in new bank portfolios.

In addition, new banks exhibit significantly higher exposure to commercial real estate (CRE) lending, historically a higher-risk lending category. Concern about higher CRE-to-capital concentrations is compounded by the fact that commercial real estate markets have weakened considerably across the country during the past two years. Nearly two-thirds of new bank activity in the Region is concentrated in or around four markets: Minneapolis, St. Louis, Kansas City, and Springfield (see Table 2). Office vacancy rates in the first three were 19.6 percent, 17.7 percent, and 18.6 percent as of fourth quarter 2002, eclipsing highs reached in the early 1990s.[10] While most lending institutions based in the Region have not reported increased delinquency levels because of deteriorating CRE markets, continued weakness could affect credit quality adversely, particularly among new banks.

[10] Torto Wheaton Research for Minneapolis, St. Louis, and Kansas City.

Conclusion

New bank activity in the Region is a positive sign, suggesting heightened economic demand for community banking services. Although new banks typically exhibit greater levels of credit risk and report weaker earnings prospects, at least initially, than established institutions, new charters overall performed well during the 2001–2002 recession. However, new charters may be more vulnerable to continued economic weakness than established institutions.

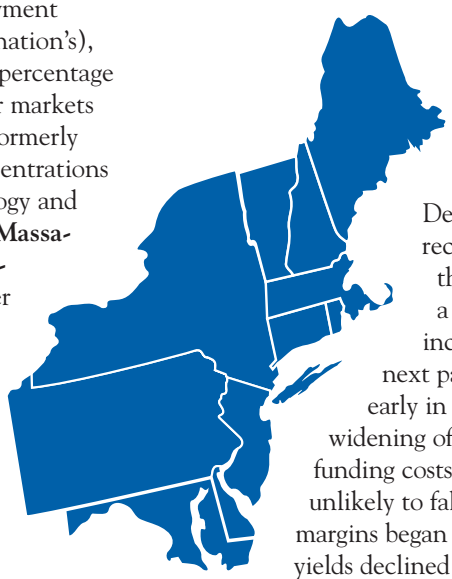
New York Regional Perspectives

New York Region Economic Performance Is Mixed

Economic growth in the New York Region[1] during 2002 remained modest and uneven, like that of the nation. The Region's total nonfarm employment declined about 1 percent (the same as the nation's), while the unemployment rate rose about a percentage point, averaging 5.5 percent in 2002. Labor markets deteriorated to the greatest extent among formerly rapidly growing state economies, with concentrations of employment in the information technology and financial services sectors—for example, in **Massachusetts, New York, Delaware, Connecticut,** and **New Hampshire.** Given lackluster labor markets, regional per capita personal income growth decelerated markedly during the first three quarters of 2002 (on a year-ago basis). However, significant tax relief during the year mitigated the effects of weak labor markets on disposable income growth.[2]

The Region's housing sector held up well during 2002. Historically low mortgage rates continued to support home sales, even in states exhibiting net job losses and sluggish income growth. Although the rate of home price appreciation eased somewhat in certain areas, year-ago home price growth remained at double-digit rates through fourth quarter 2002 in 7 of the Region's 12 states. **Pennsylvania, Vermont,** Delaware, **Maine,** and Connecticut were the exceptions, though the latter two states posted gains just under 10 percent. Meanwhile, new home construction tracked the national rate, with significant strength evident in some of the Region's markets, such as the **District of Columbia,** New Hampshire, Maine**, Rhode Island,** and Delaware.

Without further strengthening in economic growth, the Region's pace of home sales may slow this year. Should this occur, home price gains may moderate in certain markets, especially those (mentioned above) in which construction activity has accelerated. Although the potential for continued malaise in job and income growth remains a downside risk, aggregate household financial stress in the Region is still below the national average.



Bank Earnings Improved despite the Weak Recovery

Despite the sluggish economic recovery, insured institutions in the New York Region[3] posted a 13 percent increase in net income during 2002 (see Table 1, next page). Funding costs declined early in the year, contributing to a widening of net interest margins. However, funding costs are now extremely low and unlikely to fall any further. As a result, margins began to narrow late in 2002 as asset yields declined with falling interest rates.

Commercial banks holding assets less than $10 billion reported increases in net income as a result of gains on the sale of securities, lower noninterest expenses, and declining provision expenses. Overall, loan growth is moderate, but it remains strong in commercial real estate, construction, and home equity portfolios. Despite the weak recovery, credit quality, as evidenced by the steady past-due ratio, has remained sound.

Savings institutions holding assets less than $10 billion relied on net interest income to generate earnings. Despite declining asset yields across much of the industry, the Region's savings institutions reported increasing margins throughout the year. Overall loan growth slowed in 2002 but remains strong in higher-yielding commercial and noncommercial real estate, multifamily, and home equity loans. Credit quality remains strong among the Region's thrifts. However, should sluggish economic growth continue, deterioration could emerge in the traditionally higher-risk segments of the portfolio.

[1] The New York Region includes the six New England states (CT, MA, ME, NH, RI, and VT), five Mid-Atlantic states (DE, MD, NJ, NY, and PA), the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Puerto Rico and the U.S. Virgin Islands were excluded in determining aggregate regional trends.

[2] 2002 state-level disposable personal income data were not available when this article was written.

[3] Data exclude credit card lenders, de novo institutions open three years or less, and other small specialized institutions with less than $1 billion in total assets primarily operating nonlending business lines (e.g., trust business).

Table 1

New York Region Insured Institutions Continue to Report Healthy Conditions

	Commercial Banks < $10 billion			Savings Institutions < $10 billion			Insured Institutions > $10 billion		
	Dec-02	Dec-01	Dec-00	Dec-02	Dec-01	Dec-00	Dec-02	Dec-01	Dec-00
Return on Assets (ROA) (YTD)	1.17	1.02	1.13	1.02	0.91	0.91	1.04	0.97	1.28
Median ROA	1.05	1.00	1.07	0.80	0.70	0.77	1.34	1.06	1.18
Net Interest Margin (YTD)	3.73	3.75	3.83	3.49	3.32	3.36	3.56	3.21	3.28
Past-Due Ratio	2.28	2.36	2.20	1.44	1.50	1.36	3.39	2.94	2.30
Earning Asset Yield	5.95	7.16	7.95	6.24	7.16	7.51	5.83	6.68	7.80
Cost of Funding Earning Assets	2.23	3.41	4.13	2.76	3.84	4.14	2.27	3.47	4.52
Total Loan Growth (year over year)	5.55	3.59	9.74	3.49	6.50	10.12	4.39	2.00	6.20
Tier 1 Leverage Ratio	8.20	8.31	8.55	9.30	9.36	9.59	6.88	6.76	7.04

YTD = Year to Date

All figures are percentages.

Note: All data exclude credit card institutions, de novos, and other small specialty institutions.

Source: Bank and Thrift Call Reports, reported on a merger-adjusted basis.

The Region's large institutions boosted income levels by increasing net interest income, noninterest income, and gains on the sale of securities. Noninterest expenses increased slightly but more slowly than net operating revenue (net interest income plus noninterest income). As a result, the efficiency ratio[4] for large banks improved during 2002. The cost of funds remains at a historically low level. These costs are highly sensitive to changes in short-term interest rates and can reprice quickly, increasing exposure to interest rate risk and ultimately affecting profitability. The past-due ratio[5] for large banks increased significantly during the past three years and now exceeds the ratio for smaller commercial banks by more than 100 basis points. Large bank credit problems are centered in exposures to troubled industries, such as the telecommunications, high-tech, and airline industries.

The Sluggish Economy Has Taken Its Toll on State Budgets

The New York Region Faces Budget Shortfalls

As of first quarter 2003, budgets were balanced for the current fiscal year in Rhode Island, Vermont, and Delaware, while the remaining states must close deficits by the end of June. States face a much bleaker situation for fiscal year 2004 because of lower-than-expected revenues and rising expenditures as a result of the recent recession and the lackluster recovery. States in the New York Region have a combined $20.5 billion deficit for the next fiscal year, roughly one-fourth of the estimated total gap for all states in the nation. **New Jersey**, Massachusetts, Connecticut, and Maine estimate that shortfalls will exceed 10 percent of each state's budget, and New York expects a 24 percent deficit—roughly $9 billion (see Table 2).[6]

Policy Actions Have Been Implemented

States in the Region have implemented a variety of initiatives to reduce expenditures. However, many states must also raise revenue to close budget gaps. Some states instituted small tax and fee increases during FY 2003 rather than increase sales or income taxes, to minimize the effects on residents. Most states have increased cigarette taxes, and Connecticut and Rhode Island have raised fuel taxes. New Jersey increased the corporate income tax, and Connecticut imposed a minimum tax on limited liability partnerships and S corporations.

These actions are expected to correct the imbalances for FY 2003; however, more severe measures will be required to address the worsening situation during FY 2004. For example, Connecticut and New Jersey are proposing personal income tax increases, New York may eliminate the sales tax exemption for clothing,

[4] The efficiency ratio measures noninterest expense as a percentage of net operating revenue.

[5] Past-due loans are 30 or more days delinquent plus loans on nonaccrual.

[6] National Conference of State Legislatures, *State Budget Update,* February 2003.

Table 2

States Must Close Growing Budget Gaps

	Fiscal Year 2003		Fiscal Year 2004	
	Deficit ($mil)	% budget	Deficit ($mil)	% budget
Connecticut	650	5.4	1,700	12.7
Delaware	0	0.0	196	7.7
District of Columbia	128	3.5	N/A	N/A
Maine	43	1.7	475	16.3
Maryland	414	4.0	853	7.8
Massachusetts	650	3.1	3,000	13.0
New Hampshire	58	4.7	148	6.0
New Jersey	1,100	4.7	4,600	18.5
New York	2,500	6.3	9,300	24.0
Pennsylvania	433	2.1	2,400	11.4
Rhode Island	0	0.0	174	6.1
Vermont	0	0.0	30	3.4

Sources: National Conference of State Legislators State Budget Update, February 2003; District of Columbia and Pennsylvania Budget Offices

and **Maryland** and Massachusetts are considering gaming proposals to increase revenues.[7]

Some Local Areas May Be More Affected

Government layoffs have occurred primarily at the state level, as state payrolls have declined in Massachusetts, Rhode Island, Delaware, New Jersey, and the District of Columbia.[8] However, job losses may trickle down to municipalities. Stable levels of property tax collections have enabled most local government budgets to weather the downturn. However, many states have announced plans to scale back aid to local governments during FY 2004, which could result in spending cuts and tax increases among some municipalities. The **Boston, Philadelphia, New York City,** and **Washington, DC**, metro areas are home to at least 200,000 state and local government jobs, although as a share of total employment, exposures are less than the national average. Employment concentrations in local government exceed the national average in the **Barre-Montpelier, Trenton, Vineland, State College, Albany, Binghamton,** and **Dover** metropolitan statistical areas.[9] As a result, these areas could be more adversely affected by layoffs.

Insured Institutions Must Remain Alert

Overall asset quality remained stable among insured institutions headquartered in the New York Region during the 2001 recession. However, consumer loan delinquencies increased during 2002 as household balance sheets were affected adversely by layoffs and weak per capita personal income growth. Substantial state and local tax increases could offset the proposed federal income tax cuts and could contribute to declining levels of disposable income. Households that are budgeting for education will be affected by the decision of many state universities to raise tuition to compensate for lower state funding. In addition, job losses and rising debt levels could pressure consumer credit quality. Although the effects likely will be relatively small, the quality of consumer and mortgage portfolios at some institutions could be affected by borrowers' attempts to solve fiscal problems.

State and local governments increased debt levels to avoid tax increases during FY 2002. Borrowed money represented almost 10 percent of state and local revenue in 2002, the highest level since the 1950s, according to the ***Commerce Department,*** and this share has almost tripled during the past three years. During that time, Standard & Poor's lowered the credit rating for New Jersey because of significant declines in projected revenues. The "stable" outlook for Connecticut and Maine was downgraded to "negative," and the "positive" outlook for Massachusetts and Rhode Island was downgraded to "stable."[10] The outlook for New York City was also recently downgraded from "stable" to "negative," reflecting escalating budget gaps.[11] Highly leveraged state and local governments that experience revenue shortfalls could face further downgrades in credit ratings. Such downgrades would increase the cost of borrowing. As of fourth quarter 2002, roughly 11 percent of insured institutions based in the New York Region held at least one quarter of their securities portfolios in municipal holdings. Institutions that hold these relatively high concentrations should continue to analyze any proposals that would have an adverse effect on the financial condition of state and local governments and their ability to repay debt obligations.

[7] National Association of State Budget Officers, *Fiscal Report of States,* November 2002.
[8] Based on payroll employment data, year-ago percentage change from fourth quarter 2002.
[9] The national average as of year-end 2002 was roughly 14.3 percent.

[10] Standard & Poor's *Public Finance Report Card: The States,* October 7, 2002.
[11] Standard & Poor's *Public Finance Report Card: The Largest U.S. Cities,* February 19, 2003.

New York Region Financial Services Sector Hit Harder than Nation's

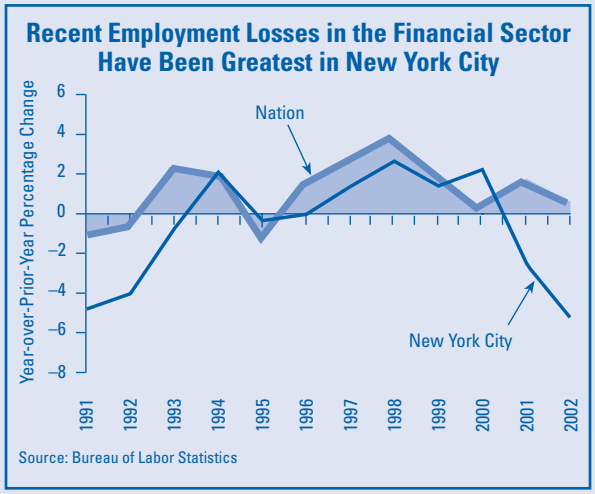
The Region, primarily **New York City,** has sustained greater employment losses in the financial services sector than the nation. During 2002, jobs in the financial sector, which includes banking, securities, and real estate firms, increased by 0.6 percent nationwide, while the Region's financial employment declined by about 1 percent. Many of the Region's financial employment losses can be traced to New York City and **Boston,** and to a lesser extent to **southern Connecticut** and **Bergen-Passaic counties** in **New Jersey.** In New York City, financial-sector job losses have declined sharply since peaking in 2000 (see Chart 1).

Employment losses in the financial sector have hurt New York City and Boston more than the nation because financial-sector employment is a significant economic driver in these metropolitan areas. Financial-sector employment in the New York City metro area represented almost 12 percent of employment and more than 30 percent of nonfarm earnings during 2000.[12] Although the Boston economy is slightly less concentrated in financial-sector jobs than New York, employment in this sector represented almost 9 percent of jobs and 12 percent of earnings, compared with 6 percent and 10 percent, respectively, for the nation.

The greater decline in financial-sector employment in New York City stems from job losses in the securities industry, which makes up the largest part of the financial sector. Moreover, compensation in the securities industry (including salary and bonuses) generally is significantly greater than in other industries. During 2002, employment in the New York City securities industry fell almost 10 percent, while Wall Street bonuses, a significant component of total compensation, are estimated to have declined 37 percent in 2002, following a 35 percent drop in 2001. In Boston, securities employment declined by 5 percent, compared with a 4.5 percent decline in the nation.

Layoffs in the securities industry have contributed to weakness in the Boston and New York office markets. Financial, law, and professional service firms lease about 68 percent of total office space in Boston.[13] Financial-sector employment in New York City fell 6 percent between 2000 and 2002, primarily owing to layoffs in the securities industry. These losses contributed to a threefold increase in New York City office vacancy rates, from 2.8 percent to 9 percent.[14]

Chart 1



Financial-sector job losses in Boston and New York City are consistent with weak business conditions in the securities industry nationwide. In 2002, the U.S. stock market suffered the third consecutive year of losses; 2002 represented the greatest annual loss since 1977, and pretax profits in the securities industry fell to an eight-year low. Investment banking activity, including initial public offerings, equity underwriting, and mergers and acquisition activity, declined sharply in 2002. According to the ***Securities Industry Association,*** the value of announced mergers and acquisitions of U.S. companies in 2002 fell 41 percent, the lowest level since 1994 and down 74 percent from the peak in 2000.[15] Commissions, trading activity, mutual fund sales, asset management fees, and margin revenue also were down sharply.

[12] Earning results are from 2000, the last year available.

[13] Susan Diesenhouse, "Layoffs Create a Glut of Space in the Boston Area," *New York Times,* p. C-6, February 5, 2003.

[14] Torto Wheaton Research.

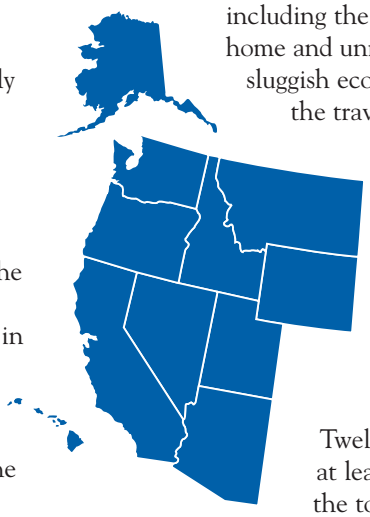
[15] Grace Toto, "Monthly Statistical Review," *SIA Research Reports.* Vol. IV, No. 1, January 31, 2003.

The outlook for the financial sector is mixed. According to ***Moody's Investors Service,*** factors such as high debt service burdens, weak U.S. corporate investing and capital spending, and ongoing litigation faced by many securities firms may delay a recovery in securities industry profits,[16] which will, in turn, constrain any rehiring on Wall Street. On the other hand, the boom in mortgage refinancing has boosted employment in mortgage banking, offsetting some job losses in the securities industry. Nonetheless, the impact of the securities industry on the New York City economy is apparent, and any continued weakness and consolidation could undermine its economic recovery. Employment in the Boston financial sector, which is dependent on asset management companies such as Fidelity, likely will not rebound significantly until mutual fund investors gain more confidence in the equity markets, which have been buffeted by poor corporate earnings, corporate scandals, and an unstable international situation.

[16] Moody's Investors Service, 2003, U.S. Securities Industry Outlook, February 2003.

San Francisco Regional Perspectives

Payroll employment growth in the San Francisco Region slightly outperformed that of the nation during 2002, primarily thanks to strength in the government and services sectors. Robust hiring in the education sector, particularly at the local level, led employment growth in several states. The services sector in **Nevada** and **Hawaii** and in several of the Region's metropolitan statistical areas (MSAs) also benefited from a recovery in tourism, which had declined significantly after 9/11.



Insured institutions headquartered in the San Francisco Region have performed well during the recession; however, bank and thrift performance remains vulnerable to several trends, including the effects of continued slow job growth at home and unrest abroad. This article explores how the sluggish economy and international events have hurt the travel and tourism sector in the San Francisco Region and the implications of these trends for the Region's insured institutions.

Travel and Tourism Are Important Economic Drivers in Several of the San Francisco Region Markets

Twelve of the Region's MSAs that are home to at least five insured institutions rank within the top quintile nationally for travel- and tourism-related employment. Tourism-related job growth in most of these markets slowed consider-

Table 1

Travel and Tourism Employment Has Declined in the Honolulu, Seattle, and San Francisco MSAs during the Past Two Years

Metropolitan Statistical[1] Area (MSA)	Travel and Tourism Employment Share in 2000: National Rank[2]	Compound Annual Tourism Employment Growth 1995–2000 (%)	Compound Annual Tourism Employment Growth 2000–2002 (%)	Count of Community Nonspecialty Institutions[3]	Share of Community Nonspecialty Institutions < 9 Yrs. Old (%)	Median Past-Due Loan Ratio[4] (%)
Las Vegas, NV	2	5.3	–0.2	21	76	1.63
Honolulu, HI	9	–1.5	–2.8	8	0	1.5
Anchorage, AK	10	4.4	2.2	8	0	1.84
San Francisco, CA	13	4.2	–1.1	25	8	0.92
Salt Lake City, UT	27	8.2	2.1	14	36	2.97
Santa Barbara, CA	31	3.0	1.6	8	25	1.66
Billings, MT	34	6.4	4.9	6	17	2.73
Phoenix, AZ	37	3.9	–0.4	25	64	0.7
San Diego, CA	41	5.2	5.0	22	50	0.6
San Luis Obispo, CA	42	5.8	1.0	7	43	0.69
Orange County, CA	43	4.3	4.6	17	53	0.09
Seattle, WA	60	3.6	–2.1	37	49	1.12
Total U.S.		4.5	1.5	3,268	17	1.52

[1] Includes MSAs in the San Francisco Region that rank in the top 20 percent of 318 MSAs nationally for employment concentrations in travel and tourism employment and that have a least five established community insured institutions based in each of those markets.

[2] Travel and tourism employment includes jobs in lodging, recreation, and air transportation services.

[3] Community institutions are defined as insured institutions holding less than $5 billion in total assets that are not specialty institutions or industrial loan companies. Figures for the U.S. are calculated on MSA-based institutions meeting the aforementioned definition. Honolulu and Anchorage data include nonspecialty insured institutions (regardless of size) headquartered in Hawaii and Alaska, respectively.

[4] Includes loans that are 30 days or more past due or in nonaccrual status. Median was calculated on community nonspecialty institutions in operation at least three years.

Sources: Global Insight; Bank and Thrift Call Reports (December 31, 2002)

ably from 2000 through 2002 as a result of the recession and the 9/11 attacks (see Table 1). In addition, hotel revenues and occupancy rates have declined significantly during the past two years. Between 1995 and 2000, the robust economy, rapid construction of theme hotels in **Las Vegas,** and the 2000 Winter Olympics in **Salt Lake City** contributed to an annual employment growth rate in the tourism sector that exceeded 5 percent in several MSAs. Subsequent declines in business and leisure travel during 2001 and 2002 significantly dampened employment growth in this sector in the Las Vegas, **Honolulu, San Francisco, Phoenix,** and **Seattle** markets.

Declines in the Number of Air Passengers Adversely Affect Air Services and Aerospace Employment

Although air travel recovered somewhat during 2002, the decline since 2000 continues to hurt airline employment. Airlines laid off around 13 percent of their workforce between August 2001 and December 2002.[1] Airline profits remain pressured by declines in air travel caused by the war in Iraq, rising fuel prices, and escalating leverage. Several airports in the Region that are hubs for financially troubled airlines are particularly vulnerable to additional layoffs: San Francisco and **Los Angeles** (United), Honolulu (Hawaiian Air and Northwest), and Phoenix and Las Vegas (American). As of early April, United and Hawaiian Air had filed for bankruptcy during the past year.

The slowdown in travel and tourism also has led to layoffs in the commercial aerospace industry, in particular at Boeing, the Seattle MSA's largest employer. According to the ***Air Transport Association,*** orders for aircraft fell more than 35 percent during the last half of 2002 compared with the last half of 2000, continuing a two-year trend. Boeing eliminated 18 percent of its **Washington** workforce during 2002 and has announced plans to lay off more workers. The Seattle MSA, which continues to feel the impact of the high-tech downturn, is characterized by relatively high shares of employment in the tourism and aerospace industries. As a result, it remains vulnerable to continued weakness in these sectors.

Lodging Employment Is Hurt by Reduced Travel

The decline in foreign and domestic travelers has affected the San Francisco Region's lodging industry adversely during the past two years. Although employment in the hospitality sector has improved since 9/11, the overall number of lodging jobs in the Honolulu, Las Vegas, Phoenix, Santa Barbara, and Seattle MSAs was lower at year-end 2002 than at the end of 2000.[2] In addition, according to ***Torto Wheaton Research,*** revenue per available room (RevPAR) was sharply lower between 2000 and 2002 in the Region's tourism-

Chart 1

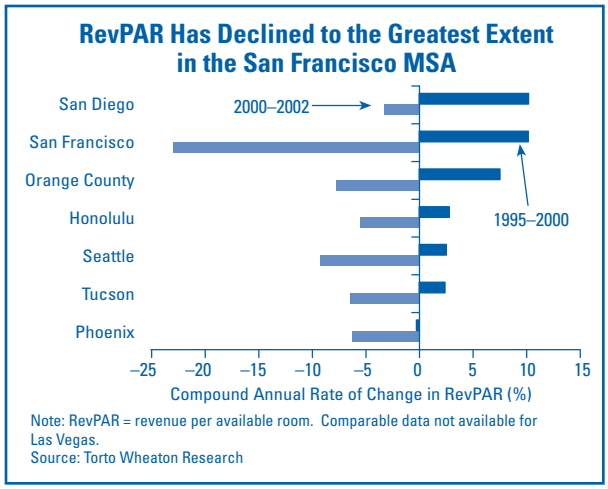
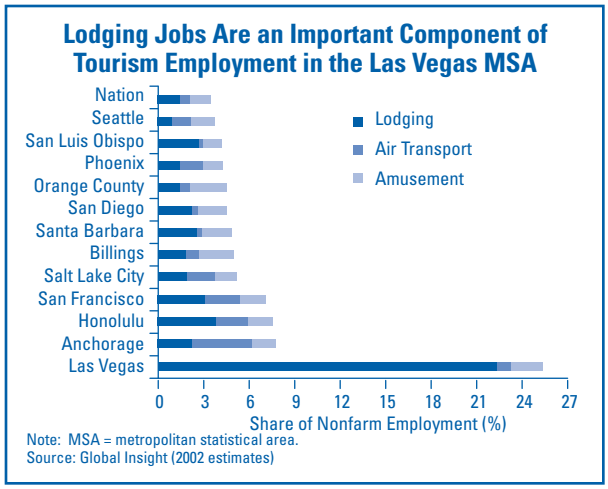


Chart 2



[1] Air Transport Association, "Airlines in Crisis; the Perfect Economic Storm," March 11, 2003, p. 14. (http://www.airlines.org/public/industry/bin/AirlinesInCrisis.pdf)

[2] Based on estimates available from Global Insight.

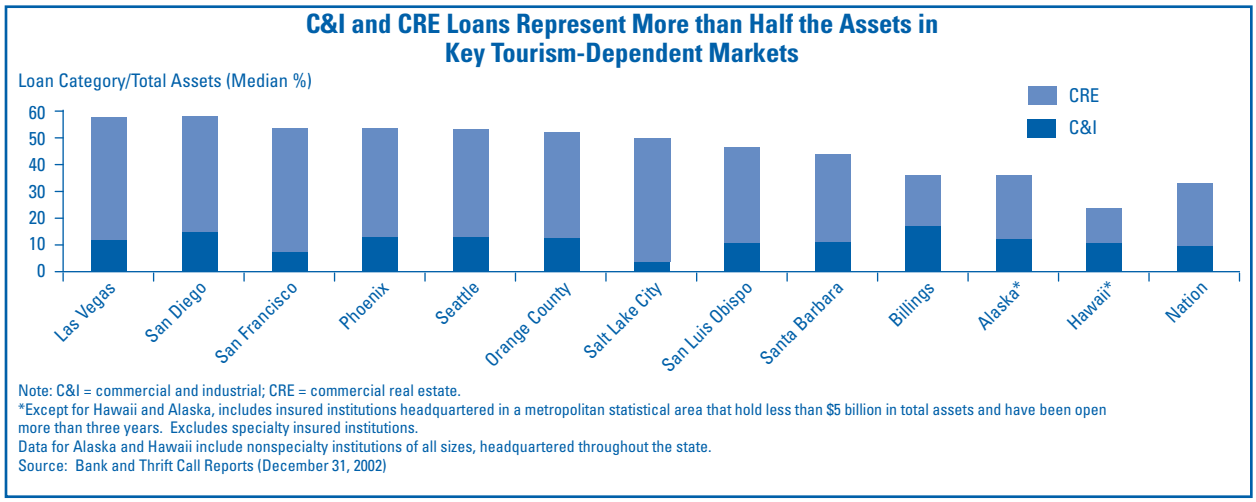
dependent markets, most notably San Francisco (see Chart 1). Trends in RevPAR are a key indicator of the health of the tourism industry, particularly in markets that rely heavily on lodging employment (see Chart 2).

Most Insured Institutions Remain Strong

Continued layoffs in the travel and tourism sectors and weak RevPAR levels could have an adverse effect on established community institutions[3] headquartered in markets with relatively high shares of travel-related employment. Low interest rates likely have mitigated the effects of reduced travel on the ability of many businesses and individuals in tourism-dependent areas to service debts. In fact, at year-end 2002, the median past-due loan ratio had declined year-over-year in 9 of the Region's 12 travel-exposed markets; however, delinquencies remained high among established community institutions headquartered in the Salt Lake City and **Billings** MSAs (see Table 1). In contrast, established community institutions based in **Alaska** and in the **Santa Barbara** and Las Vegas MSAs reported rising median past-due loan ratios.

Loan and age mixes among insured institutions in the 12 tourism-dependent markets referred to in Table 1 could magnify asset quality and earnings pressures should weaknesses persist in the tourism and aerospace sectors. Insured institutions based in these markets hold elevated concentrations in commercial real estate[4] and commercial and industrial loans, two traditionally higher-risk loan categories (see Chart 3). Moreover, a high proportion of insured institutions in some of these markets are relatively unseasoned, which could make them vulnerable should economic disruptions hamper loan growth or asset quality, both of which are important for break-even earnings performance in the early years of operation. As of fourth quarter 2002, 20 percent of all community institutions in these 12 markets were

Chart 3



[3] For purposes of this analysis, outside of Anchorage and Honolulu, established community institutions are defined as insured institutions holding less than $5 billion in total assets that have been open more than three years and are not specialty institutions or industrial loan companies. These data restrictions were used to isolate insured institutions that might have loan concentrations within the headquarters MSA and to mitigate the effects of unseasoned loan portfolios or newly chartered institutions on performance measures. Because they typically derive a significant share of deposits from the MSA in which they are headquartered, institutions holding up to $5 billion in assets were included. Specialty institutions and industrial loan companies were excluded because they lack traditional bank asset mixes (e.g., low loan-to-asset ratios) or pursue loan niches with broader geographic reach. As a result, performance measures might not reflect economic conditions within the headquarters MSA. In the cases of Honolulu and Anchorage, statistics for all established nonspecialty insured institutions were used, given the isolated nature of these banking markets and the relatively small number of insured institutions.

[4] Commercial real estate loans include mortgages secured by nonfarm-nonresidential, multifamily, and construction projects.

less than three years old, and another 26 percent were less than nine years old. As noted in Table 1, at least half of all community institutions in the Las Vegas, Phoenix, **Orange County,** and **San Diego** markets have been in operation less than nine years.

Conclusion

The travel and tourism sector, although recovering from the effects of 9/11, remains vulnerable to global political and economic uncertainties, new terror alerts, and a weak national economy. Established community institutions based in most of the Region's 12 travel-dependent MSAs have not reported rising past-due loan ratios despite tourism sector layoffs, airline bankruptcies, and declines in RevPAR. However, without a quick rebound in the travel sector, banks and thrifts operating in these markets remain vulnerable to asset quality and earnings pressures.

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