Regional Outlook

Federal Deposit Insurance Corporation — Third Quarter 1997

FDIC
New York
Region

In Focus This Quarter

◆ ***Subprime Lending: A Time for Caution***—**The extent of subprime lending is increasing as strong competition for high-quality borrowers has some lenders moving down the credit quality spectrum. Subprime lending requires a commitment of resources and expertise beyond that required in more conservative lending, and the consequences of deficiencies in underwriting, servicing, and collection can be severe.** *See page 3.*

By Kathy R. Kalser, Debra L. Novak

◆ ***Retail Shakeout: Causes and Implications for Lenders***—**Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions.** *See page 6.*

By Richard A. Brown, Diane Ellis

Regular Features

◆ ***Regional Economy***—**The New York Region adds jobs at an accelerating rate . . . office vacancy rates are on the decline as demand increases . . . consolidation in the health care industry poses risks and uncertainties for the Region's labor market.** *See page 10.*

By Norman Gertner

◆ ***Financial Markets***—**Securitization of home equity loans is growing rapidly . . . consumer debt consolidation loans may be driving this growth . . . signs of relaxed underwriting have appeared . . . the arrival of FASITs could increase the appetite of community banks to enter the ABS market.** *See page 14.*

By Allen Puwalski

◆ ***Regional Banking***—**Loan losses at the Region's credit card banks continue to increase . . . banks may be tightening underwriting standards in response . . . competition drives residential loan-to-value ratios higher, increasing risks to lenders.** *See page 18.*

By Karen A. Denu, Suzannah L. Susser

Division of Insurance

Suzannah L. Susser, Senior Regional Analyst

Norman Gertner, Regional Economist

Karen A. Denu, Financial Analyst

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the New York Region's ***Regional Outlook,*** please call Suzannah Susser at (212) 704-1482 or send an e-mail to *ssusser@fdic.gov.*

Subprime Lending: A Time for Caution

- **Subprime lenders specialize in lending to borrowers with blemished or limited credit histories.**
- **The consequences of deficiencies in underwriting, servicing, and collection can be severe with subprime lending. Lenders that fail to dedicate the necessary resources in these areas likely will have trouble succeeding in the increasingly competitive market for subprime loans.**
- **Some institutions insured by the FDIC have failed to properly assess and control the risks associated with their subprime lending programs.**

What Are Subprime Loans?

Faced with strong competition and shrinking margins on loans to high-quality borrowers, some lenders are moving down the credit quality spectrum. The strategy to extend loans to borrowers perceived as less creditworthy is referred to as "subprime" lending. *Subprime lending is most commonly associated with auto, home equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories.* Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

Subprime loans also are referred to as marginal, nonprime, or below "A" quality loans. There are no established guidelines for determining the degree to which a borrower is considered subprime, so one lender's "B" customer could be another lender's "C" customer. Definitional variations aside, some general market parameters on ranking loans are presented in Table 1.

Table 1

Criteria for Loan Rankings		
Grade	Payments Late 30 Days	Bankruptcy Filing
Prime	None	None
A-	Less than 2	None in 5 years
B	Less than 4	None in 3 years
C	Less than 6	None in 2 years
D	Constantly Late	None in 1 year

Sources: Duff & Phelps, Standard & Poor's, Mortgage Market Information Services

How Big Is the Market?

The lack of a standard definition for a subprime loan makes it difficult to accurately determine the extent of the market. However, some industry experts estimated that during 1996, subprime loans secured by residences, including both home equity and mortgage loans, amounted to between $100 billion and $150 billion compared to the estimated $800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between $75 billion and $100 billion, or about 20 percent of total auto loans outstanding.

Who Makes Subprime Loans?

In the past, subprime lending was primarily the domain of a limited number of finance companies. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of subprime lenders, however, has surged in recent years as more companies have been attracted by the significantly higher rates and fees earned on subprime loans. In some cases, yields on these higher risk assets have been as high as 15 percent to 30 percent. The new subprime participants include finance companies that traditionally served prime borrowers, new specialized subprime lenders, and banks.

The increase in the number of subprime lenders has been fueled by strong demand from investors for asset-backed securities (ABS). This method of funding enables the lender to effectively raise cash at a lower rate to fund loan growth. In addition, the subprime ABS market has attracted lenders that previously refrained from making subprime loans because they did not want to maintain these high-risk loans or the associated reserves on their balance sheet. By issuing securities backed by subprime loans, lenders now have the ability to originate subprime loans and sell them to ABS investors.

Favorable stock market conditions also helped to fund the growth of subprime lenders. Approximately 30 subprime lenders raised nearly $3 billion from stock offerings from January 1995 through April 1997, according to market watchers. This financing avenue may become less accessible, as investors' concerns over financial problems of several major market participants have caused stock prices of subprime lenders to decline significantly during the first part of 1997.

Financial Difficulties of Some Subprime Lenders

Market participants have observed that, as in credit card lending, *increasing competition may be compelling some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share*. Financial difficulties reported by major subprime auto lenders Jayhawk Acceptance Corporation and Mercury Finance Company highlight these concerns.

Problems in subprime lending are not limited to auto loans. Lenders that specialize in subprime home equity loans and mortgages also are showing signs of stress. In April 1997, Moody's Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home equity loans. The reason was concern over the increasing level of delinquencies in the issuer's loan portfolio and the highly competitive environment for subprime home equity loans (see ***Financial Markets***).

Differences between Prime and Subprime Lending

There are key differences between the underwriting, servicing, and collection methods used for prime and subprime lending programs. The goal of the subprime underwriting process is to differentiate those subprime borrowers whose past credit problems were due to such temporary events as illness or job loss from the habitually bad credits. Subprime lenders often supplement a prospective borrower's credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. This process allows the lender to better determine the credit risk or "grade" of the borrower. If this determination is successful, the lender can better establish the price at which the loan will be profitable.

Servicing and collection of subprime loans tends to be more labor intensive and costly than in prime lending. Subprime lenders tend to monitor payments more closely than prime lenders. Some purportedly call their borrowers regularly to remind them when a payment is due. In addition, while prime lenders may be willing to work with late borrowers by adjusting minimum amounts or payment schedules, subprime lenders generally pursue collections more aggressively and repossess collateral more quickly.

Insured Institutions and the Subprime Market

Bank involvement in subprime lending is difficult to quantify because subprime loans are not delineated in bank and thrift Call Reports. *However, both large and small banks reportedly are participating in credit card, auto, home equity, and mortgage subprime lending.* Insured institutions have used various strategies to establish a presence in the subprime market. Some have:

- acquired or formed joint ventures with companies specializing in subprime lending;
- built subprime lending programs internally, using existing resources; and
- tapped a network of loan brokers with access to subprime borrowers. Smaller banks entering the market for subprime mortgages may use this method more commonly.

Through these strategies, insured institutions have:

- extended loans directly to subprime borrowers or purchased subprime loans from loan brokers;
- lent to subprime specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines; and
- serviced subprime loans or invested in asset-backed securities secured by subprime loans.

Risks Associated with Subprime Lending Need to Be Considered Carefully

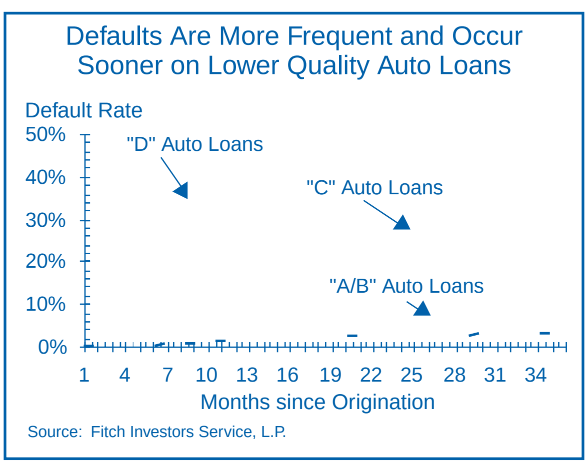
According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC's Division of Supervision, *recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending.* Because of the relatively high default rates on such loans, the FIL indicates that this type of lending warrants particular caution and management attention.

Institutions need to be thoroughly aware of the increased risks and costs associated with lending to higher risk borrowers. Some of these risks include:

- *Delinquencies and defaults tend to be more frequent and occur sooner on lower quality loans* (see Chart 1).
- Loan loss reserves that would have been adequate for prime lending may not properly cover higher loss rates associated with subprime loans.
- Strains on underwriting and collection resources may emerge.
- Because selling collateral is more frequently the source of repayment on subprime loans, failure to accurately estimate recovery values could severely affect the profitability of subprime lenders. For example, several subprime auto lenders recently reported lower profits when the supply of better quality cars coming off leases depressed the prices they received on repossessed cars.

Insured institutions that rapidly increase subprime exposures also may need to reevaluate delinquency measurement methodologies. Rapid loan growth can make it more difficult to accurately track delinquency and default trends. Generally loans do not default immediately, but "season" or reach peak loss rates over a period of time. *Delinquency and default rates can be deceptively low if the proportion of new loans exceeds the proportion of seasoned loans in a lender's portfolio.* Calculating default rates over time for loans originated in a particular period or lending program, instead of as a percentage of total outstanding loan balances, helps reduce the distortion caused by rapid loan growth. This method of computing delinquency and default rates, known as "static pool" or "vintage analysis," is a common measurement tool among investment analysts.

CHART 1



Banks involved in subprime lending also should realize that the recent increase in subprime lending has occurred during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be more susceptible to downturns in the economy, which could further exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

In addition, banks that lend to subprime specialty lenders, who rely heavily on securitization, should evaluate the accounting treatment of securitization and the effect securitization may have on earnings (see ***Financial Markets***).

Conclusion

The extent of involvement by insured institutions in subprime lending is difficult to quantify. To be successful in subprime lending requires a commitment of resources and expertise. Conversely, deficiencies in assessing and controlling the risks of subprime lending can have serious consequences. Such deficiencies have surfaced at a number of FDIC-insured institutions. Striking an appropriate balance between the risks and rewards of subprime lending is a challenge for bankers and merits the continued attention of bank supervisors.

Kathy R. Kalser, Chief
Financial Sector Analysis Section
Debra L. Novak,
Division of Resolutions and Receiverships

Retail Shakeout: Causes and Implications for Lenders

- **Changes in the marketplace, technology, and finance are transforming retailing.**
- **These trends have given rise to rapid growth in the new "big box" store format.**
- **Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.**
- **The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.**

For the past two decades, construction of retail space has outstripped many indicators of demand such as growth in retail sales, population, and income. The broadest measure of the industry's health is sales per square foot, and, for shopping centers, it has fallen by around 35 percent in real terms since 1972. Chart 1 shows how growth in leasable shopping center space has exceeded growth in shopping centers' sales since 1972.

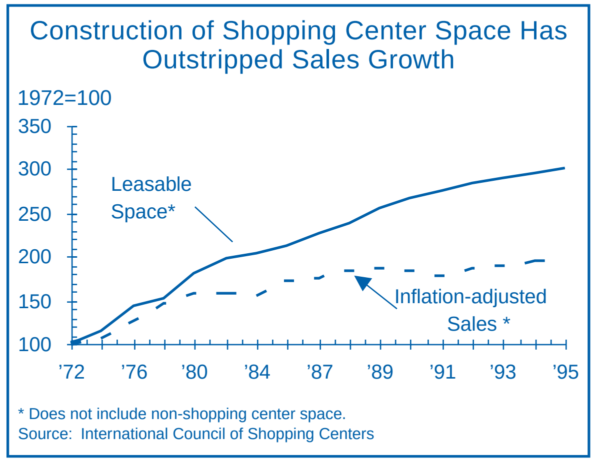
Based on signs of "overstoring," a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate, they are exposed to heightened credit risk as the shakeout unfolds.

New Forces Are Reshaping the Retail Landscape

A combination of demographic and economic forces has reduced growth in demand for retail goods from the boom days of the 1970s and mid-1980s. Meanwhile, technology is reconfiguring the way retail goods are marketed and delivered, and a low cost of capital has stimulated investment in new retail space and new retailing concepts.

A retail industry boom began roughly in 1970 when baby boomers and women began entering the work force in record numbers. At the same time, proliferation in general-purpose credit cards facilitated an extension in consumer borrowing power. As a result, there was a

CHART 1



98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

To meet this demand and serve expanding suburban communities, developers built shopping centers at a rapid pace. The number of shopping centers, from small neighborhood strip centers to huge regional malls, grew from about 13,000 in 1972 to over 41,000 in 1995.

Despite economic conditions that seem favorable for the retail sector, revenue growth has been painfully slow in the 1990s. Payrolls have seen net growth of 13.4 million jobs since mid-1991, while real disposable personal incomes and consumer confidence have risen commensurately. An optimistic household sector has shown a willingness to take on debt under these favorable conditions and has done so with the benefit of lower interest rates compared to the 1980s.

Even with generally positive economic conditions, retail demand has grown slowly in the 1990s (see Chart 2, next page). Annual rates of increase in real expenditures on many durable and, especially, nondurable goods have lagged behind rates of the previous two decades.

Slow growth in retail revenues can be explained in part by the fact that retail goods overall have risen in price at only around two-thirds of the general rate of inflation during the 1990s, while the appliance, electronics, and personal computer sector has seen actual price deflation.

An aging consumer base is another factor holding down retail sales growth. The total number of households headed by persons age 20 to 35—the age at which families are getting established and acquiring household durable goods—is the same now as it was in 1980. The lack of growth in this key demographic group has limited growth in retail demand and should continue to do so for the foreseeable future. The total population in the 20 to 35 age bracket is projected to decline slightly by 2007.

Other broad trends have contributed to slower retail sales growth. Retail sales as a percentage of personal income fell from 46 percent to 38 percent between 1967 to 1996 as consumers shifted more of their disposable income to the purchase of personal services, housing, education, travel, and entertainment. A ***Standard and Poor's Industry Survey*** reports that consumers have reduced their number of trips to shopping malls by 35 percent since 1980, while total shopping hours are down 70 percent.

Looking ahead, mail-order retailing through electronic media, including cable television and the Internet, may be poised to gain significant market share at the expense of shopping centers. "Virtual shopping malls" such as Amazon.com, an Internet bookseller, have made headlines with their initial successes, although analysts caution that widespread adoption of high-tech shopping may be some years down the road.

Technology has become a key to distribution and marketing. Faced with slower revenue growth, retailers have been investing in technology to cut their expenses and boost their bottom lines. For example, point-of-sale scanning delivers a vast amount of information that can be used to target marketing efforts and manage and control inventories—providing a distinct competitive advantage for large retail chains with vast marketing and distribution networks.

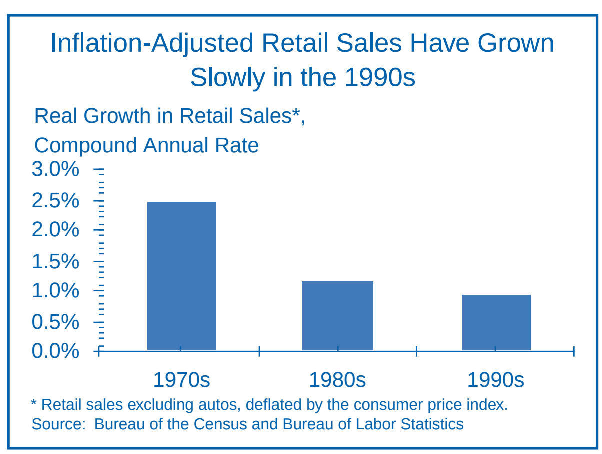
A low cost of capital has fueled investment. Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise have been infeasible. Since 1991, around 1.13 billion square feet of new retail space has been added nationwide representing an increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost $33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although they are known to be sizeable.

Growth of the "Big Box" Format

Leading retailers have responded to these forces with aggressive expansion in the "big box" store format. Big box retailers are typically discount stores and superstores, such as Circuit City, PetSmart, and The Home Depot, Inc., which tend to cluster in large strip malls called "power centers." In many towns and cities, the arrival of big box stores has left smaller, local retail establishments with only a small fraction of their former share of the local market.

The big box format has a number of advantages. Among the most important is the ability to offer a large, diverse on-shelf selection. This approach enables a single location to dominate that retail category in the local market, which is why the big box chains are often referred to as "category killers." Large retail chains also have more leverage over suppliers. They can negotiate more favorable prices and demand cooperative advertising from manufacturers. Large retailers typically have the financial resources to invest in the latest distribution methods and technology. Finally, unlike smaller traditional retailers, these large chains can obtain financing through the capital markets.

CHART 2



Industry Consolidation to Continue

Rapid expansion among the large retail chains has contributed to a highly competitive retail sector marked by intense battles for domination of the major retail categories. The result of this competition, analysts say, will be consolidation in the industry as weaker chains give way to market leaders.

One sign of this consolidation is in multibillion dollar acquisitions, such as Federated Department Stores' acquisition of R.H. Macy. The five largest department store chains (JC Penney, Federated, May, Dillard, and Nordstrom) now account for 87 percent of department store sales nationwide. The top three discount department store chains (Wal-Mart, K-Mart, and Target) account for 87 percent of full-line discount department store sales.

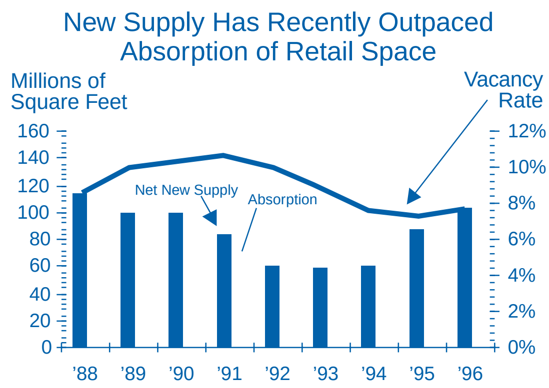
Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more likely to be forced into bankruptcy. ***Dun & Bradstreet*** reports that domestic business failures among retail establishments rose in 1995 by 2.8 percent to 12,952. While most of these failures were individual stores and small chains, a number of larger chains also filed for bankruptcy during 1995, including Barney's, Bradlees Inc., Caldor, The Clothestime Inc., Edison Brothers Stores, Elder-Beerman, Herman's Sporting Goods, Jamesway, and Today's Man.

As the retail shakeout moves forward, any credit losses on commercial and industrial loans to retailers are more likely to arise from bankruptcies and restructurings than from mergers and acquisitions. Unfortunately, it is difficult to say in advance exactly how consolidation in the industry is likely to take place.

Overbuilding Is a Risk for Retail Real Estate

Retail industry analysts are particularly concerned about the potential for overbuilding of retail space. Because of this concern, lenders and examiners should be alert to possible credit quality problems with commercial real estate loans secured by retail properties.

CHART 3



Source: FDIC, *The Real Estate Report* (Summary for 58 major markets)

Although a vacancy rate of 7.7 percent does not suggest that the U.S. retail market is vastly overbuilt at present, there are warning signs. One is that the U.S. aggregate vacancy rate has begun to tick upward since 1995 as net completions of new retail space have caught up to and surpassed the absorption of that space by retailers (see Chart 3). Another frequently cited indicator of overbuilding is a falling ratio of sales per square foot in the industry, reflecting the fact that additions to retail space have outpaced sales growth for some time. In any case, local market conditions may be somewhat more volatile than the national figures would suggest, particularly in areas where a great deal of construction activity has recently taken place (see inset, ***Retail Vacancy Trends Reverse in Several New York Region Markets***).

Besides market conditions, underwriting is the other major determinant of credit quality in retail real estate lending. Market analysts report that many of the problems resulting from local market downturns have been on loans with 1980s-vintage underwriting, particularly those with high loan-to-value ratios. Analysts also voice concern that the rapid expansion of space may be putting downward pressure on lease rates. *In light of an ample supply of space and a number of large chains continuing to add space, any valuations that assume future growth in lease rates should be closely reviewed.* The viability of rapid expansion on the part of the large retail chains would undergo a particularly severe test in the event of a recession.

Richard A. Brown, Chief, Economic Analysis Section
Diane Ellis, Senior Financial Analyst

Retail Vacancy Trends Reverse in Several New York Region Markets

Consistent with trends throughout the nation, retail vacancy rates in the Region fell between 1993 and 1995. However, this trend now appears to be reversing (see Table 1). A slight rise in 1996 retail vacancy rates in several markets across the Region corresponds to a change in market conditions, as net new supply exceeded absorption of retail space for the first time since 1991 (see Chart 4).

The **Baltimore** and **Pittsburgh** markets recorded the lowest fourth quarter 1996 retail vacancy rates in the Region. However, ***Valuation International***, an Atlanta-based consortium of appraisers and consultants, estimates that between 1996 and 1999 over 2 million square feet of new retail space will be constructed in Baltimore and over 3 million square feet of new space will be built in Pittsburgh. As a result, vacancy rates could rise if retail sales slow.

Other reports from around the New York Region indicate that certain segments of the retail industry may be at risk of excess capacity in the future. One such report by ***New Jersey Business News*** suggests that overcapacity among **New Jersey** retailers could ultimately lead to instability in the local retail industry and even the failure of some large retail outlets. Another report by the ***Albany Times Union*** indicates that retail space in the **Albany** area has recently been increasing by hundreds of thousands of square feet per year even while population growth has remained stagnant and major employers have been cutting back their workforces. Four prominent retailers in the Albany area have declared bankruptcy in recent months. According to a report by the ***Philadelphia Planning Commission***, there is currently a record high number of dress shops, insurance agencies, coffee bars, and other consumer businesses in the city despite the recent decline in the city's total population.

The exception to these trends appears to be the New York City area. In every year since 1988, the New York City area has experienced a net loss of retail space. Since that year, the area has lost about 13 million square feet of retail space as a number of large department stores went through bankruptcy or downsizing. However, a new proposal by the New York City Council designed to rejuvenate the retail industry appears to be gaining support. The proposal is modeled after a similar plan put in place in Chicago, where large retail districts were established within existing manufacturing districts apparently without detrimental effects on local businesses. The New York City Council plan designates 60 or more sites where superstores can be built; however, it would allow communities or the council to decide where the stores would be located. The city's administration had been pushing vigorously to make it easier for new stores to open throughout New York City, which would offset the recent losses in the retail business to new superstores operating in suburban areas.

Norman Gertner, Regional Economist

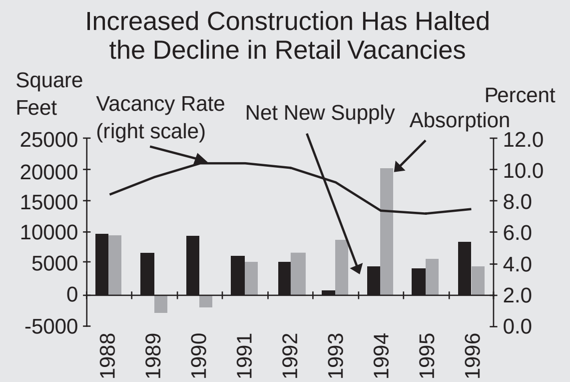
Table 1

Retail Vacancy Rates Have Begun to Rise Slightly in the New York Region

	1993	1994	1995	1996
Baltimore MSA*	7.6	5.1	5.4	5.5
Nassau-Suffolk PMSA*	8.6	8.2	8.4	7.4
New York PMSA	14.8	9.9	9.6	9.7
Newark PMSA	5.7	5.5	6.0	6.3
Philadelphia PMSA	8.2	7.1	6.5	7.4
Pittsburgh PMSA	4.3	3.2	3.4	3.2
Washington, DC MSA	7.9	7.7	7.2	7.7
US Average	9.0	7.6	7.4	7.7

*MSA = Metropolitan Statistical Area;
PMSA = Primary Metropolitan Statistical area
Source: FDIC The Real Estate Report

Chart 4



Source: FDIC Division of Research and Statistics, *The Real Estate Report.* (Summary for the NY Region.)

New York Region: Job Growth Is Catching Up to the Nation

- **The New York Region is adding jobs at an accelerating rate and has significantly closed the gap between the Region's and the nation's employment growth.**

- **Office vacancy rates have declined throughout the Region, indicating an increasing demand for office space.**

- **Consolidation in the health care industry, a major employer in the Region, poses risks and uncertainties for the Region's labor markets.**

The New York Region's economy began 1997 on a strong note with acceleration in job growth during the first quarter. Many areas of the Region, including **Delaware**, **Maryland**, and central **Pennsylvania**, are adding jobs at a faster pace than the national average. Still, some cities, including **Trenton**, **Newark**, and those in upstate New York, lag behind in job creation.

New Service, Trade, and Construction Jobs Drive the Region

In aggregate, the Region added over 378,000 new jobs during the first quarter of 1997. This increase of about 1.8 percent on an annual basis almost matches the national employment growth rate of 2.2 percent. By comparison, in 1996, employment growth in the nation was more than a full percentage point above that of the Region. In 1995, the nation's growth exceeded the Region's growth by a point and a half.

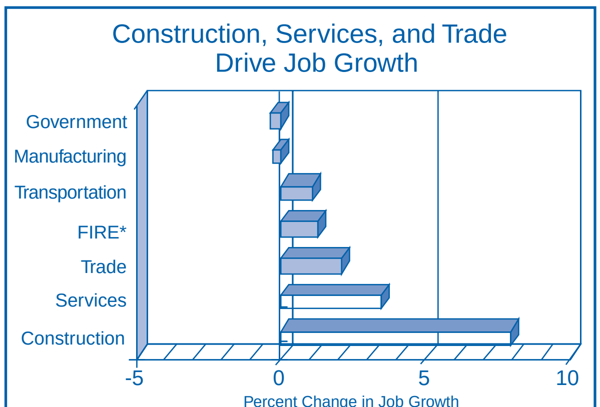
During the first quarter of 1997, employment in the Region was stimulated mainly by gains in the construction, services, and trade sectors (see Chart 1).

The service sector represents the largest component of the Region's workforce, accounting for about one-third of the total. Growth in high-tech services, tourism, and social and educational services is responsible for much of the gain in the service sector. Between the first quarter of 1996 and the first quarter of 1997, service employment increased by 223,000 jobs. This represents an increase of 3.5 percent, one of the sector's best performances of the decade. Over the same period, trade employment increased by 92,000 jobs, an increase of 2.1 percent. Construction employment jumped about 55,000 jobs, an increase of 7.9 percent. Much of the surge in construction employment can be attributed to the mild winter throughout the Region, which boosted residential construction activity. The construction sector represents only 4 percent of the Region's total workforce and is subject to cyclical and interest rate swings. Nonetheless, its growth is reflective of an increase in the Region's economic growth.

The Region's finance, insurance, and real estate (FIRE) sector added only 19,000 jobs, an increase of about 1.3 percent annually. According to the New York State Comptroller's Office, employment growth in the securities industry has been restrained. Securities firms have concentrated on controlling costs, investing in labor-saving technology, and building up more profitable business areas. In addition, the FIRE sector has been hurt by consolidations in the banking and insurance industries, which have kept employment growth down.

Implications: Employment growth in the Region is accelerating and catching up to the nation's pace. *More jobs and higher incomes generate higher business and*

CHART 1



*FIRE - Finance, Insurance, and Real Estate
Source: Bureau of Labor Statistics, First Quarter 1996 - First Quarter 1997

consumer confidence and a greater willingness to spend and invest. As a result, the environment for growth in both commercial and consumer lending portfolios is more favorable.

State Labor Markets Are Improving

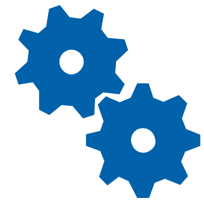
Favorable economic conditions are evident at the state and many metropolitan levels as well. Although it has the smallest workforce in the Region, **Delaware** continues to be the leading state for job growth. In the first quarter of 1997, Delaware's year-over-year employment growth was about 4 percent, or 14,000 jobs, its best performance of the decade. The state has benefited from 6.5 percent growth in business services and 6.3 percent growth in the FIRE sector. Employment in **Wilmington**, the state's largest city and center of employment growth, also rose about 4 percent.

Employment in **Pennsylvania** during the first quarter of 1997 rose 2.6 percent, or 137,000 jobs—the state's best quarterly showing of the 1990s. Pennsylvania has benefited from 4 percent growth in service sector employment and 3.1 percent growth in trade employment. Business service employment rose 9.8 percent on an annual basis, reflecting a large demand for computer programmers, systems analysts, and accountants. As a result of a mild winter compared to the harsh winter of 1996–1997, year-over-year construction employment rose 11 percent during the first quarter. A 22 percent jump in permits for single-family homes suggests continued strength in this sector.

The central Pennsylvania area is leading the state in job growth (see Chart 2).

Its strength primarily stems from faster growth in the service and trade sectors than the rest of the state. In particular, the area has benefited from growth in business, social, and educational services. Growth in **Williamsport** has been boosted by a more than 5 percent increase in manufacturing jobs. The area also has benefited from a rise in construction activity. First quarter year-over-year construction employment is up over 11 percent in many parts of central Pennsylvania, fueled by a 59 percent rise in permits for single-family homes in **Harrisburg** and a 9 percent rise in **Lancaster**.

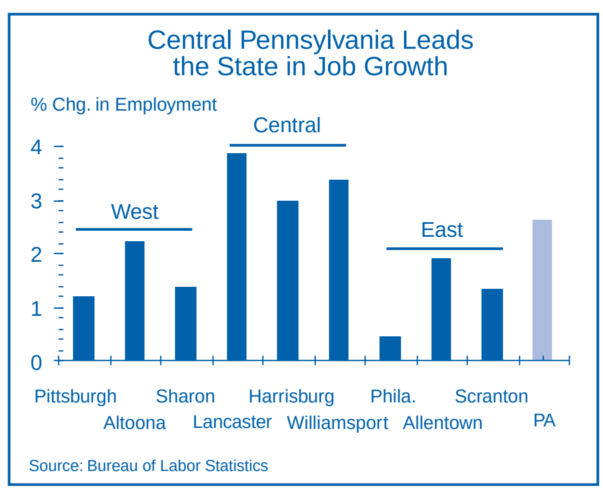
A recent business roundtable review of central Pennsylvania's economy found strong potential for continued employment and tourist industry growth and predicted a vibrant real estate market. In particular, local business leaders expect further economic development of research and industrial parks, completion of various transportation initiatives, and growth in health maintenance organizations to boost the local economy's growth. By contrast, growth in eastern Pennsylvania has been more sluggish. That part of the state continues to lose manufacturing jobs and has not added service sector jobs as fast as the rest of the state.



Job growth in **Maryland** also has been led by service and construction jobs. Employment rose by 55,000 jobs, or 2.6 percent, during the first quarter of 1997 on an annual basis. Service sector employment grew 4.3 percent, powered by a 9.5 percent rise in business services. An annual outlook conference on the Maryland economy predicted that service employment would account for three-fifths of all new jobs created in the next year. The forecast, developed by the ***Regional Economic Studies Institute of Towson State University,*** projected that gains in computer-related industries and temporary personnel would generate service employment at a growing pace. Health services, social services, and hotels also were identified as promising areas for additional growth.

As in the rest of the Region, a mild winter helped construction employment leap by about 11 percent. However, the manufacturing, government, and FIRE sectors showed little gain. Employment in **Baltimore**, the state's largest city, grew somewhat more slowly than

CHART 2



the rest of the state and rose by only 1 percent. Baltimore's unemployment rate of 7.8 percent is substantially higher than Maryland's statewide rate of 4.6 percent. Baltimore's labor market has not experienced growth in the business service sector as other parts of Maryland have.

Employment growth in **New Jersey** was just shy of the national average; during the first quarter of 1997, it registered 2.2 percent, or 78,000 jobs on an annual basis. Job growth continues to be hindered by weakness in cities such as **Newark** and **Trenton**, which are coping with persistent structural unemployment problems. Employment gains in these cities ranged from 1 to 1.5 percent during the first quarter of 1997.

On the other hand, **Atlantic City** is showing very strong employment performance thanks to the construction of several new casinos. Year-over-year employment growth in Atlantic City rose 4.4 percent during the first quarter of 1997. Planned new construction of $7 billion over the next five years should add even more to the employment base. Atlantic City, like other major gaming areas in the nation, is experiencing rapid growth. *The risk is the potential for overbuilding, which would ultimately put downward pressure on Atlantic City's economy.*

Job growth in **Puerto Rico** increased a modest 1.9 percent, or 18,000 jobs, during the first quarter of 1997 on an annual basis. The Puerto Rican economy has been adding jobs throughout the 1990s, mainly in services and trade. Growth in manufacturing jobs, once the dominant sector, has been relatively flat. Puerto Rico's unemployment rate has fallen from over 20 percent in the 1980s to about 13 percent in early 1997.

In **New York**, the state with the largest labor market in the Region, first quarter year-over-year employment growth rose only 1.1 percent, 86,000 jobs—the slowest growth in the Region. Losses in the manufacturing and government sectors combined with limited growth in the FIRE sector have held down net job growth. Upstate New York has been adding comparatively few new jobs (see ***Regional Outlook,*** Second Quarter 1997).

Office Market Is Tightening throughout the Region

Strong employment growth is aiding the Region's office markets. According to the most recent data, office vacancy rates continue to decline throughout the New York Region.

Table 1 shows that office vacancy rates for many metropolitan areas have fallen to their lowest levels since 1991.

According to reports from around the Region, office vacancy rates have continued to decline even more during the first quarter of 1997. Some of those reports forecast further tightening in office space and rental rate hikes. According to the ***Grubb and Ellis 1997 Real Estate Forecast Report,*** a shortage of office space will soon lead to rental hikes in the suburban **New York City** markets. The report predicts tightening in the Princeton, New Jersey, area and continuing recovery in the **Westchester**, New York, market. According to a recent report by the ***Edward S. Gordon Company,*** only one office building is currently being built in New York City, the nation's largest office market. ***Edward S. Gordon*** projects renewed development activity in New York City in the near future because of the decline in vacancy rates and the lack of new construction.

Implications: *Given tightening of office vacancy rates, some areas in the Region could be poised for an increase in commercial real estate development and new office building construction.*

Table 1

Office Vacancy Rates Are Dropping throughout the Region

Metro Area	1991	1993	1995	1996
Baltimore	19.1	17.2	13.8	11.5
Long Island	18.9	14.4	13.8	10.5
Manhattan	16.5	15.1	14.9	11.6
Mid-NJ	20.7	18.6	20.5	14.9
Northern NJ	22.5	20.8	16.2	12.6
Philadelphia	16.5	16.6	13.3	13.2
Washington, D.C.	14.9	11.3	9.6	8.3
Westchester, NY	21.5	22.1	22.4	17.0
Wilmington	NA	19.5	13.1	12.8
United States	20.4	17.2	13.4	11.1

Source: CB Commercial Property Information Systems. Units in percent.

Health Care Consolidation Poses Uncertainties for the Region and the Nation

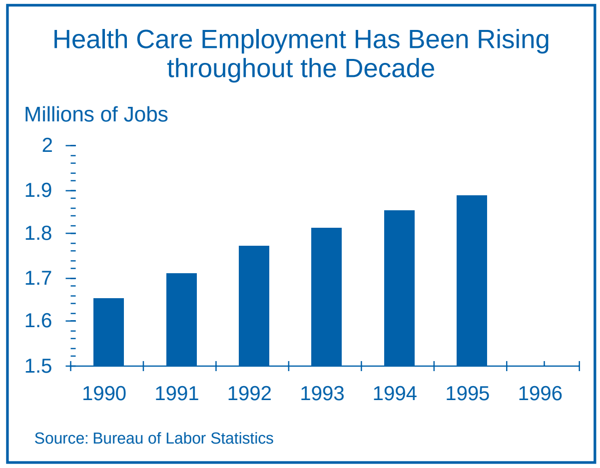
Approximately 20 percent of all health care workers in the United States are employed in the New York Region. That figure represents 1.9 million employees, or about 9 percent of the Region's total workforce, compared to 8 percent for the nation. Health care employment has been growing steadily throughout the 1990s (see Chart 3).

The health care industry has been undergoing extensive restructuring that has resulted in changes in health care management, costs, and delivery. A study by the ***Sachs Group,*** a health research organization in **Evanston**, **Illinois**, reported that the New York Region could be more vulnerable than the nation to the new trends generated by managed care. The penetration of managed care into the health care industry over the past few years has translated into reductions in fees and hospital use rates, constraints on care, and consolidations among health care institutions, principally hospitals.

The report stated that hospitals in **Pittsburgh**, **Boston**, New York, and **Philadelphia** could lose the most business as managed care becomes more widespread. In extreme cases, the report indicated that if there is a shift exclusively to managed care, the demand for hospital beds could drop by 50 percent. In Pittsburgh, the study forecasted that demand for beds would drop 51 percent if the city went exclusively to managed care. Hospitals in the New York Region would be hit hardest because they tend to keep patients longer than do hospitals in other areas of the country.

Consolidation in health care delivery may not necessarily reduce overall health care employment. A study by the ***New School for Social Research*** points out that the health care system will indeed move away from hospital-based care to outpatient facilities because of the emphasis on cost-effectiveness.

CHART 3



This move may produce a shift in health care jobs. Hospitals may eventually have fewer nurses, but many dislocated nurses would find work in growing health care areas such as nursing homes and home health care. However, some health care workers may leave the industry because of the generally reduced pay and benefits offered by outpatient facilities relative to hospitals.

Demographic changes may mitigate some of the changes arising from consolidation in the health care industry. Demand for health care services should continue to rise as the large baby boom cohort ages and requires more medical care.

Implications: *Ongoing consolidation in the health care industry could negatively affect the Region's economy if the consolidation results in large job losses.* Changes in the health care industry could force economic dislocation on hospitals, health care providers, and health care workers.

Norman Gertner, Regional Economist

Financial Markets

- **Deteriorating credit quality trends in the rapidly growing home-equity backed securities market could portend trends in bank residential mortgage lending.**

- **Financial asset securitization investment trusts, known as FASITs, promise to change the asset-backed securities market significantly and could make securitization more accessible to community banks.**

- **The Treasury yield curve is steeper and higher than it was at year-end 1996.**

- **During the first quarter of 1997, the New York Region's Community Bank Index gained steadily despite disturbance in the broad market and other bank indices.**

Trends in the Home-Equity Asset-Backed Market Are Important to Banks

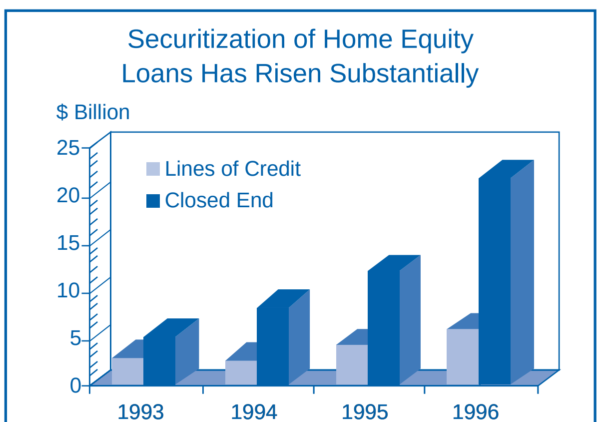
The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has been accompanied by abnormally early and high levels of delinquencies. Banks that are investing in HEL ABS, considering securitizing HELs, or lending significantly for debt consolidation should be aware of credit quality developments in the HEL ABS market.

The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market. The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, know as cash-out refinancing, grew substantially when home-equity borrowers were motivated by lower rates to refinance their first mortgages for amounts greater than the remaining principal balance instead of adding a second mortgage.

Debt consolidation is the primary reason for home-equity borrowing. Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens. According to the ***Consumer Bankers Association 1997 Home-Equity Loan Study,*** debt consolidation accounted for 36 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior to 1992, home improvement was the primary reason for home-equity borrowing. This trend toward debt consolidation as the reason for home-equity borrowing has significant risk implications because, unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance the lender's collateral value.

The rapid growth of the HEL securitization market has been attended by signs of relaxed underwriting. Adverse credit quality trends have been particularly prominent for loans that were originated in 1995. Chart 2 (next page) shows the total delinquency rates for closed-end loan pools originated in 1995 versus 1994. The sharp upward path of delinquency rates for loan pools originated in 1995 raises concern that aggressive competition for volume, and apparently relaxed underwriting standards, could lead to unprecedented default levels. *Furthermore, HEL originations in 1996 more than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.*

CHART 1



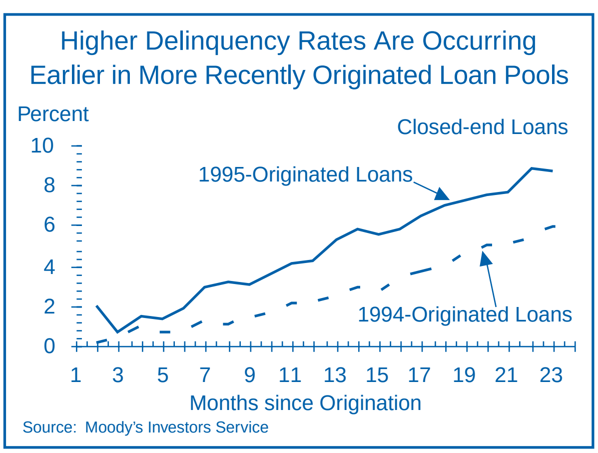
Source: Moody's Investors Service

The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks' larger and less risky portfolios of purchase mortgage loans. The trends would be obscured because banks report all first mortgage lending on 1 to 4 family residential properties without distinguishing between purchase mortgages and cash-out refinancings. The unfavorable trends in the HEL ABS market suggest that banks that engage in significant cash-out refinancing and other forms of home-equity lending should be able to monitor trends in the credit quality of these loans separate from purchase mortgage loans.

A Combination of Several Factors Could Induce More Banks to Securitize HELs

Although the present volume of bank-originated HEL securitizations is relatively small, banks have recently entered this finance company-dominated market, and a combination of several factors is likely to cause more to follow. First, home equity lines of credit are currently growing at rates exceeding total consumer lending, and, by and large, the deposit growth to fund this lending is less than robust. In addition, according to ***Moody's Investors Service,*** investor demand is high for bank-originated home-equity line of credit securitizations because bank-originated lines are perceived to have lower credit risk. The funding benefits and profitability of securitizing bank-originated home-equity lines of credit could entice more banks into the securitization market. Finally, the combination of these factors with the potential cost savings provided by using the new financial asset securitization investment trust (FASIT) structure (see discussion below) could produce momentum that will result in banks, large and small, securitizing home equity loans in significantly increased amounts.

CHART 2



Source: Moody's Investors Service

Securitizing HELs can change the balance sheet and income statement of the securitizer significantly, resulting in significant servicing assets and gains on sale. Beginning in 1997, when a company sells loans, it must comply with the requirements of Financial Accounting Standard (FAS) 125. If the company retains servicing rights on the assets sold, FAS 125 requires the seller to book an asset related to the gain on sale that represents the future income derived from servicing the loans. This asset is similar to mortgage servicing rights in that it represents the present value of future expected cash flows derived from loan servicing. One major home-equity securitizer, which indicated that FAS 125 would not materially affect its financial statements, reported servicing assets at almost 90 percent of equity, and gains associated with the sale of serviced assets at 71 percent of total revenue.

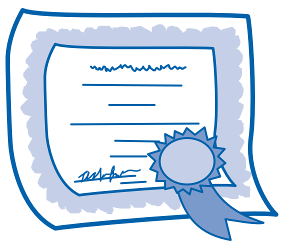
The value of servicing assets is based on management's assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results in charge-offs or early repayment through foreclosure of serviced assets, could require the adjustment of the valuation assumptions and the write-down of the servicing assets.

FASITs Promise to Change the ABS Market

The Small Business Job Protection Act of 1996 created two new sections of the Internal Revenue Code that create and govern FASITs. The FASIT provisions, patterned in part on the real estate mortgage investment conduit (REMIC) rules issued in 1986, are intended to provide tax certainty for ABS issuers and purchasers and enhance the flexibility of asset securitizations. The FASIT provisions take effect on September 1, 1997.

The advent of the FASIT is likely to change the ABS market in important ways. First, the FASIT will clarify the tax treatment of securitizations. Because of the current tax ambiguity, designing ABS structures to avoid taxation is administratively costly, and it restricts the forms that securitizations can take. The higher administrative cost associated with current securitization techniques establishes a practical minimum size for asset pools that can be feasibly securitized. With FASITs and the reduced costs associated with tax clarity, the economically feasible pool size may be significantly smaller. *The lowering of this threshold could result in more community banks entering the securitization market.*

ABS issuers believe that the market for their product has been hampered by the restrictive nature of current asset-backed tax ambiguity, which prevents them from responding to investor preferences for varying maturities, coupon types, and prepayment and credit risk profiles. FASITs allow sponsors the flexibility to create multiple-class securities that satisfy these preferences with the certainty that the securities will count as debt and that the FASIT will not be treated as a taxable corporation. This combination of flexibility and tax certainty could lead to the kind of innovations in ABS structures that followed the 1986 REMIC legislation, which brought analogous benefits to the mortgage-backed market.



FASITs will bring to the ABS market the ability to add and remove assets throughout the life of a securitization. This feature could be applied by securitizing revolving construction loans and then replacing the revolving loans with permanent financing when construction is completed. A FASIT also will be able to contain a mixed pool of assets such as real estate, non-real estate assets, and unsecured credit, allowing exposures to very different markets from the same security. Finally, a FASIT can hold swaps and other hedging instruments. Using this feature, an issuer could combine a mortgage passthrough security with a hedging instrument that is designed to offset mortgage prepayment risk, such as a reverse-index amortizing swap.

The increased flexibility that the FASIT promises to bring the ABS market comes with the potential for greatly increased complexity and risk. Banks that invest in FASIT securities will need to understand fully not only the risk characteristics existing at the outset of security but also the risk that could arise throughout the security's life if assets are to be removed and replaced.

Changes in Interest Rates and Bond Values

The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained there for the next 23 days. The FOMC met again on May 20, 1997, and left the target rate unchanged.

The model portfolio responded to the rise in rates, but only modestly (see Table 1). The relatively short weighted average maturity of the portfolio served to moderate the effect of the 54 basis point rise in the five-year Treasury between December 31, 1996, and March 31, 1997. As discussed in ***Regional Outlook***, Second Quarter 1997, changes in the value of the model portfolio correlate more with changes in the five-year Treasury rate than with the 30-year bond rate.

The yields along the April 30, 1997, yield curve imply that the market expects the curve to continue to flatten through the remainder of the year with short rates rising somewhat. In order to gauge what affect a 25 basis point rise in the yield curve could have on bank fixed-income portfolios, the model portfolio has been "shocked" to

CHART 3

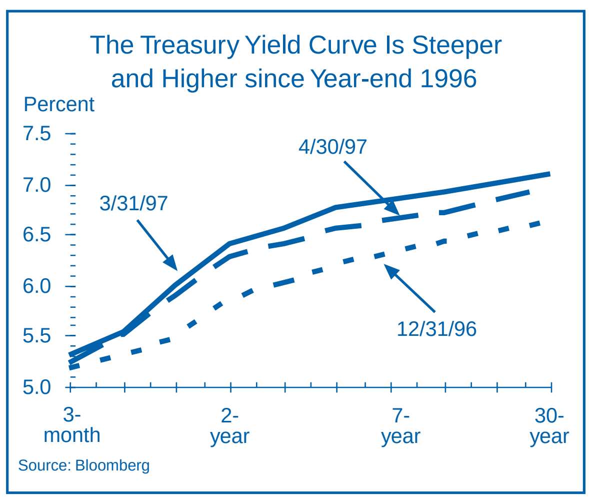


TABLE 1

Type of Security	Par Value	Percent of Portfolio	Maturity or WAL as of 12/31/96	Percent Change from 12/31/96 to 3/31/97	Change Resulting from a 25 bp Rate Increase on 5/28/97
U.S. Treasury 5.6%	2,000	20%	1 YR	–0.30%	–0.16%
FNMA Agency 5.8% Callable	1,200	12%	2 YR	–0.50%	–0.38%
State County Municipal GO 4.8%	800	8%	11 YR	–2.05%	–2.03%
FNMA Mortgage Passthrough 7.5%	3,000	30%	8 YR	–1.78%	–1.44%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5 YR	–1.27%	–0.50%
Credit Card Asset-Backed Security	1,000	10%	5 YR	–0.09%	0.00%
TOTAL	10,000	100%	4.85 YR	–1.08%	–0.77%

Note: Portfolio composition based on estimates derived from aggregated Bank Call Report information.

simulate the effect of an instantaneous 25 basis point shift in the yield curve on May 28, 1997.

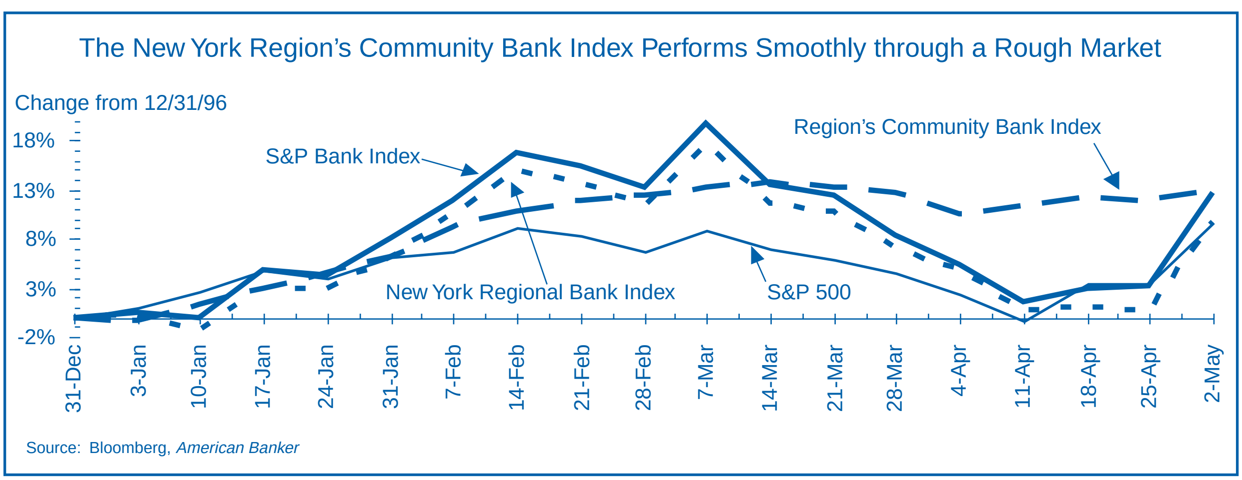
Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demonstrate the least price sensitivity. The municipal bond is the most sensitive to rate changes owing to its longer maturity. The mortgage passthrough security also is more sensitive to rising rates because its weighted-average life (WAL) extends as rising rates discourage the underlying mortgage holders from prepaying their loans. The decline in prepayment rates results in extending the maturity of the security while rates are rising, a combination unfavorable to the security's value.

Community Bank Stocks in the New York Region Performed Smoothly Despite Turmoil in the Broad Market during the First Quarter of 1997

Both the S&P Composite Bank Index and the New York Regional Bank Index have been subject to similar performance swings this year (see Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The New York Region's Community Bank Index was spared from much of the influences of a gyrating market, rising in value fairly steadily to a 12.82 percent gain through May 2, 1997, outperforming both the S&P Composite Bank and New York Regional Bank Indices.

Allen Puwalski, Banking Analyst

CHART 4



Current Regional Banking Issues

- **The New York Region's financial institutions reported solid performance in the first quarter of 1997.**
- **Credit card losses escalate despite reports of tightening underwriting standards.**
- **Residential real estate underwriting standards appear to be weakening as banks compete for customers with debt consolidation packages and low down payment mortgages.**
- **Residential real estate development revives in New York City.**

The Region's Insured Institutions Remain Healthy

The Region's banks and thrifts continue to report relatively strong financial conditions (see Chart 1). For the quarter ended March 31, 1997, insured institutions in the New York Region reported:

- a return on assets of 1.14 percent, up from 0.85 percent one year earlier, despite a slight decline in net interest margin to 3.61 percent. The increase was due mainly to a decline in noninterest expense;
- an average leverage capital ratio of 7.32 percent that remained steady from one year earlier; and
- a decline in nonperforming assets to 0.91 percent of total assets from 1.11 percent in the first quarter of 1996, primarily due to improvement in commercial real estate loan portfolios.

Twenty-six insured institutions, with combined assets of $18 billion, reported net losses in the first quarter of 1997. Together, these institutions lost a total of $51.1 million.

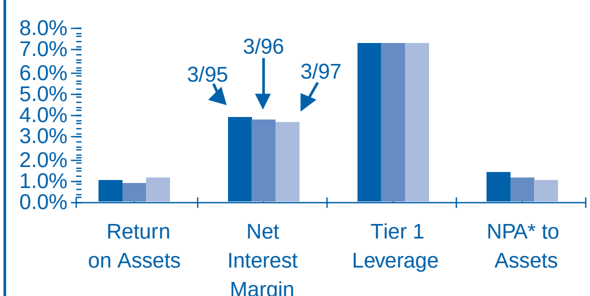
Credit Card Losses Continue to Escalate

Many analysts anticipate that credit card losses will continue to increase in 1997. This trend is especially significant for the New York Region, since the Region's 27 insured credit card specialty banks and credit card concentration banks (collectively referred to as "credit card banks")[1] hold 43 percent of all U.S. commercial banks' credit card loans and 50 percent of unfunded credit card commitments. The New York Region's credit card banks continue to experience increasing loan losses. As of December 31, 1996, these banks had a weighted average charge-off rate of 3.72 percent, compared to 3.09 percent as of December 31, 1995. This number increased sharply to 4.86 percent at March 31, 1997. Past-due and nonaccrual rates rose to 4.69 percent on December 31, 1996, from 3.75 percent a year earlier. Encouragingly, this figure dropped slightly in the first quarter of 1997, to 4.45 percent.

Banks could face increased risk if the poor performance in credit card portfolios migrates to other consumer loans. Charge-offs on other consumer (or installment) debt remain low but have risen slightly. As of March 31, 1997, installment debt was charged off at an annual rate of 1.49 percent, up from 1.27 percent at year-end 1996 and from 1.07 percent as of December 31, 1995. However, this rate remains substantially below the credit card charge-off rate (see Chart 2).

CHART 1

New York Region Institutions Show Financial Strength



Source: Bank and Thrift Call Reports * Nonperforming Assets

[1]A credit card specialty bank is one whose total loans exceed 50 percent of assets and whose credit card loans exceed 50 percent of total loans. A credit card concentration bank has credit card loans exceeding 100 percent of equity capital or 25 percent of total loans. Only banks that met the definition on March 31, 1997, are included in this analysis.

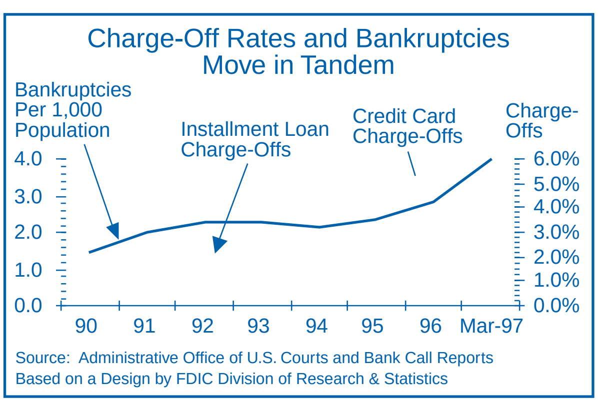
According to a February 1997 ***Moody's Investor Service report***, ***Consumer Finance Industry Outlook***, delinquencies should begin to moderate or decline in the second half of the year if the current credit cycle follows its historical pattern. According to Moody's, the current cycle began with its cyclical low rates of delinquency and charge-offs in the 1993-1994 period following the last recession. Should the typical 5- to 6- year duration of a full credit cycle hold true, the current cyclical highs in delinquencies should begin to decline in the second half of 1997, with the level of charge-offs declining in 1998 from their current cyclical highs. However, structural, economic, or social changes could cause the current cycle to depart from past trends.

Credit Card Growth Slows, Reflecting Tightening Underwriting Standards

Efforts by credit card banks to tighten underwriting standards, coupled with less aggressive marketing tactics over the past year, have begun to affect growth in outstanding credit card receivables in the Region's credit card banks. Total managed credit card receivables (credit card receivables managed on balance sheet plus those receivables managed that have been securitized and sold) increased 28 percent in the 12-month period ending March 31, 1997. However, the rate of growth in managed receivables was only 2 percent for the first quarter of 1997, a considerable slowing.

Growth in unfunded credit card commitments slowed from 32 percent in 1996 to an annualized rate of 19.4 percent in the first quarter of 1997. During 1996, the most significant growth was in the Region's specialty credit card banks with total assets exceeding $5 billion, which experienced 38 percent growth. The Region's smaller credit card banks and banks with less of a concentration in credit card lending reported growth in unfunded commitments of only 7.8 percent. The disparity in growth rates between large and small credit card banks essentially disappeared in the first quarter, reflecting the broad trend of scaling back operations in the face of rising delinquencies.

CHART 2



Moody's Investors Service cites several potential reasons for continued growth in unfunded commitments despite tightening underwriting standards. First, changes in underwriting standards generally do not have a material effect on portfolios for 12 to 15 months. Second, the report states that tightening of some standards may be less effective than initially planned. For example, some issuers may have curtailed lending to renters because their repayment performance historically has been less favorable than that of homeowners. *However,* ***Moody's*** *suggests that the link between homeownership and creditworthiness may not be as strong as in past credit cycles.* Low down payment mortgages have made homeownership attainable to borrowers previously excluded by lack of a down payment. Estimates indicate that more than 25 percent of conventional mortgages originated in 1996 had a down payment of 10 percent or less. *Therefore, although banks have tightened underwriting criteria by historical standards, the benefits may not be as strong as originally anticipated.*

Many Factors Linked to Rising Bankruptcies

The correlation between bankruptcy rates and charge-off rates is strong (see Chart 2). Personal bankruptcies in the United States and the New York Region have been increasing steadily since 1994. However, the New York Region tends to have lower bankruptcy rates than the national average.

Economists predict that bankruptcies will increase by 10 to 30 percent in 1997. In addition to increasing debt burdens, ***Moody's Investors Service*** suggests several factors for this rise in bankruptcies, including:

- changing bankruptcy laws that allow debtors to keep more assets;
- a diminishing social stigma associated with bankruptcy;

- changing attitudes about loyalty and meeting obligations in an era of corporate downsizing and other employment dislocations; and
- the expanding presence of legalized gambling. (As many as 10 to 15 percent of personal bankruptcies reportedly are related in some way to gambling losses.)

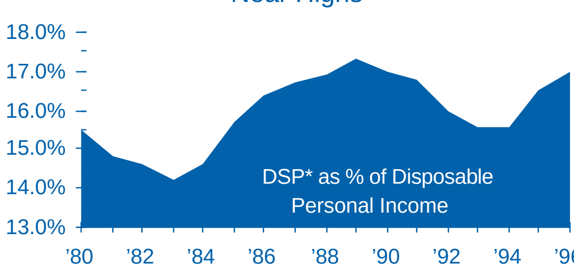
Will High Debt Burdens Hamper the Economy?

The sharp increase in household indebtedness and the rising share of income going to payments on credit cards, mortgages, auto loans, and other household loans (see Chart 3) have recently caused concern in the banking industry. A February 1997 report by the ***Federal Reserve Bank of New York*** found that *consumer expenditures decline because of a tightening credit supply, not because of high debt levels.* The report studied the link between rising debt service burdens and consumer spending and found that a rise in household debt is less likely to reduce consumer spending. *Consumers will continue to spend in anticipation of increased earnings.* Only when incomes fall for an extended period of time will households cut expenditures and reduce debt loads.

What does this mean for the banking industry? *Consumers may continue to increase debt service burdens despite rising delinquencies, charge-offs, and bankruptcies.* Banks may be more vulnerable to a downturn in the economy if this trend continues, because consumers will be less able to service higher accumulated levels of debt if income levels decline.

CHART 3

Consumer Debt Service Payments Are Near Highs



* Debt service payments include scheduled payments on mortgages, credit cards, auto loans, and other household loans.
Source: Board of Governors of the Federal Reserve System

Competition and Rising Consumer Debt Are Changing Residential Lending Standards

The consumer finance industry's current highly competitive environment, combined with a rising level of consumer debt, appears to be affecting residential real estate lending. *Analysts indicate that competition is at least partially responsible for an industry trend toward rising loan-to-value (LTV) ratios in the residential real estate lending arena.* In fact, some banks are extending mortgages with LTV ratios of as much as 125 percent of appraised value, up from previous standards of 80 percent to 90 percent.

The rise in LTV ratios appears to be partially attributable to the current popularity of consolidating consumer debt through home equity loans (see ***Financial Markets***). *Strong consumer demand, higher yields compared to traditional mortgage loans, and a familiar source of collateral are drawing some banks to this product.* A strengthening housing market provides some comfort level despite rising LTV ratios (see Table 1).

While this type of debt consolidation product is not new, the easing of terms for home equity loans is apparently a factor in the recent rapid growth in these loans,

TABLE 1

MEDIAN HOME PRICES RISE (SELECTED AREAS WITHIN THE REGION) 12/31/95-12/31/96

	MEDIAN PRICE	%CHANGE
BALTIMORE	$110,500	–0.18%
WASHINGTON, DC	$159,000	2.45%
ATLANTIC CITY	$107,300	2.58%
BERGEN-PASSAIC	$200,200	8.63%
NEWARK	$198,700	3.98%
TRENTON	$135,800	8.64%
ALBANY	$106,100	0.19%
BUFFALO	$81,100	0.87%
NASSAU-SUFFOLK	$158,700	2.39%
NEW YORK-LONG ISLAND	$172,900	2.73%
ROCHESTER	$85,200	0.59%
SYRACUSE	$79,100	0.00%
PHILADELPHIA	$124,400	9.70%
PITTSBURGH	$81,500	0.62%
U.S.	$117,600	3.34%

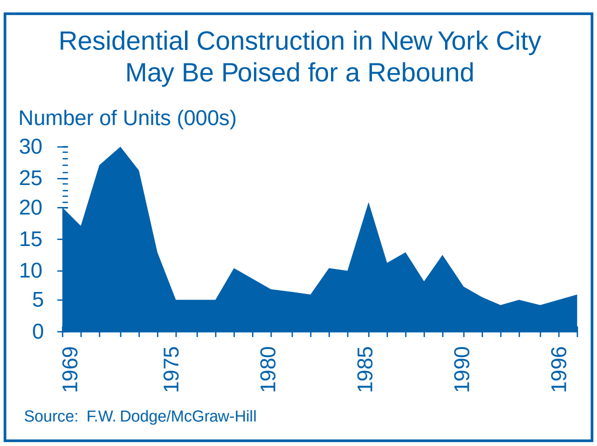
SOURCE: NATIONAL ASSOCIATION OF REALTORS according to the January 1997 ***Federal Reserve Senior Loan Officer Opinion Survey.*** One-third of the survey respondents (out of about 60 large domestic banks) said that easing terms on home equity loans, including entering the market for low-equity or no-equity loans, had boosted the volume of these loans on their books.

Some banks in the Region have created various packages that combine a regular mortgage with a home equity loan for up to another 15 percent of the purchase price. This up-front combination of a conventional mortgage and a home equity loan is "the big thing—and it's new to the Northeast," said one executive mortgage banker. One year ago many banks would not go beyond 75 percent LTV; now borrowers may get up to 95 percent. According to the ***Mortgage-Backed Securities Letter,*** homebuilders are becoming increasingly tuned in to this product and are using it to qualify more new homebuyers.

Do Rising Loan-to-Value Ratios Increase Risk?

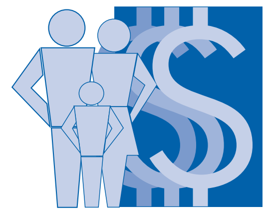
Residential mortgage lending (loans secured by 1 to 4 family residential real estate) represents a significant business for banks in the Region. A total of 250 institutions (out of 979) hold such loans in amounts exceeding 50 percent of total loans and 100 percent of Tier 1 capital. As of March 31, 1997, insured institutions in the Region had increased mortgage loan holdings to $252.3 billion, or 2 percent over one year earlier, to approximately 27 percent of aggregate total loans. Mortgage loans are the second largest loan category for the Region's banks behind commercial and industrial loans. Any change in residential mortgage underwriting could therefore have a significant effect on the risk profile of the Region's banks.

CHART 4



A recent study by the ***Office of Thrift Supervision*** indicates that LTV ratios explain more of the variation in default rates than any other factor. The data show that the percentage of high LTV loans (LTV ratios greater than 90 percent) increased significantly, from 7 percent in 1993 to 26 percent in 1995. The data also show that delinquency rates generally rise along with rising LTV ratios. Mortgages in the 96 to 105 percent LTV segment have delinquency rates nearly eight times as high on average as mortgages with LTV ratios at or below 80 percent.

Loan-to-value ratios are just one gauge of credit underwriting and must be assessed within the context of compensating factors such as shifting credit profiles, reserve policies, innovations in credit scoring, and collection capabilities. *However,* ***Fitch Research*** *notes that loosening credit standards could materially affect long-term profitability and asset quality if home prices experience a sharp deterioration.* High LTV mortgages, whether in the form of debt consolidation packages or affordable purchase mortgages, expose underwriters to additional risk if the favorable economic conditions experienced over the past six years do not continue indefinitely. A decline in housing values could undermine the collateral protection that residential real estate provides. Further, there is the possibility that some consumers will increase credit card and other consumer debt after a debt consolidation package is completed, thereby weakening their ability to repay outstanding debts and increasing the likelihood of bankruptcy.



One Segment of Commercial Real Estate Development Revives in New York City

After several years of little construction activity, residential real estate development activity is re-emerging in New York City (see Chart 4). Higher residential rental prices and strong residential sales indicate a tightening market. The ***Halstead Property Company*** reported that apartment rental rates in the city increased by double digits in the third quarter of 1996 compared to one year earlier. A ***Corcoran Group*** survey of the Manhattan condominium and cooperative market revealed that the number of sales rose over 23 percent in 1996. As a result, developers have many apartment building projects planned, although few are currently at the construction stage. Although construction and development lending have remained static in banks in the **Manhattan and New York East** Field Offices in the first quarter, *the number of planned projects suggests that bank loans for such undertakings will be increasing in the future.*

Some developers have indicated that residential real estate development dollars are increasingly available; however, both the lenders and the rules have changed. Lenders are demanding substantial up-front cash commitments from developers and are requiring written preleasing commitments from tenants. If there are cost overruns during construction, lenders are requiring that the amount of the overrun be made up immediately by the developer. To the extent that lenders adhere to these strict underwriting standards, the risk profile of this segment of the loan portfolio will be strengthened.

Karen A. Denu, Financial Analyst
Suzannah L. Susser, Senior Regional Analyst

For More Information

Consumer Finance Industry Outlook, Moody's Investors Service, February 1997.

Financial Institutions Special Report, Fitch Research, March 3, 1997.

McCarthy, Jonathan, *Current Issues in Economics and Finance — Debt, Delinquencies, and Consumer Spending,* Federal Reserve Bank of New York, February 1997.

Mortgage-Backed Securities Letter, April 14, 1997.

National Mortgage Default Rates and the Vintage Effect, Office of Thrift Supervision, First Quarter 1997.

Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve Board, January 1997.

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ____________________

Contact Person ____________________

Telephone ____________________

Street Address ____________________

City, State, Zip Code ____________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta	________	Boston	________	Chicago	________
Dallas	________	Kansas City	________	Memphis	________
New York	________	San Francisco	________	All	________

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE MAIL
Postage & Fees Paid
FDIC
Permit No. G-36