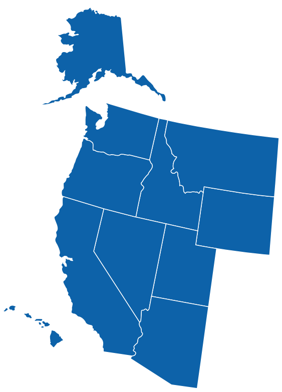
Regional Outlook

Federal Deposit Insurance Corporation
Third Quarter 2000

FDIC
San Francisco
Region



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Regional Perspectives

◆ ***The San Francisco Region's nonfarm employment growth continues to outpace the nation's*****—However, performance varies across industries. Construction payrolls expanded rapidly, while manufacturing and agricultural employment showed some weakness.** *See page 3.*

◆ ***Reported earnings and asset quality among the Region's insured institutions remained stable during first quarter 2000*****—Concentrations in traditionally higher-risk lending categories, such as commercial real estate and construction loans, increased, particularly among insured institutions in MSAs with robust high-tech sectors.** *See page 5.*

◆ ***Despite some recent weakness, the Region's high-tech sector has contributed to employment and personal income gains as well as to increases in residential and commercial real estate activity.*** *See page 6.*

By the San Francisco Region Staff

In Focus This Quarter

◆ ***Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding*****—Commercial real estate construction has boomed in a number of U.S. metropolitan markets during recent years amid falling vacancy rates and growing demand for new space. Insured depository institutions have reasserted their role as primary sources of capital for this construction boom, particularly in the wake of the 1998 financial markets crisis that left some important market-based lenders on the sidelines. Recent data for some metropolitan areas show that on-balance-sheet exposures of FDIC-insured institutions are by some measures higher now than at the peak of the last commercial real estate cycle during the late 1980s. This article reassesses major U.S. metropolitan real estate markets in search of possible signs of overbuilding that could drive up vacancy rates and drive down rents in the near term. This review points to an underlying trend of markets experiencing more vigorous construction activity across multiple property types.** *See page 11.*

By Thomas A. Murray, Senior Financial Analyst

◆ ***San Francisco Markets Most Vulnerable to Overbuilding*****—On the basis of the preceding information, the following six markets are considered to be most at risk for broad-based overbuilding: Las Vegas, Phoenix, Portland, Sacramento, Salt Lake City, and Seattle.** *See page 18.*

By San Francisco Region Staff

◆ ***Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate*****—Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios.** *See page 25.*

By Alan Deaton, Financial Economist

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Regional Perspectives

- **The San Francisco Region's economy continues to outpace the nation's, but performance across industries varies. Construction employment has increased strongly, while the number of aerospace manufacturing jobs has declined.**

- **Return on assets deteriorated slightly at the Region's insured institutions over the past four quarters, but has remained generally stable. Overall reported asset quality remained strong; however, a slight majority of institutions posted higher past-due loan ratios.**

- **The economic performance of certain Metropolitan Statistical Areas (MSAs) in the Region has become increasingly reliant on the high-tech sector and may be more vulnerable to a national recession or downturn in the stock market.**

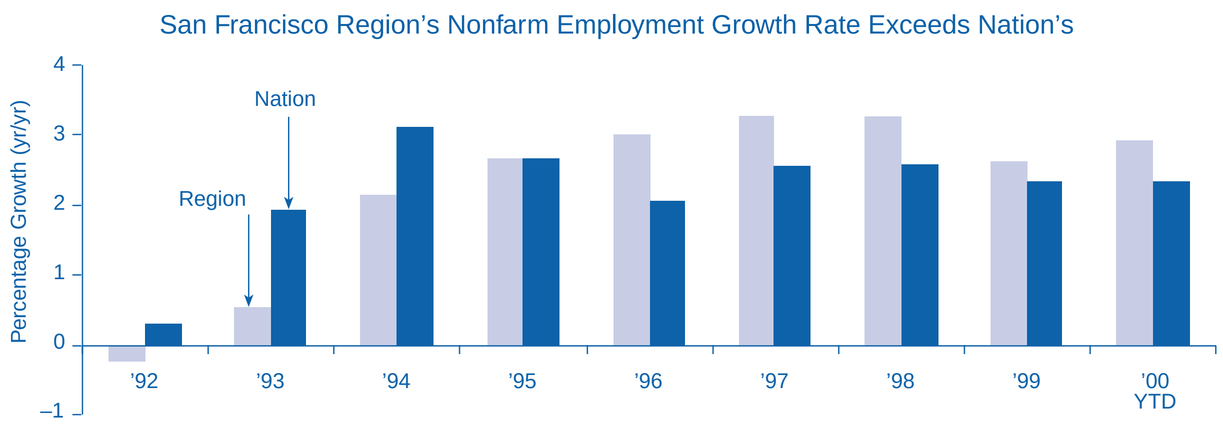
Economic Overview

Employment in almost all major sectors of the San Francisco Region's economy expanded from May 1999 through May 2000. The Region's nonfarm payroll employment growth continued to outpace the nation's during the first five months of 2000.[1] The Region's nonfarm employment increased 3.1 percent during early 2000, compared with a national increase of 2.3 percent.

The Region's unemployment rate declined faster than the nation's during the past two years. In 1998, the Region's unemployment rate averaged 5.5 percent, while the nation's averaged 4.5 percent. In early 2000, the gap narrowed to 4.6 percent for the Region compared with 4.0 percent for the nation.

Chart 1 shows nonfarm employment growth for the Region and the nation beginning in 1992. In the early 1990s, the Region's employment expanded more slowly than the nation's. This slower growth was attributed in large part to the significant downsizing of the nation's defense sector, including military base closings. These developments disproportionately affected **California,** and the state's level of nonfarm employment remained below its previous peak, attained in 1990, until 1996. From 1996 to 1999, California's employment expanded

CHART 1



Source: Bureau of Labor Statistics

[1] Although the Region includes 11 states, California represents 60 percent of the Region's population and nonfarm employment. Thus, the overall economic performance of the Region tends to be dominated by what happens in California.

at a 3.1 percent annual rate, compared with the nation's 2.5 percent annual growth rate.

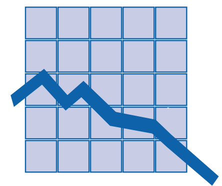
Construction Employment Could Slow

Employment in the construction sector grew more rapidly than employment in any other sector in the Region during the first five months of 2000, expanding 6.9 percent. Expansion was concentrated in residential and commercial building activity; infrastructure construction activity (e.g., road construction employment) grew much more slowly. Housing permit growth in the Region was only 1.1 percent during the first five months of the year, which suggests that construction employment growth may slow by year-end. Single-family permits declined by 2 percent, while multifamily permits, which include apartment buildings and condominium units, increased by 11 percent. Housing permits increased 11.7 percent in California, where housing construction was at very low levels during the 1990s compared with the 1980s. In contrast, housing permits declined somewhat in two of the Region's hottest markets in recent years, **Arizona** and **Nevada.** Higher mortgage interest rates likely are an important reason for this slowdown.

Manufacturing Employment Declines Slightly

Manufacturing sector employment declined 0.3 percent during the first five months of 2000. Slippage in the high-tech and aerospace subsectors was offset by gains in other subsectors.[2]

High-tech manufacturing employment has been an important driver of the Region's growth during the past several years. However, during the first five months of 2000, employment in electronic equipment and instruments declined from a year ago.[3] This decline can be attributed in part to significant increases in labor productivity in high-tech manufacturing, as well as outsourcing to foreign plants. This decline has occurred despite the reported successes and high stock-market valuations of many firms in this sector.[4] Recent developments in high-tech manufacturing and services and the role of venture capital in the Region are discussed below.



The Region's commercial aircraft sector declined significantly over the past two years, almost exclusively as a result of layoffs from **Seattle-**based Boeing. Air travel nationwide increased during the past several years in line with the continuing U.S. economic expansion. However, passenger and freight traffic in other parts of the world has been adversely affected by the Asian financial crises that peaked in 1998. Furthermore, Boeing is competing worldwide with its single major competitor for large-scale passenger aircraft, Airbus Industrie. Boeing's **Washington** and Southern California employment declined by 35,000 between mid-1998 and mid-2000, a 24 percent reduction.[5]

In contrast to high-tech and aerospace manufacturing, other types of manufacturing activities have expanded. For example, lumber and wood products employment increased 1.6 percent during the first five months of the year despite ongoing environmental/conservation debates and restrictions regarding lumber cutting in several western states. Furniture and fixtures manufacturing employment increased 4.3 percent during the same period. These two industries have been expanding, likely in response to the high rate of home building in both the Region and the nation.

Agriculture Is Performing Well in California, But Showing Weakness in the Rocky Mountain Area

The agricultural sector presents a mixed picture in the western United States. The weather during early 2000 in the Rocky Mountain area—which includes portions of **Montana, Wyoming, Utah,** and Arizona—ranged from abnormally dry to a first-stage drought. Montana was particularly hard hit. The price of wheat, the state's

[2] High-tech manufacturing and services is a complex mix of companies defined differently by various analysts. High-tech firms typically devote at least 10 percent of revenues to research and development. On an aggregate level, it is generally convenient to group together such employers as computer and telecommunications manufacturers, software developers, and biotechnology companies.

[3] The growing use of contract or contingent workers by many firms makes interpretation of employment data by sector more difficult. Many high-tech firms, which tend to have relatively volatile labor requirements, have turned to employee contract agencies. Such employees are usually included under the business services sector rather than the sector in which they actually work.

[4] March 22, 2000. High-Tech Jobs Index Continues to Decline. *The Wall Street Journal* ("California" insert).

[5] Boeing website (www.boeing.com/employment), June 22, 2000.

major crop, declined significantly in 1999 and only recently has begun to stabilize. In contrast, Northern California experienced above-average precipitation during the winter of 1999–2000; as a result, the state's Central Valley should have plenty of water for irrigation in 2000.

Over the longer run, the allocation of water among agricultural, urban and industrial, and environmental uses will continue to be a contentious political issue in California. The agricultural sector uses more than 80 percent of the state's available water supplies and has been under pressure from other sectors for many years to consume less of this resource. Shifting water allocations or raising water's effective price could hurt some farmers.

The Region's most important products in terms of sales as of 1997, the most recent year for which data are available, are fruits, nuts, and berries; cattle and calves (primarily for meat products); dairy products; and vegetables and melons.[6] Prices have generally improved in these sectors.[7] Beef cattle prices have increased from year-ago levels, although they still were below levels of the early 1990s.

International Trade Drives Port Activity Up Sharply

U.S. exports, which declined in response to the economic problems of Asia in 1998, are growing again. In contrast, imports have increased almost continuously during the past decade. West Coast ports benefit from growing international trade regardless of whether U.S. imports exceed exports. Water transportation jobs in California increased 14.1 percent during the first five months of the year.

Banking Overview

The Region's strong economy is reflected in insured institutions' earnings. The combined annualized return on assets (ROA) for the Region's insured institutions was 1.35 percent during first quarter 2000, slightly lower than during the past four quarters. ROAs at the Region's largest commercial banks fell from recent record high levels, resulting in weaker aggregate performance. Thrifts, influenced by performance of the largest institutions, experienced the highest aggregate ROA during the past five quarters. Net interest margins held steady or increased for a large majority of the Region's insured institutions during the first quarter, compared with a year ago.

Reported aggregate asset quality continued to be strong in the first quarter of 2000, with the Region's total past-due loan ratio unchanged at 1.69 percent and loan charge-off levels holding steady. Commercial banks' past-due loan ratio increased slightly, while thrifts' past-due ratio declined. However, just over half of the Region's insured institutions reported higher past-due ratios during first quarter 2000. Institutions with more than 25 percent of their loan portfolios in agricultural and consumer loans are represented disproportionately in the group with past-due loan ratios above 5 percent. Agricultural banks were the most likely to have experienced a significant, greater than 100-basis-point rise in the past-due loan ratio, reflecting the ongoing weakness of many grain and oil seed farms.

Loan portfolios of the Region's insured institutions continue to grow briskly, particularly in the commercial real estate (CRE) category. Median overall loan growth of 22 percent, reported in the first quarter of 2000, reflected strength in the Region's economy. Much of this growth is attributed to an increase in CRE loans, which have grown as a share of total assets at two-thirds of the Region's insured institutions from first quarter 1999 through first quarter 2000. As a result, concentrations in CRE lending have been rising.[8] In addition, 85 percent of the Region's insured institutions reported an increase in construction and development (C&D) lending as a share of total assets. A significant share of the CRE and C&D growth is occurring at institutions located in markets benefiting from strong growth in the high-tech sector.

[6] U.S. Department of Agriculture website (www.nass.usda.gov/census/census97/rankings/wklstate.htm).
[7] U.S. Department of Agriculture website (usda.mannlib.cornell.edu/reports/nassr/pric/pap_bb/2000/agpr0500.txt).
[8] The median ratio of CRE loans to total assets in the Region's insured institutions was almost 25 percent at the end of first quarter 2000, compared with just under 20 percent a year earlier.

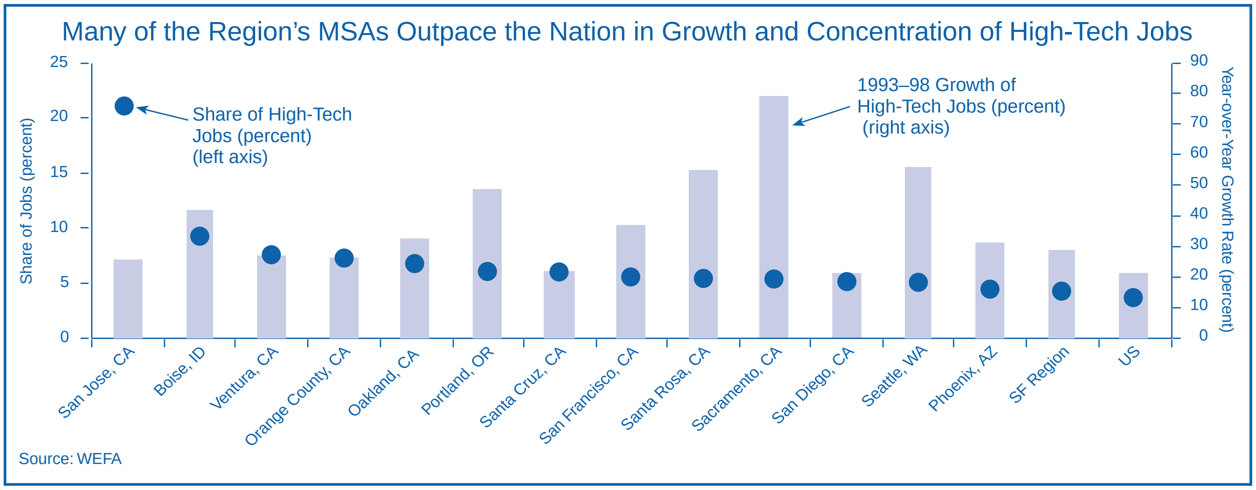
The High-Tech Sector Is Driving the Region's Growth

Although some weakness has been noted recently, the Region's high-tech sector experienced steady employment growth during the last half of the 1990s.[9] In addition, analysts have credited the sector with fueling gains in export activity, wage increases, and research and development activities. Between 1993 and 1998,[10] the Region's high-tech sector created approximately 304,000 jobs, primarily in California, Washington, **Oregon,** and Arizona.[11] California is the nation's leader in the level of high-tech employment; the state has more than twice as many high-tech workers as Texas, which ranks second in the nation. California is home to 9 of the top 20 information technology companies in the world, including Siebel Systems, Oracle, and Sun Microsystems, as ranked in ***Business Week's*** *Information Technology Annual Report.* Washington, home to Microsoft, is also regarded as one of the nation's leaders in the high-tech industry, in large part because it boasts the highest average wage level in the sector, indicative of companies' willingness to pay wages necessary to attract high-quality talent. Oregon and Arizona are important states as well for high-tech manufacturing. Companies in Oregon's "Silicon Forest," most notably Intel, generally specialize in manufacturing semiconductors, computer chips, and other electronic devices, while Arizona's high-tech manufacturing operations are primarily in the computer and office equipment, communications equipment, and electronic components subsectors.

While many of the Region's states are leaders in the high-tech sector, much of the Region's employment growth in this category has been concentrated in 13 metropolitan statistical areas (MSAs)—**San Francisco, San Jose, Oakland, Santa Rosa, Santa Cruz, Sacramento, Ventura, Orange County,** and **San Diego** in California as well as **Phoenix, AZ; Boise, ID; Seattle, WA;** and **Portland, OR.** From 1993 through 1998, these "high-tech MSAs" experienced more rapid growth in high-tech employment than the national average. In addition, each MSA reports a higher concentration of high-tech employment than the national average (see Chart 2).

These high-tech MSAs differ significantly from the Region's other metropolitan areas. Per capita personal income growth between 1993 and 1998 in the high-

CHART 2



[9] The high-tech sector is defined for this subsection as including biotechnology (Standard Industry Classification (SIC) 283 and 384), computers and electronics (SIC 357, 367, and 382), telecommunications (SIC 366 and 481), and computer and data processing (SIC 737).
[10] All data in this section were analyzed over the five-year period from 1993 to 1998 (the most recent data for many items) unless otherwise specified.
[11] According to the American Electronics Association *Cyberstates* report.

tech MSAs was much stronger than in the Region's other MSAs. In addition, the CRE markets in many of the Region's high-tech areas have reported higher levels of price appreciation and housing permit issuance than in other areas. There is contrast within the group of high-tech MSAs between those that are home to several high-tech headquarters and those that are home to high-tech companies' manufacturing operations. Large inflows of venture capital are one indicator of a significant concentration of high-tech headquarters locations.

Venture Capital Flows Differentiate MSAs

Recent venture capital flows to high-tech industries[12] have been heavily concentrated in the San Francisco Region, according to the ***PriceWaterhouseCoopers MoneyTree*** survey, a quarterly study of equity investments made by the venture capital community in U.S. companies. The Region's 13 high-tech MSAs accounted for nearly 45 percent (about $9 billion) of all high-tech venture capital issued nationwide from first quarter 1999 through first quarter 2000. This capital has contributed significantly to economic growth in the Region's high-tech MSAs, as it funds payrolls, office, and other expenses.

While high levels of venture capital issued in an area support continued growth in payroll or business expansion, they may also link a company's success closely to stock market performance. Anecdotal evidence shows that while second quarter 2000 venture capital financing nationwide remained strong, investors are exercising more caution, wary that the current somewhat volatile environment in the stock market may not be conducive to taking companies public as quickly as in the past.

In many of the Region's high-tech MSAs, venture capital funding is very concentrated in a few subsectors. The software subsector attracted the largest share of venture capital over the past four quarters; more than one-third of the total capital issued was directed to this subsector ($3.3 billion). The networking and telecommunications subsectors attracted nearly $2 billion each. Both geographic and industry subsector concentration heighten the vulnerability of some areas of the Region in the event of a decline in investors' willingness to fund high-tech companies.

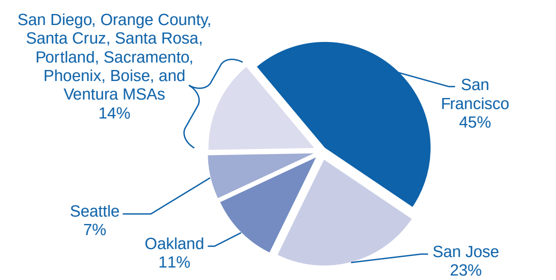
The San Francisco Bay Area's three MSAs (San Francisco, Oakland, and San Jose) and the Seattle MSA attracted the majority of the Region's high-tech venture capital issued in the 12 months ending March 2000 (see Chart 3). Therefore, these four MSAs may be the most vulnerable to a slowdown in the high-tech sector or to a reversal of stock market gains. The San Francisco Bay Area venture capital was concentrated in the networking and telecommunications subsectors during the second, third, and fourth quarters of 1999. In contrast, the amount of venture capital funds flowing into the software subsector significantly increased during first quarter 2000, with about $2.3 billion in over 150 deals, the largest amount of venture capital coming into the Bay Area in the past year. While venture capital investment in Seattle also was concentrated in the software subsector, primarily because of large amounts of money allocated in the first quarter of 2000, the biotechnology and telecommunications subsectors also received a significant share during the previous three quarters.

Higher-Paying Technology Jobs Contribute to Growth in Personal Income

The ***American Electronics Association***[13] recently reported in its *Cyberstates* analysis that growth in high-tech wages significantly outpaced overall wage increases in the private sector between 1993 and 1998. During

CHART 3

The San Francisco Bay Area and Seattle MSAs Have Been the Region's Most Active Venture Capital Markets

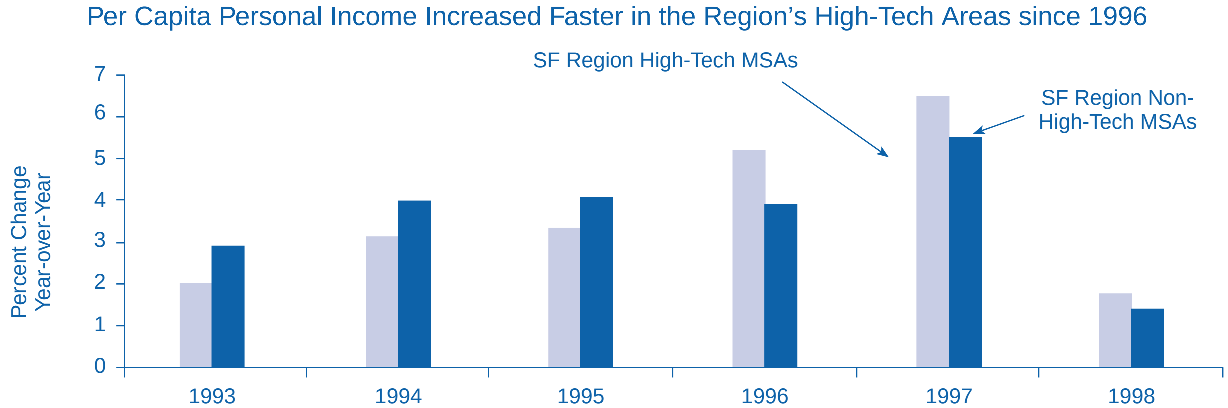


Note: Data for 2nd quarter 1999–1st quarter 2000.
MSA = metropolitan statistical area
Sources: PriceWaterhouseCoopers MoneyTree and San Jose Mercury News

[12] High-tech venture capital includes funds flowing to the following industries: biotechnology, computer and related, electronics, Internet content, Internet services, networking, semiconductors, software, and telecommunications.

[13] The American Electronics Association is a trade group that represents the high-tech and information technology sectors.

CHART 4



SF = San Francisco; MSA = metropolitan statistical area
Source: Bureau of Economic Analysis, Regional Financial Associates

this time, high-tech wages increased 20 percent nationwide while private sector wages increased 8 percent. Per capita personal income growth rates are greater in high-tech MSAs, at least in part because of increasing high-tech wage levels. The level of per capita personal income in the Region's high-tech MSAs has been consistently higher than in non-high-tech MSAs. However, as Chart 4 shows, growth in the median level of per capita personal income in the Region's high-tech MSAs also has been stronger than in other MSAs in the Region since 1996. This fact may confirm that these areas have attracted skilled employees and enabled high-tech companies and the industry to expand.

The Region's most active high-tech markets—San Jose, San Francisco, and Seattle—have contributed significantly to the rapid growth in personal income. Some analysts attribute this growth to stock options given to high-tech company employees, particularly those working at headquarters locations where much of the entrepreneurial activity takes place. For example, software employees in Washington's King County (where Microsoft's headquarters is located) reported per capita annual wages[14] of nearly $300,000 in 1998. Recently, the state's chief economist determined that the effect of the $15 drop in Microsoft's stock price during first quarter 2000, which still largely remained on paper in midsummer, approximately equaled the potential economic impact of the layoffs of 19,000 Boeing employees. Although this segment of workers accounts for a relatively small share of Seattle's total labor force, the large share of compensation they receive in stock options may make the area disproportionately vulnerable to a stock market downturn.

[14] The annual wage figure includes salary compensation and stock options awarded to employees.

Residential Real Estate Markets Strong in High-Tech MSAs

Rapid growth in the high-tech sector also has affected the Region's residential real estate markets. Median home prices and housing permit issuance increased more rapidly in the 13 high-tech MSAs than in the rest of the Region's MSAs.

Home prices in many of the Region's high-tech MSAs increased quite rapidly from 1993 through 1999. In particular, median home prices in Portland, the San Francisco Bay Area, and Phoenix grew 56, 44, and 42 percent, respectively, compared with the national average of 30 percent during this period. While each MSA outperformed the Region, in part because of strong job growth in high-tech employment sectors, higher rates of home price appreciation in Portland and Phoenix are also a result of these MSAs starting from relatively low home price levels in 1993. In contrast, San Francisco continues to experience significant increases in reported median home price even though its price level is one of the highest in the nation.

Issuance of housing permits remained strong from 1993 through 1998. Housing permit issuance in the Region's high-tech MSAs increased significantly more than in non-high-tech MSAs during the same period (see Chart 5). In fact, the number of housing permits issued doubled in San Francisco, San Jose, San Diego, and Ventura. In comparison, housing permits in the

Region's non-high-tech MSAs areas increased only 7 percent.

Office Real Estate Markets in High-Tech MSAs Are Strong

Growth in high-tech jobs also has contributed to strength in CRE markets in the Region's high-tech MSAs, as evidenced by additional construction activity, rent increases, and declines in vacancy rates. San Francisco, San Jose, Seattle, San Diego, and Phoenix matched or exceeded the growth in average national rental rates for all grades of office space between 1993 and 1999. In addition, San Francisco and San Jose far exceeded the national average in 1999 as a result of strong demand outpacing tight supplies of office space. For example, as of first quarter 2000, the South of Market (SOMA) and Financial District San Francisco submarkets, home to many software and dot-com companies, reported average rental rates for Class A, B, and C space between $63 and $65 per square foot per year,[15] compared with $59 in the aggregate San Francisco office market and $27 in the national market.[16]

The growth in high-tech jobs has contributed significantly to the decline in office vacancy rates, in some cases to record lows. The difference in vacancy rates between the Region's high-tech and non-high-tech MSAs is particularly apparent. The median vacancy rate for office space in the Region's high-tech MSAs was 8.6 percent at year-end 1999, compared with 13.5 percent in the non-high-tech MSAs. The demand for office space in some of the Region's most active high-tech markets, including San Francisco, San Jose, and Seattle, had driven vacancy rates below 5 percent at year-end 1999, much lower than the national rate of 8.2 percent.

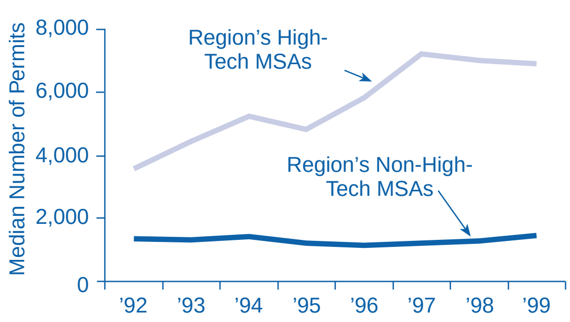
Community Banks'[17] Portfolios in High-Tech Areas Are Becoming More Concentrated in Traditionally Higher-Risk Loan Types

Although few of the Region's insured institutions lend directly to large high-tech companies, many do business in high-tech MSAs. In general, institutions in these areas have exhibited more rapid deposit and loan growth than institutions in non-high-tech MSAs.

In particular, rapid growth in high-tech jobs and related strength in CRE markets in high-tech areas have resulted in increasing concentrations of C&D, CRE, and commercial and industrial (C&I) loans in insured community institutions headquartered in these areas. As shown in Chart 6, insured institutions in the Region's high-tech MSAs have consistently reported a greater combined share of these three loan types for the past five years (reaching 51 percent in 1999) than the national average (42 percent in 1999). Not only are the Region's high-tech MSAs heavily concentrated in traditionally higher-risk loan types, but the growth rate of C&D and CRE loans in these MSAs has outpaced the national growth rate in all high-tech MSAs each year since 1997.

CHART 5

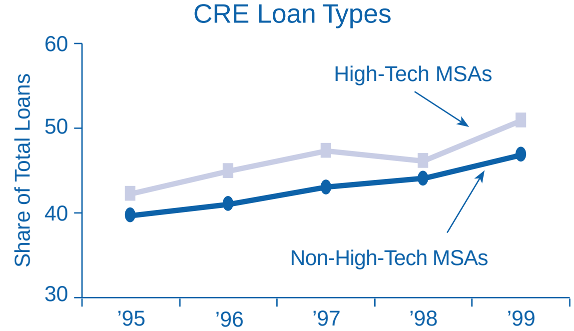
More Housing Permits Are Issued in the Region's High-Tech Areas



MSA = metropolitan statistical area
Source: Bureau of the Census

CHART 6

Community Banks in the Region's High-Tech Areas Are More Exposed to C&D, C&I, and CRE Loan Types



C&D = construction and developments; C&I = commercial and industrial; CRE = commercial real estate
Source: Bank Call Reports

[15] According to CB Richard Ellis.
[16] Forecast by Torto Wheaton Research for 2000.

[17] This group of community banks includes commercial banks with less than $1 billion in total assets and excludes de novo institutions and credit card banks.

In recent years, earnings of the Region's insured institutions in high-tech MSAs have differed from those in non-high-tech MSAs. However, the institutions in high-tech areas reported lower ROAs (1.08 percent in 1998 and 1.03 percent in 1999) than those in non-high-tech areas (1.11 percent in 1998 and 1.13 percent in 1999). Consistent with higher wages and CRE rents in high-tech areas noted earlier, slightly lower earnings could be attributed to the higher salary and premises expenses incurred by banks in high-tech MSAs.

Some Risk May Be Mitigated by Stronger Asset Quality

Community banks in the Region's high-tech areas, however, reported generally strong asset quality during the past five years. The median past-due loan ratio for insured institutions in high-tech MSAs was low at year-end 1999 at 0.84 percent, compared with 1.15 percent in non-high-tech MSAs.

In addition, a small group of larger institutions in California has recently increased lending to Internet-related firms, as evidenced by warrant income reported by some of the Region's bank holding companies. The level of warrant income reported by these companies in first quarter 2000 was nearly equal to the amount reported for all of 1999. Although analysts consider venture capital and warrant gains as nonrecurring income and tend to discount these gains when valuing a bank's stock, these gains do offer these institutions increased financial flexibility.

In conclusion, the high-tech sector's influence on many of the Region's MSAs has been positive. Employment and per capita personal income levels have risen, and activity in the residential and CRE markets has been strong. Insured institutions in high-tech MSAs also have benefited from healthy economic conditions. However, given the increased exposure to traditionally higher-risk and volatile asset types and relatively lower earnings reported in some institutions in the high-tech MSAs, there could be cause for concern in the event of a stock market downturn.

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Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding

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

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

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

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

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

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

Previous Real Estate Cycles Are Well Documented

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

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

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

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

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

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

Factors Contributing to Cycle of Overbuilding in CRE

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

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

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

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

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

Recent Developments

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

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

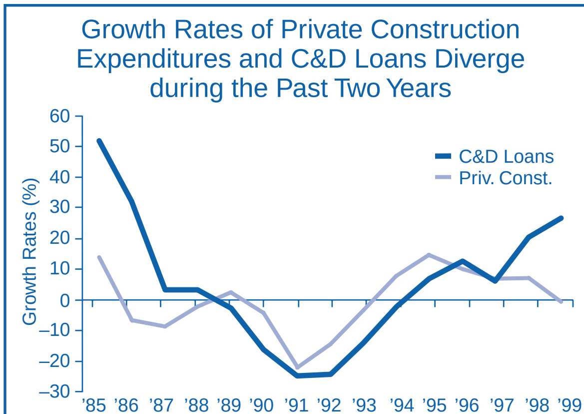
A new characteristic of the CRE industry in the current expansion has been the marked increase in capital availability through the financial markets. Annual issuance of CMBSs has grown from negligible amounts in 1990 to over $67 billion in 1999. Financing made available through REITs has been the other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

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

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

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

CHART 1



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

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

Identification of Markets at Risk for Overbuilding

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

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

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

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

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

Most Active Construction Markets

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

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

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

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

Chart 2

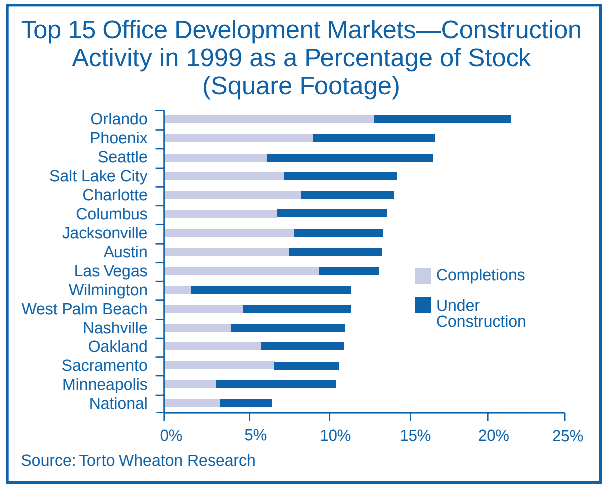


Chart 3

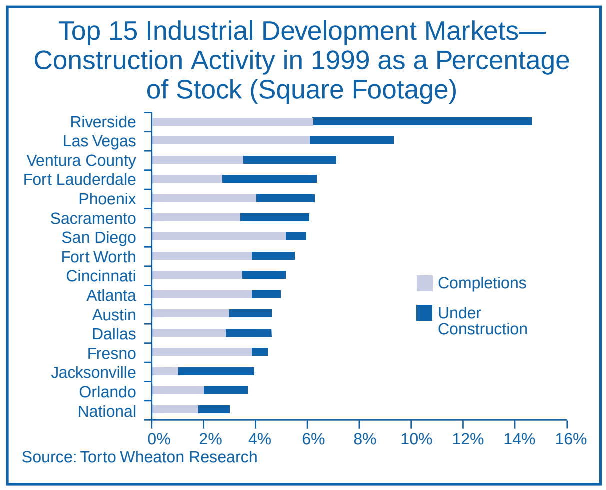
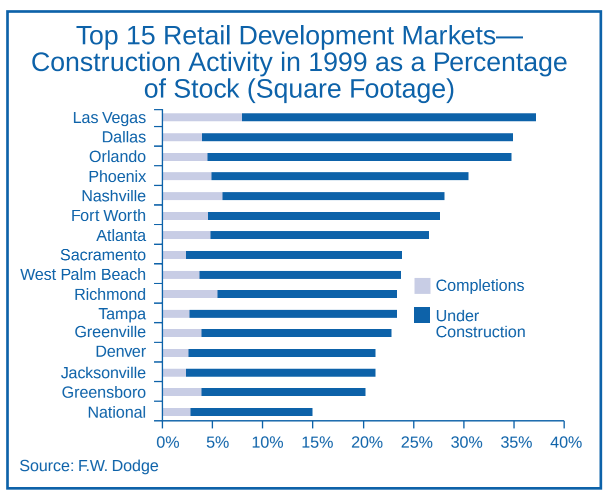


Chart 4



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

C&D Loan Concentrations

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

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

Construction Employment Concentrations

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

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

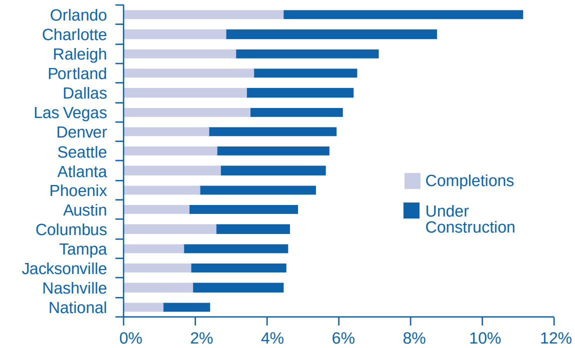
[12] For community banks that have C&D loans.

[13] Since 1992, the aggregate C&D-to-asset ratio for the nation's community banks has been higher than the C&D-to-asset ratio for institutions larger than $1 billion. This is a reversal of the condition from 1984 through 1991 when the aggregate C&D-to-asset ratio for institutions larger than $1 billion exceeded the C&D-to-asset ratio for community banks.

[14] Construction concentrations are the percentage of construction employees relative to the nonfarm workforce.

CHART 5

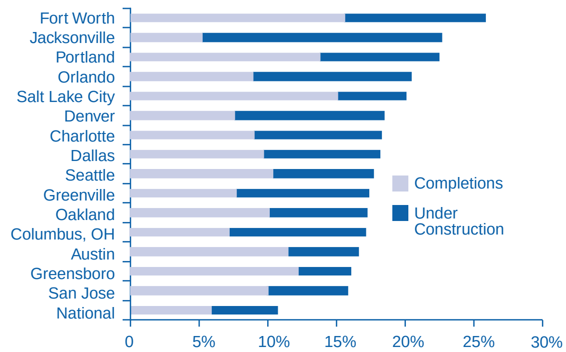
Top 15 Multifamily Development Markets—Construction Activity in 1999 as a Percentage of Stock (Units)



Source: F.W. Dodge

CHART 6

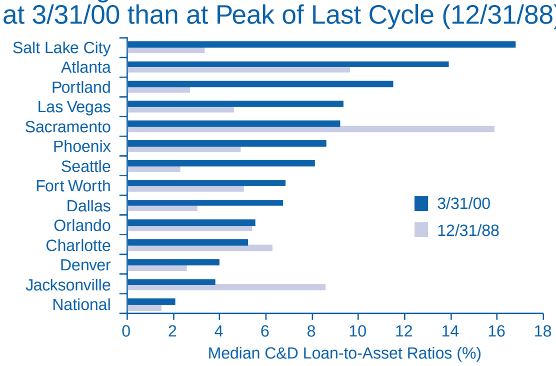
Top 15 Hotel Development Markets—Construction Activity in 1999 as a Percentage of Stock (Square Footage)



Source: F.W. Dodge

CHART 7

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



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

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

High Construction Activity and High Vacancy Levels

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

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

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

Chart 8

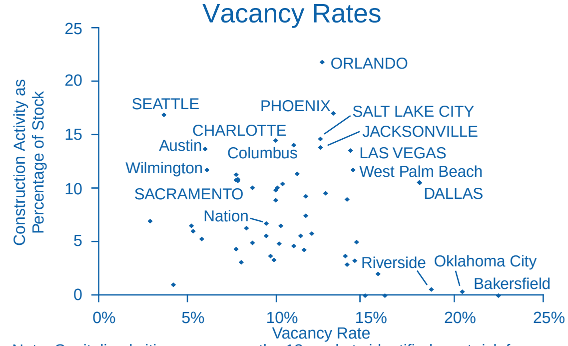
Many of the 13 At-Risk Markets Are among the Nation's Metropolitan Statistical Areas Having the Highest Construction Employment Levels as of First Quarter 2000

Source: Bureau of Labor Statistics (Haver Analytics)

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

Chart 9

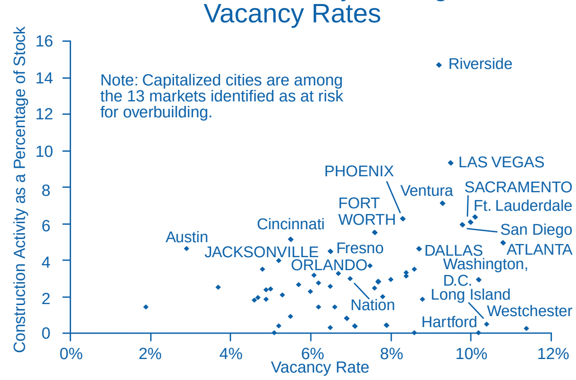
Many of the 13 At-Risk Markets Report High Office Construction Activity and High Office Vacancy Rates



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

Chart 10

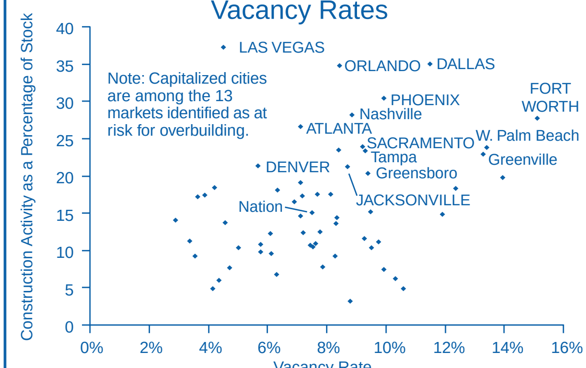
Many of the 13 At-Risk Markets Report High Industrial Construction Activity and High Industrial Vacancy Rates



Source: Torto Wheaton Research

Chart 11

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



Source: F.W. Dodge

What Market Analysts Are Saying

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

Office

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

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

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

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

[16] Torto Wheaton Research. Spring 2000. *Office Outlook.*
[17] Thierry Perrein, Donaldson, Lufkin & Jenrette. April 2000. *DLJ REIT Corporate Handbook, "Cautious Optimism."*
[18] Urban Land Institute. *ULI 2000 Real Estate Forecast.*
[19] Templin, Neal. June 7, 2000. Economic Focus: Houston, Dallas Are Draw for Immigrants. *The Wall Street Journal.*
[20] Barnes, Brooks. June 7, 2000. Economic Focus: Seattle Enjoys Influx of Foreign Workers. *The Wall Street Journal.*

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

Multifamily

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

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

Industrial

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

Retail

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

Hotel

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

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

[21] Gordon, Sally. June 2, 2000. Moody's Investors Service, *Special Report—CMBS: Red-Yellow-Green Update, Second Quarter 2000, Quarterly Assessment of U.S. Property Markets.*
[22] PaineWebber. June 6, 2000. *Real Estate Investment Trust—Initiating Coverage on the REIT Industry.*
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] PaineWebber. June 1, 2000. *Industry Outlook Lodging, U.S. Hotel Construction Update—First Quarter 2000.*

CHART 12

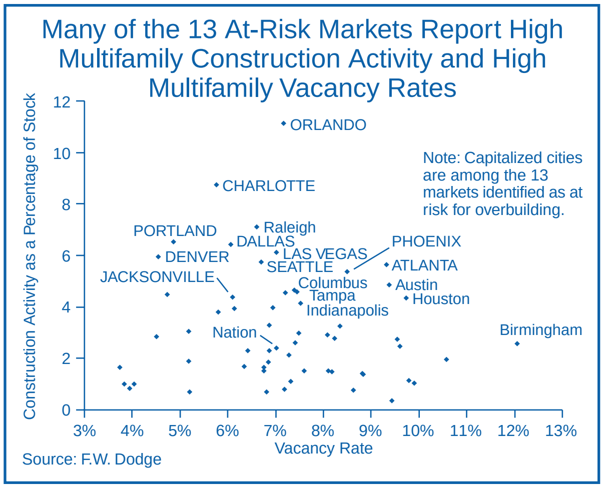
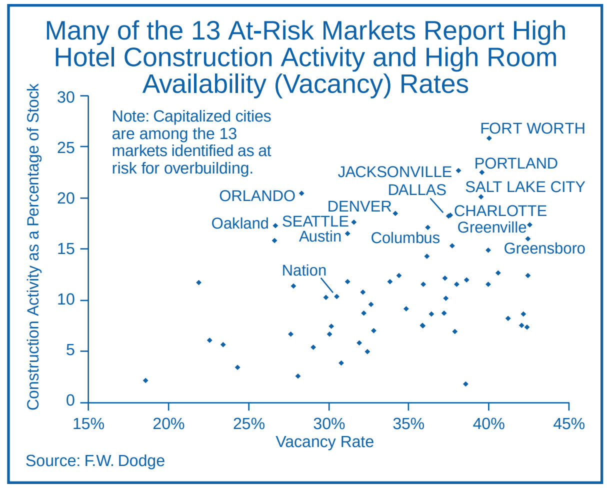


CHART 13



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

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

Conclusion

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

Markets Most Vulnerable to Overbuilding

On the basis of the preceding information, the following six markets are considered to be most at risk for broad-based overbuilding: Las Vegas, Phoenix, Portland, Sacramento, Salt Lake City, and Seattle. (See page 19.)

Thomas A. Murray, Senior Financial Analyst

San Francisco Region Markets Most Vulnerable to Overbuilding

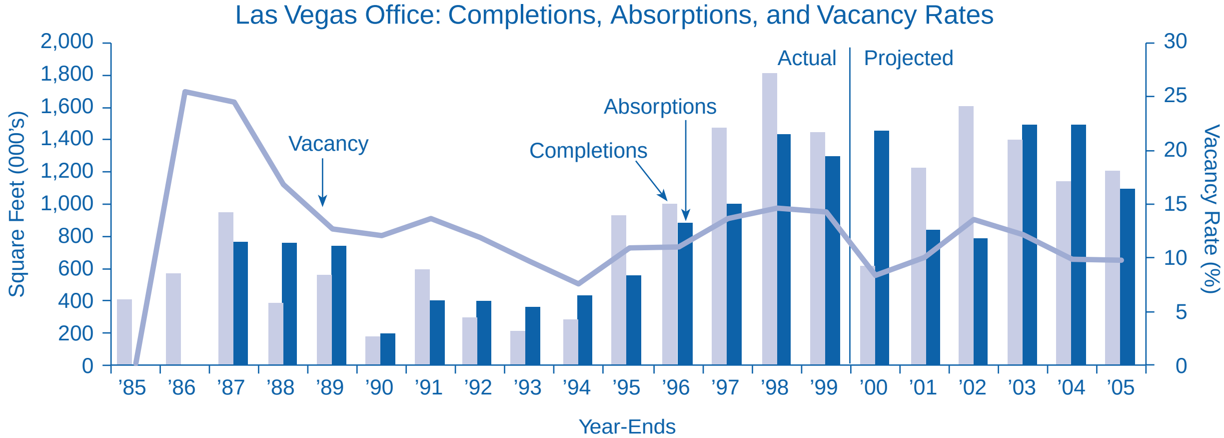
Las Vegas

Las Vegas ranks among the top ten metropolitan areas for new construction in four of the five property types. With 10 percent of its workforce employed in construction, Las Vegas is the most construction-concentrated metropolitan area in the country. In addition to its popularity as a gaming resort, the area also has become a popular site for business startups and relocations because of its low cost of living, business-friendly tax structure, and telecommunications infrastructure. Of the property types for which Las Vegas has been identified to be at risk, office (see chart), industrial, and retail seem to be the most vulnerable. Without strong in-migration, the resulting constriction in the labor market would damage the gaming industry and associated economies, particularly construction and retail. Gaming continues to be the most significant driver of Las Vegas' economy, and while the gaming industry is currently strong, the effect of just-approved gambling on Indian land in California has yet to be felt.

As a group, the 17 community banks in the Las Vegas metropolitan area report slightly higher concentrations in construction and CRE than the San Francisco Region as a whole. Since March 1998, these concentrations have roughly doubled in magnitude. As of March 2000, average construction and commercial real estate loans stood at 9.8 percent and 33.0 percent of assets, respectively. Reported past-due ratios of all Las Vegas community banks do not differ significantly from those of the Region as a whole.

Stephanie Galloway, Financial Analyst

Las Vegas Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

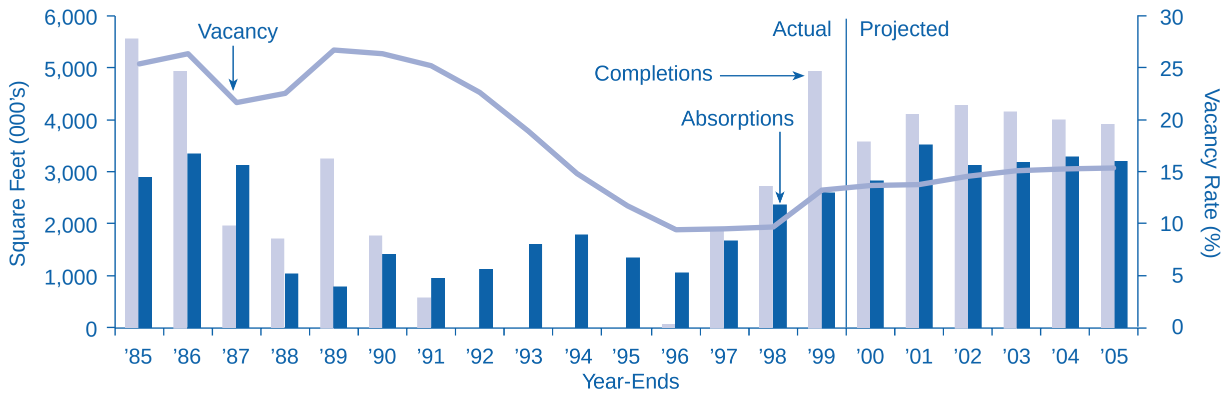
Phoenix

Phoenix ranks among the top ten metropolitan statistical areas (MSAs) for new construction activity for each property sector except the hotel sector. It ranks second in construction activity for office and fourth for retail. The Phoenix MSA has relatively high vacancy levels in each of the five property sectors. In contrast to the rapid pace of construction activity, the office employment growth rate for Phoenix was a relatively low 3.4 percent for 1999, placing it thirty-third in the nation for this category. Corresponding to the low office growth rate and the new supply coming forward in this market, office rental rates remained nearly flat between year-end 1998 and 1999, with a growth rate of only 0.54 percent. At the same time, office vacancies jumped from 9.7 percent to 13.2 percent (see chart). The preliminary, unaudited ***Torto Wheaton Research***[27] first-quarter office vacancy rate for Phoenix showed a further increase to 14 percent. Much of the recent economic development in Phoenix has been driven by an expansion among its computer chip manufacturers, along with communications companies and Internet startups. Torto Wheaton Research forecasts that the vacancy rate in the MSA's office market will continue to rise through 2005. After remaining nearly equal to the national level during most of 1997, vacancy rates in the MSA's industrial markets increased rapidly and now exceed the national level by nearly 4 percent.

While community banks in Phoenix, as a group, report less exposure to construction and CRE loans than the average for metropolitan areas in the San Francisco Region, new institutions may be more vulnerable. In first quarter 1999 and 2000, de novo institutions in Phoenix reported higher concentrations of construction and CRE loans as a share of assets than the Region's average for new banks in the other MSAs. During the same periods, total past-due construction and CRE loans at Phoenix's de novo institutions exceeded the Region's average for new banks.

Shayna Olesiuk, Economic Analyst

Phoenix Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

[27] Torto Wheaton Research. July 2000. *2nd Quarter 2000 TWR Pre-audit Office Vacancy Index.*

Portland

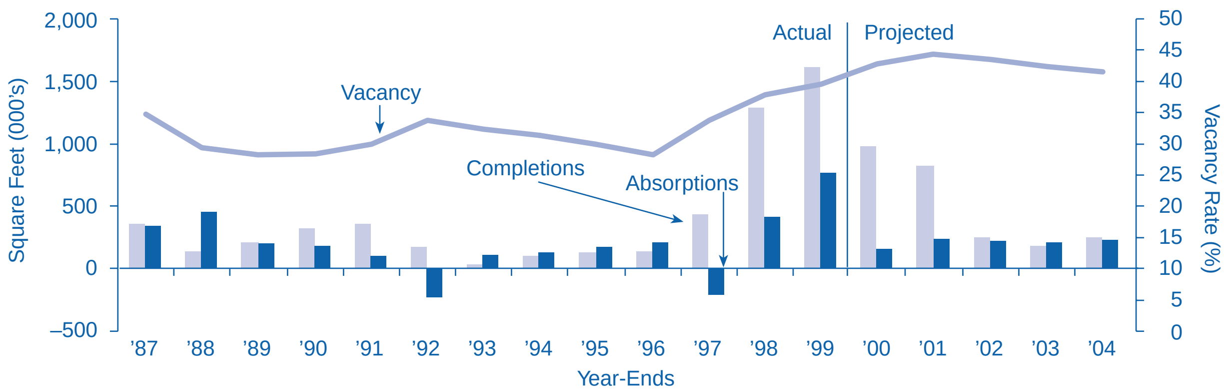
The Portland metropolitan statistical area (MSA) ranks third and fourth, respectively, for most active new construction in the hotel and multifamily sectors. At the same time, it is experiencing high vacancy rates in its hotel sector (see chart). Portland has experienced a falling employment rate for the past four year-end periods. The office vacancy rate jumped from 5.9 percent to 8.7 percent between year-end 1998 and 1999. While actively constructing new multifamily units, Portland is facing declining population growth, and net in-migration is at its lowest levels since U.S. Census reports began showing this figure in 1991, according to ***Economy.com, Inc.***[28]

With recently improved demand from Asia, job gains in Portland's high-tech sectors have offset the slowing employment growth in the services and lumber sectors. Payrolls in high-tech subsectors, such as the electronic and electrical equipment industry, saw significant growth during first-quarter 2000. Furthermore, Portland's high-technology firms continue to grow at a faster rate than their counterparts nationally.

With construction loans comprising 15 percent of total assets in Portland's community banks, rising vacancy rates give cause for concern. This level of exposure is twice the regional and three times the national peer levels of 7 percent and 5 percent, respectively. Portland's insured institutions also have higher concentrations of CRE lending. More than half the community banks in the MSA report CRE loans totaling more than one-third of total assets as of first quarter 2000, while three report concentration levels in excess of 50 percent of assets. Asset quality indicators for both construction and CRE also have deteriorated at some area banks; reported past-dues in construction and CRE loans were more than triple the regional average.

Stefani Rose, Research Assistant
Robert Burns, Senior Financial Analyst

Portland Hotel: Completions, Absorptions, and Vacancy Rates



Source: F. W. Dodge

[28] Economy.com, Inc. (formerly RFA, Dismal Science). July 2000. *Precis: Metro 2000.*

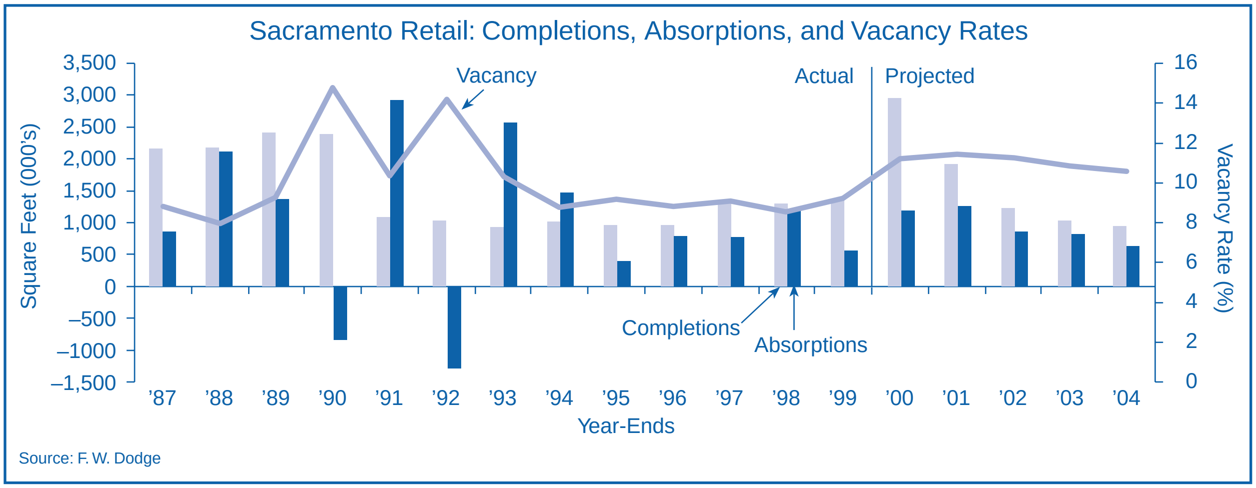
Sacramento

The Sacramento metropolitan statistical area (MSA) ranks sixth and eighth, respectively, for most active new construction in the industrial and retail sectors. At the same time, it is experiencing high vacancy rates in both of those sectors, along with its hotel sector. During the past five years, California's nonfarm employment expanded by 15.9 percent, while the increase for Sacramento was 21.1 percent. A detracting factor for Sacramento's economy over the past several years has been military base closures. In line with the rest of northern California, however, base closures appear to be at an end. Rapid growth in high-tech manufacturing in recent years has been an important positive driver of Sacramento's economy. Electronic and computer equipment manufacturing jobs expanded 37.7 percent in the past five years to approximately 17,000, a spillover from booming Silicon Valley 100 miles to the west.

The number of retail, office, and industrial building permits each have tripled from 1996 to 1999. ***F.W. Dodge's***[29] forecasts indicate that retail space completions will outpace absorptions and result in the vacancy rate rising from approximately 9 percent in 1999 to between 11 and 12 percent over the next five years (see chart). Similarly, ***Torto Wheaton Research***[30] forecasts that construction of industrial space will keep industrial vacancy rates at around 10 percent for the next several years and that the office vacancy rate will rise from around 8 percent currently to over 12 percent within the next two years.

Community banks headquartered in Sacramento exhibit increasing exposure to CRE loans. Aggregate exposure levels to construction loans and total CRE loans are higher than averages reported by community banks headquartered in other MSAs in the Region and the nation.

Phillip E. Vincent, Regional Economist



[29] F.W. Dodge. *REAPS.* Fourth Quarter 1999.
[30] Torto Wheaton Research. Spring 2000. *Office Outlook.*

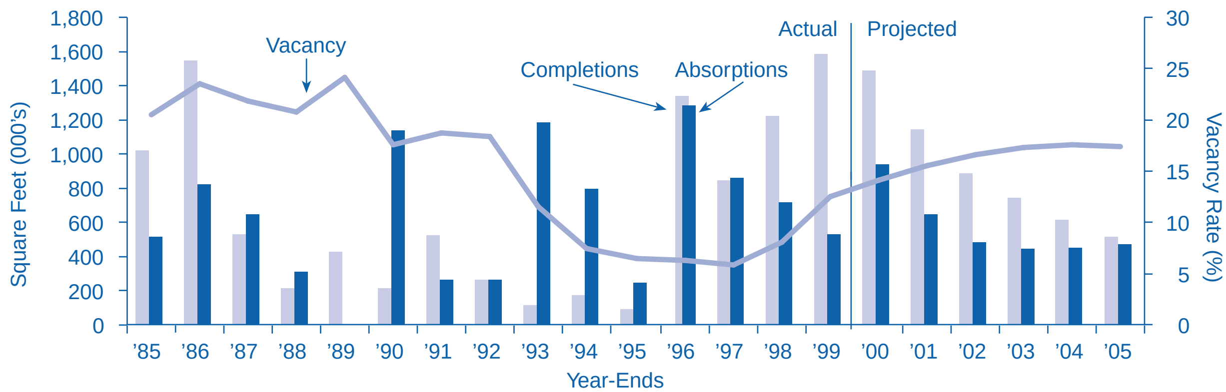
Salt Lake City

The Salt Lake City metropolitan statistical area (MSA) ranks in the top ten for active construction in both the office and hotel sectors. It is currently experiencing moderately high vacancy rates in the office and industrial sectors and high vacancy rates in the hotel sector as newly completed hotels to accommodate the Winter Olympics 2002 population are completed. The Salt Lake City construction employment level as a percentage of the total workforce is now the seventh highest in the country, and construction employment grew 5.65 percent in 1999. Office vacancies rose sharply for the past two year-end periods, from 8.1 percent at year-end 1998 to 12.5 percent at year-end 1999 (see chart). Rent growth was flat over the past two years. Although most new construction is occurring in the suburbs, office vacancy levels have risen in both the downtown and suburban sections of the Salt Lake City MSA. The suburbs were able to absorb only 58 percent of last year's newly created office space. Salt Lake's hotel occupancy slipped 4 percent in 1999 to approximately 60.5 percent, while average room rates fell 3 percent. Two new hotel properties with a total of 1,147 rooms are scheduled to open in November 2000.

Although Salt Lake City's office and hotel sectors have deteriorated in the past few years, community banks have been relatively unaffected. Salt Lake City's established community banks report high levels of exposure to CRE loans, compared to the Region average. In first quarter 2000, the MSA's community banks that have CRE loans and have been in existence more than 3 years reported a median level of CRE loans as a share of assets at 41 percent, higher than the region median of 33 percent. In the event of a downturn in the area's economy, the MSA's established community banks may be more vulnerable than other community banks in the Region.

Shayna Olesiuk, Economic Analyst

Salt Lake City Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

Seattle

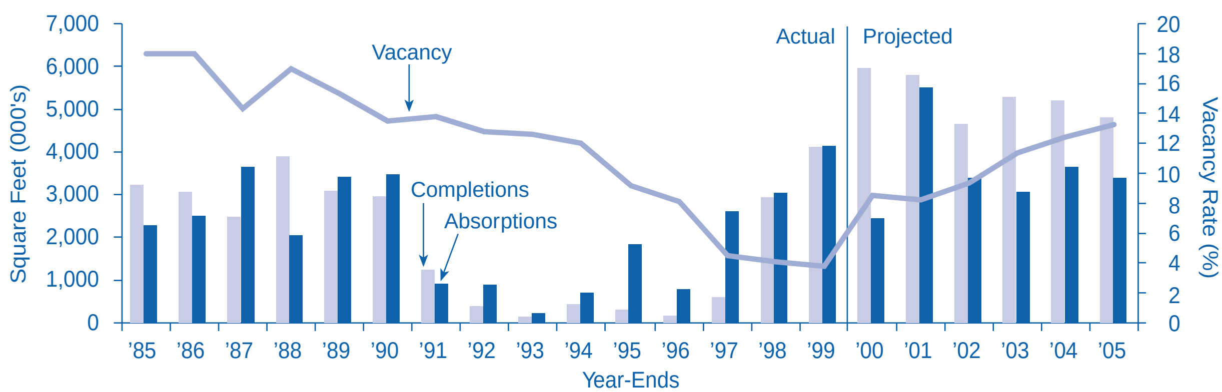
Strong growth in high-technology sectors and large amounts of venture capital have contributed to Seattle's rank among the top ten metropolitan areas for new construction as a percentage of stock in the office, hotel, and multifamily sectors. The emergence of the high-technology industry, specifically software (Microsoft being a prime example) has fueled high employment and personal income growth in recent years. In addition, Seattle has gained popularity as a location for venture capital investing. Recent volatility in the stock market, coupled with continued layoffs by Boeing, the state's largest employer, has begun to slow the MSA's employment growth. Office absorption rates, which are closely tied to business expansion, could decrease if companies become constrained by labor shortages or choose to slow their growth in the face of more volatile capital markets.

The vacancy levels for all five property sectors in Seattle are below national averages. The downtown Seattle office market has an enviable vacancy rate of only 1.4 percent and over 100 percent absorption for the past four years. A recent study by ***Torto Wheaton Research,***[31] however, predicts much lower absorption levels in the coming years. With slower business growth, office vacancy rates in the Seattle MSA are expected to reach levels as high as 10 percent in three years (see chart).

As a group, community banks in the Seattle metropolitan area have higher levels of exposure to construction and development and CRE loans than those in other metropolitan areas in the Region or the nation. In the first quarter of 2000, Seattle community banks reported CRE loans at 36.6 percent of total assets. Reported asset quality for the area's community banks, however, remains strong.

Sara Zachary, Research Assistant
Robert Burns, Senior Financial Analyst

Seattle Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

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

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

- **Home prices have risen rapidly in several major U.S. metropolitan areas.**
- **The credit quality of residential real estate loan portfolios traditionally has been solid.**
- **New lending programs such as subprime and high loan-to-value lending could change the historical loss experience associated with residential real estate.**

Introduction

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

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

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

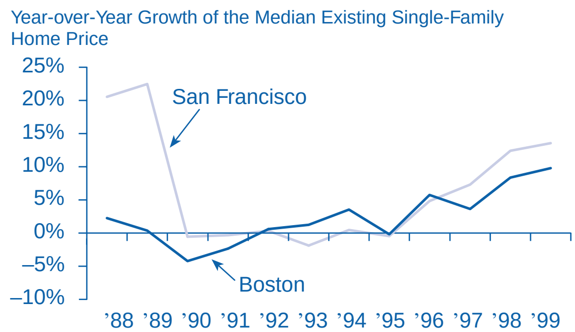
Home Prices in Some Local Markets Are Soaring

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

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

Chart 1

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



Source: National Association of Realtors (Haver Analytics)

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

Table 1

Of the 20 U.S. Cities with the Most Expensive Housing, More than Half Have a Concentration in High-Tech Employment		
The shaded areas indicate markets where high-tech employees constitute at least 5 percent of the total payroll employment (see note).		
Metropolitan Statistical Area Ranking by Median Home Price	Median Price of an Existing Single-Family Home March 2000	Percent Change from One Year Ago
1 San Francisco, CA	$418,600	25.0%
2 Orange County, CA	$300,800	10.3%
3 Honolulu, HI	$289,000	–2.0%
4 Boston, MA*	$255,000	8.4%
5 San Diego, CA	$251,400	16.1%
6 Bergen-Passaic, NJ	$250,200	9.8%
7 Newark, NJ	$229,500	18.8%
8 Seattle, WA	$226,100	8.3%
9 New York, NY	$221,500	14.3%
10 Nassau-Suffolk, NY	$209,200	12.8%
11 Los Angeles, CA	$202,900	5.6%
12 Middlesex, NJ	$198,500	8.6%
13 Monmouth-Ocean, NJ	$186,200	19.4%
14 Denver, CO	$181,500	12.9%
15 Washington, DC-MD-VA	$177,500	5.6%
16 Portland, OR	$166,700	0.8%
17 Chicago, IL	$166,700	0.4%
18 Lake County, IL	$162,600	–2.2%
19 Aurora-Elgin, IL	$158,200	7.5%
20 Raleigh-Durham, NC	$156,300	–4.2%
Nation	**$133,533**	**2.7%**

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

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

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

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

Favorable Economic Conditions Have Sustained Consumer Spending Patterns

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

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

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

Overall Credit Quality of Residential Mortgages Has Been Solid

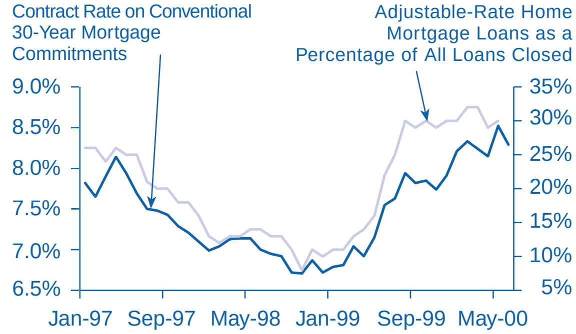
Historical losses from residential real estate exposures at insured institutions are well documented. In the 1980s, areas such as Texas, California, and New England experienced strong economic growth, rapid residential development, and sharp home price appreciation that created asset price inflation.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

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

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

CHART 2

More Consumers Have Chosen ARMs as Mortgage Rates Have Risen



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

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

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

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

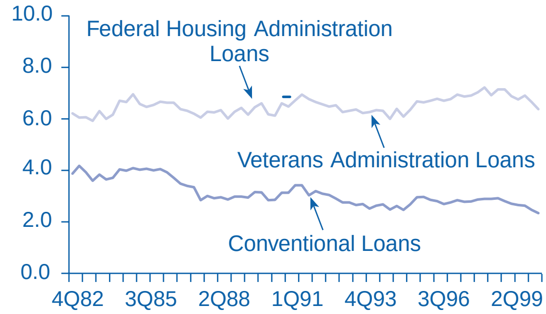
By contrast, Veterans Administration (VA) and Federal Housing Administration (FHA) loans have performed less well during this expansion. These loan types are both designed to aid less creditworthy borrowers in securing a home loan. VA and FHA loans, which include a portion of the higher-risk high-LTV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

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

Chart 3

Past-Due Rates on FHA and VA Loans Have Historically Been Higher than on Conventional Loans

Loans Past Due as a Percentage of All Loans

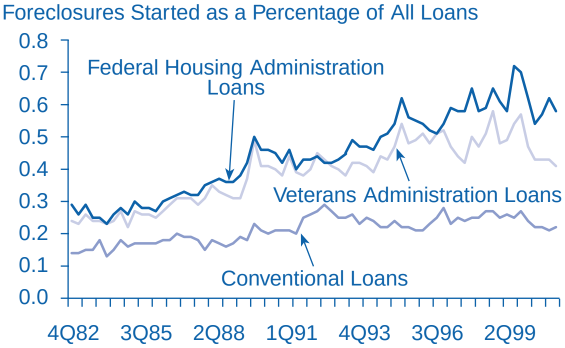


Source: Mortgage Bankers Association (Haver Analytics)

Chart 4

Foreclosure Rates on FHA and VA Loans Remain Higher than on Conventional Loans

Foreclosures Started as a Percentage of All Loans



Source: Mortgage Bankers Association (Haver Analytics)

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

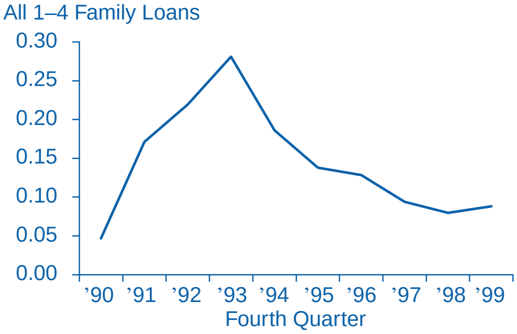
Concerns have arisen recently about the future of residential loan credit quality and consumer credit quality in general. The ***Board of Governors of the Federal Reserve System*** warned that, although the consumer sector seems healthy by most measurable standards, "[consumer] delinquency rates may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

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

Chart 5

1–4 Family Loan Charge-Offs May Have Reached the Bottom of the Credit Cycle

1–4 Family Loan Charge-Offs as a Percentage of All 1–4 Family Loans



Source: Bank and Thrift Call Report Data (Research Information System)

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

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

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

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

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

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

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

Table 2

Pockets of Risk May Be Forming Where the LTV Is Highest

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

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

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

[8] Federal Housing Finance Board.

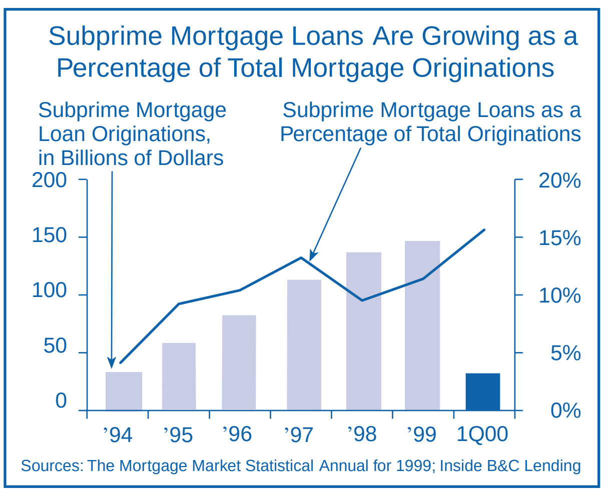
[9] See also Kathy R. Kalser and Debra L. Novak. "Subprime Lending: A Time for Caution." *Regional Outlook,* third quarter 1997; http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf.

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

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

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

CHART 6



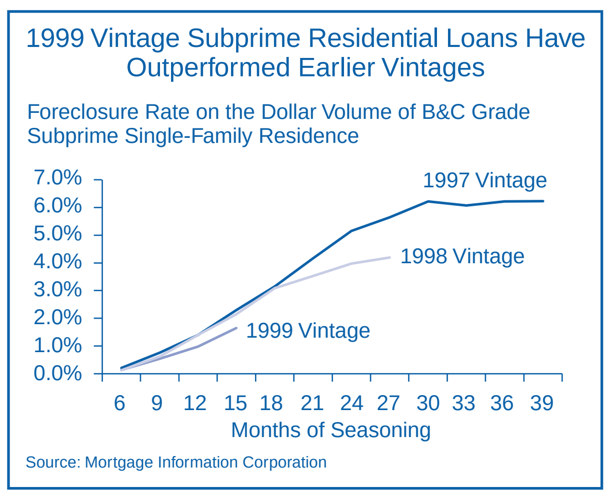
Conclusion

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

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

Alan Deaton, Financial Economist

CHART 7



[10] Subprime Mortgage Market Faces More Challenges in Second Half of Turbulent 2000. *Inside Mortgage Finance.* July 7, 2000.

[11] Mortgage Delinquency Rates Decline in Early 2000 But Industry Braces for Shift in the Wind. *Inside Mortgage Finance.* July 14, 2000.

[12] Seriously delinquent loans are defined as loans at least 90 days delinquent or in foreclosure.

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