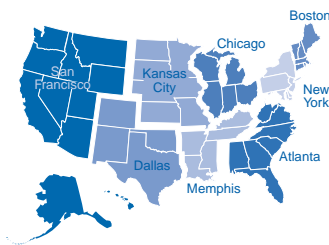

Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION

FIRST QUARTER 2002

FDIC NATIONAL EDITION



DIVISION OF
INSURANCE

In Focus This Quarter

◆ *Housing Market Has Held Up Well in This Recession, but Some Issues Raise Concern*—Recent trends in mortgage underwriting are of particular interest, as an estimated \$2 trillion in mortgage debt, approximately one-third of the total outstanding, was underwritten during 2001. Nonconstruction residential mortgages traditionally have represented one of the better-performing loan classes during prior downturns. The level of credit risk, however, may be higher this time around because the mortgage lending business has changed since the last downturn. This article examines these changes, including increased involvement by insured institutions in the higher-risk subprime credit market, the acceptance of higher initial leverage on home purchases, and greater use of automated underwriting and collateral valuation processes, which have not been recession-tested.

◆ Home price softening could have an adverse effect on residential construction and development (C&D) and mortgage portfolios. In the aggregate, the level of risk appears modest. However, insured institutions with significant C&D loan exposures in markets that experienced ongoing residential construction during 2001, despite slowing local economies, are at higher risk. Weakening home prices could hurt loan quality in selected markets. The San Francisco Bay area stands out as a place to watch in this regard. *See page 3.*

*By Scott Hughes, Regional Economist
Judy Plock, Senior Financial Analyst
Joan Schneider, Regional Economist
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Regional Perspectives

◆ *Atlanta*—The current downturn may adversely affect the Region's insured institutions that have relied on rapid economic growth, such as those experiencing their first recession or institutions with concentrations in traditionally higher risk loans. *See page 14.*

◆ *Boston*—Interest rate risk appears to be increasing, especially for the Region's smaller savings institutions. Managing this risk will involve a trade-off between short-term profits and long-term earnings stability. *See page 15.*

◆ *Chicago*—Despite years of economic restructuring, the recession is still felt keenly in the Region. Rapidly falling interest rates improved margins, but may challenge asset/liability management strategies. *See page 16.*

◆ *Dallas*—Slowing employment growth and overbuilding may contribute to weakening of housing price growth in the Denver and Austin MSAs. Leaner collateral positions could heighten the level of risk in mortgage lending. *See page 17.*

◆ *Kansas City*—Layoffs in the aircraft manufacturing industry since September 11, 2001, have hurt the Wichita economy. As the Region's commercial real estate sector has weakened, insured institutions have increased CRE lending exposures. *See page 18.*

◆ *Memphis*—Credit quality deterioration remains a major concern for many of the Region's insured institutions. In addition, continued interest rate volatility could challenge interest rate risk management and pressure earnings performance. *See page 19.*

◆ *New York*—The aftermath of September 11, 2001, further weakened the Region's economic outlook. Insured institutions appear better positioned to weather this economic downturn than the last recession; however, credit quality and interest rate risk challenges lie ahead. *See page 20.*

◆ *San Francisco*—Declining demand for real estate could signal the potential for credit quality weakening among the Region's construction lenders. *See page 21.*

The **Regional Outlook** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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Housing Market Has Held Up Well in This Recession, but Some Issues Raise Concern

Trends in housing markets are important performance drivers for many FDIC-insured institutions. The health of residential markets can affect the credit quality of residential mortgage loans, home equity loans, and loans to finance residential construction and is linked indirectly to the performance of other types of consumer and small-business debt. Further, an estimated \$2 trillion in mortgage debt, approximately one-third of the mortgage market, was underwritten during 2001, with 56 percent of this activity in refinancing transactions.¹ This activity makes recent trends in underwriting of particular interest. An ancillary issue for many mortgage lenders, interest rate risk, is not addressed in this article.²

The U.S. economy entered a recession in March 2001, and the question arises as to how consumer creditworthiness, housing values, and recent mortgage-lending practices will fare during this downturn. Developments contributing to increased credit risk include higher consumer debt burdens, looser mortgage loan underwriting standards, and the emergence of subprime mortgage lending as a significant line of business for some banks. Mitigating this risk has been the steady appreciation of home prices, which have shown signs of softening in some markets but not to the extent seen at a comparable stage in previous recessions.

Home price weakness may be more pronounced in 2002 as the effects of the recession take hold, but in the authors' judgment, systemic weakness in home prices is unlikely, absent a deep and long recession. Adverse mortgage lending trends are not expected to threaten the capital or earnings of the vast majority of insured institutions. Nonconstruction residential mortgages, even during the most pronounced periods of stress in the 1980s and early 1990s, remained the best-performing loan class, especially for lenders specializing in residential real estate; and, historically, these mortgages have been

one of the lowest credit-risk loan types for all manner of insured institutions.³

That said, however, there *are* pockets of risk for insured institutions. There is evidence that borrowers with weak credit may be experiencing greater repayment difficulties, elevating the risks faced by subprime mortgage lenders. Further, a slump in residential real estate markets could be especially detrimental to insured institutions with significant exposures to housing construction because projects might not sell at projected asking prices or as quickly as anticipated. Finally, in specific markets where housing prices may have achieved unsustainable levels, some increase in housing-related credit quality problems can be expected, and in this regard, the San Francisco Bay area stands out as a place to watch.

The Recession Thus Far Has Had a Minimal Impact on Mortgage Delinquencies at Insured Institutions

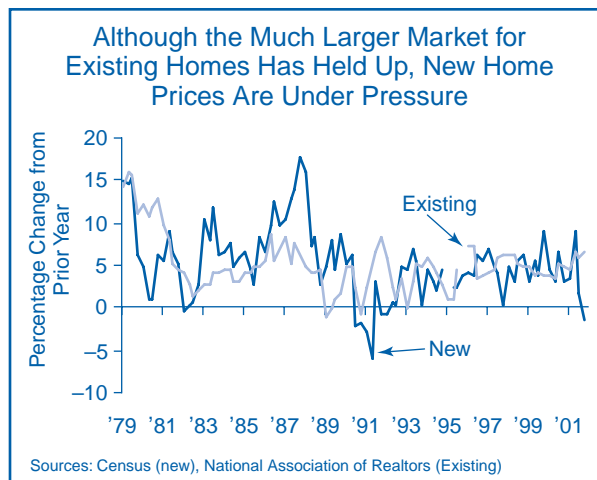
Despite three quarters of recession, most housing indicators remained quite healthy this past year relative to trends seen in past recessions. For example, new and existing home sales both set records during the year, while new home construction failed to decline, an occurrence not seen in the past six recessions. Another indicator, year-over-year growth in existing home prices—as measured by either the *Office of Federal Housing Enterprise Oversight (OFHEO)* repeat sales price index or the *National Association of Realtors (NAR)* median single-family price statistic—showed deceleration but remained well above trends seen at similar points in past recessions. This behavior partly reflected the early robustness of household income in the face of recession and relatively low fixed mortgage rates during 2001, which helped to counter some of the

¹ Mortgage Market Forecast, www.mbaa.org/marketdata/forecasts/, January 2002.

² For a discussion of this issue, see "Regional Perspectives," Boston and Chicago Regions, *Regional Outlook*, First Quarter 2002.

³ See "Region's Insured Institutions Exhibit Lower Risk Profile than the Nation's, Appendix: Risk-Weighting Methodology," Table A in Boston Region, *Regional Outlook*, First-Quarter 2000.

CHART 1



initial adverse effects of the recession on housing demand.

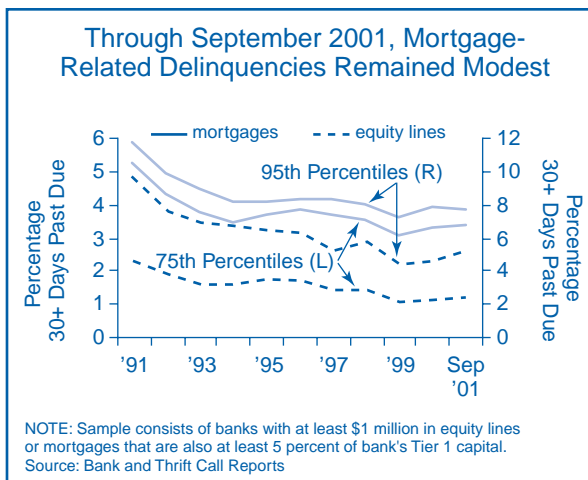
One sign of potential weakness appeared late in 2001 in the modest year-over-year decline in median prices of new single-family homes (see Chart 1). Because existing home sales outnumber new home sales roughly fivefold, price trends in the latter are generally not predictive of prices for the much larger existing home market.⁴ However, as discussed later in this article, adverse pricing trends in the new home segment do raise concerns for residential developers and insured institutions that finance residential construction.

The steady increase in prices of existing homes depicted in Chart 1 masks considerable regional variation. As detailed later in this article, home price growth began to weaken in 2001 in a number of metropolitan statistical areas (MSAs). While there is no clear common denominator among the markets in which this occurred, a number of these markets had both extremely rapid home price growth in the recent past and significant slowdowns in employment growth or outright contractions in employment last year.

Credit quality indicators for insured institutions' mortgage loans have shown only preliminary signs of weakness thus far. Through the first nine months of 2001, insured institutions showed negligible advances in median past-due ratios for mortgages and equity

⁴ Existing home prices are also more reflective than new home prices of trends in broader economic indicators, such as aggregate per capita personal income.

CHART 2



lines of credit, although continued strong mortgage origination activity in 2001 may have masked (in the aggregate) developing credit problems for more seasoned mortgage loans. For institutions that held at least \$1 million in residential mortgages or home equity lines of credit *and* whose exposures comprised at least 5 percent of Tier 1 capital, some modest deterioration is evident in the worst-performing mortgages and home equity lines since 1999, as seen in Chart 2.⁵ Even if this recession lingers, worsens, or both, residential mortgage lending (nonconstruction and development-related) likely poses only modest risk to most insured institutions' earnings and capital, since it has held up better in prior recessions than other loan types.

What Are the Risks Facing Housing Lenders in 2002 and Beyond?

In an environment of significantly slower economic growth than prevailed during the 1990s, can the strength of housing prices and the relatively benign credit quality environment for housing lenders be expected to continue? The answer will depend on the interplay of economic conditions and lenders' risk profiles. In the remainder of this article, we discuss the gradual increase in the risk profile for insured mortgage lenders that appears to have occurred during the

⁵ It is interesting to examine the (adverse) tail of the credit quality distribution when looking at residential mortgage trends, as average and median past-due ratios move little and are typically very low—thus, only the highest 25th and 5th percentiles of past-due ratios are presented in Chart 2.

1990s, as well as some cyclical risks to their performance that may exist as the recession plays out.

Evolving Lending Practices Have Increased the Risk Profile for Mortgage Lenders

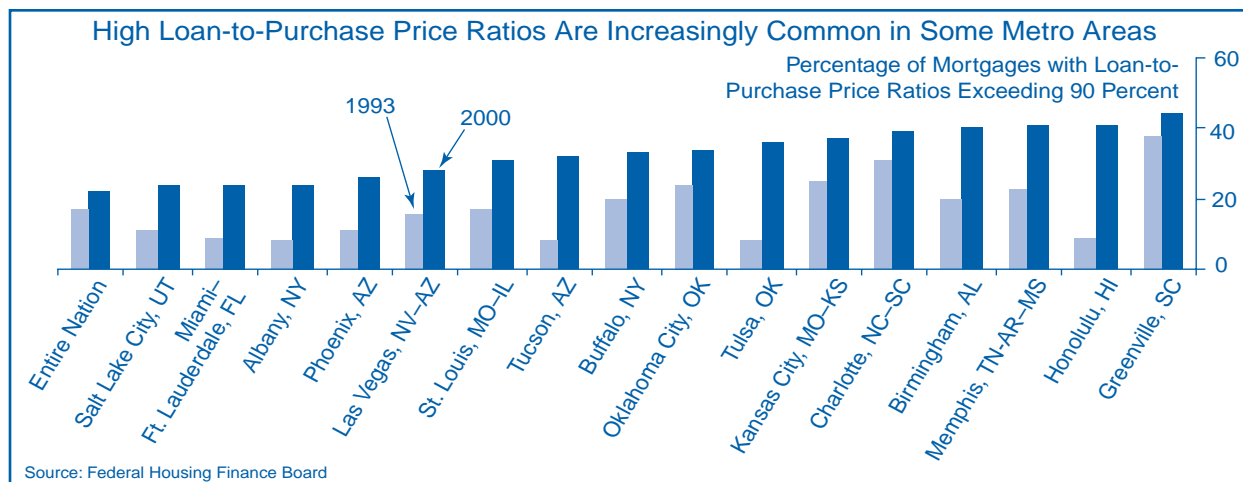
Although history suggests that residential mortgage defaults will be relatively low even in a recession, changes in the mortgage market since the 1990–1991 recession could affect mortgage performance during the present downturn. Many underwriting changes over the past decade have been driven in part by the growing importance of the secondary market for mortgage debt, and of Fannie Mae and Freddie Mac in particular. In 1980, federal and related agencies had direct or indirect interests in approximately 17 percent of all mortgage debt.⁶ By 2000, their share of the mortgage market had increased to roughly 41 percent. Insured bank and thrift mortgage exposures grew over the same period, but, as a share of direct mortgage debt, bank and thrift mortgage holdings decreased from 59 to 35 percent. These trends notwithstanding, insured institutions still provide substantial funding, directly or indirectly, to the housing market: as of September 30, 2001, 1 to 4 family mortgage loans and mortgage-backed securities held by insured institutions aggregated \$2.3 trillion, up 37 percent from five years earlier.

Although an active secondary mortgage market has broadened homeownership, improved mortgage loan liquidity, and allowed insured institutions to allay credit risk, it has also heightened market competition and transformed the lending process. In presecondary market

days, lenders largely had to retain originated mortgages in their own portfolios. Consequently, only lenders with ready funding sources (such as banks, thrifts, and insurance and finance companies) were able to compete in the mortgage markets. The advent of the secondary market enlarged the pool of available funding and permitted both insured institutions and other originators to transfer their mortgage business readily into entities such as mortgage pools and trusts. Consequently, many new players, including on-line and brick-and-mortar mortgage brokers, have entered the mortgage origination market.

The resulting robust mortgage loan competition, combined with Internet-based consumer research tools, has led to considerable commodification of the mortgage market. Rather than competing on the basis of traditional relationships, lenders' market shares are increasingly driven by price. For smaller savings institutions that focus heavily on residential mortgage underwriting, this issue has likely elevated business risk. Heightened competition has caused some loosening of mortgage underwriting standards and pushed lenders to use technology to expedite and streamline the underwriting process. Consequently, credit-scoring mechanisms and automated valuation techniques currently in place have not been tested through a full credit cycle. Because pricing competition has pressured margins, some mortgage lenders have pursued subprime or high loan-to-value (HLTV) mortgages. The ability of insured institutions to mitigate subprime losses through an economic downturn is untested to a large extent as well—finance companies dominated the high-risk mortgage market in past recessions.

CHART 3



⁶ These interests include residential, commercial, and farm real estate debts held directly by, or held in mortgage pools or trusts issued by, federal and related agencies. Source: Table 1186, Statistical Abstract of the United States: 2001, page 733.

In general, mortgage underwriting standards have loosened industrywide over the past decade. For instance, lenders have increasingly accepted higher loan-to-purchase price (LTPP) ratios for purchase money mortgages.⁷ According to the *Federal Housing Finance Board*, LTPP ratios are high and have risen in several metropolitan areas over the past seven years (see Chart 3). Between 1993 and 2000, the **Honolulu, Tulsa, and Tucson** markets exhibited the largest increases in mortgages with LTPP ratios exceeding 90 percent.

Although lenders often mitigate the risk of loss associated with low downpayments by requiring private mortgage insurance (PMI), recently the mortgage industry has allowed borrowers to avoid purchasing PMI. In particular, “piggyback” financing has made homeownership increasingly possible for households that cannot afford the traditional 20 percent down payment or do not wish to pay for PMI. With piggyback financing, the borrower often arranges a conforming 80 percent LTPP first mortgage and finances a portion of the remaining 20 percent with a concurrent second mortgage on the property (e.g., “80-10-10”). This type of transaction has become popular because interest paid on the (albeit more expensive) second mortgage is tax-deductible, whereas PMI premiums are not. Thus, piggyback financing is probably most attractive to individuals in higher-cost/tax areas or higher tax brackets, such as those in the **Northeast and California**. This trend effectively shifts the first loss position on all low down payment loans to the lender that retains the junior position. These institutions are, of course, compensated for some of this risk with the higher interest rates charged on the piggyback portion of these mortgages.

Competitive factors have prompted the industry to enhance underwriting automation. As part of the push, credit scoring has become a routine part of the credit analysis process, and, increasingly, lenders are using automated valuation models (AVMs) to determine collateral coverage. However, credit scoring and collateral valuation models have been in popular use only since the 1990–1991 recession; consequently, their predictive ability in a downturn is uncertain. Although some have touted AVMs as the answer to appraisal fraud, the ability of statistical models to simulate the qualitative judgments considered critical to traditional appraisals is unknown. Paper appraisals reportedly

⁷ Purchase money mortgages are loans extended solely for the initial purchase of a home. Statistics on loan-to-value ratios for supplemental home equity loans/lines (e.g., piggyback or “80-10-10” financing), as well as refinanced mortgages, are not readily available.

continue to dominate the industry; however, recently, the two largest government-sponsored enterprises have begun accepting AVMs in lieu of standard appraisals for loans under \$275,000.⁸ For lenders that specialize in HLTV mortgages, there is less room for error with AVMs.

Cyclical Weakness Is Already Apparent in Subprime Mortgage Lending

Historically, certain insured institutions have made mortgage loans with narrow collateral margins or to borrowers with limited or blemished credit histories. However, significant entry by FDIC-insured institutions into mortgage lending to borrowers with weak or marginal credit, *as a targeted line of business*, generally has occurred only since the early 1990s. These “subprime” mortgages are neither defined nor reported on Bank Call Reports. As a result, gauging the extent of bank involvement in subprime lending at any point in time is difficult. However, the FDIC estimates that fewer than 1 percent of all insured institutions have significant subprime residential mortgage exposures. Nevertheless, according to some measures, subprime mortgages as a share of total mortgage originations peaked at 13 percent in early 2000, before moderating somewhat during the first three quarters of last year.⁹ Thus, a much larger number of institutions probably have some limited involvement in subprime mortgage lending. A survey by the *Minneapolis Federal Reserve Bank* found that 29 percent of banks in the **Minneapolis District** offered loans to low-credit quality consumer borrowers in 1999.¹⁰

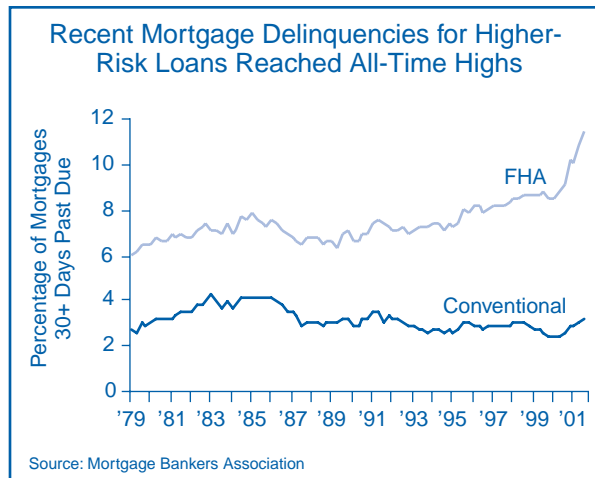
Subprime mortgage loan performance appears to have deteriorated notably during 2001. One source of support for this observation comes from delinquency trends on Federal Housing Agency (FHA)-insured mortgages, which are often granted to first-time homebuyers with troubled credit histories and borrowers with low down payments. The *Mortgage Bankers Association* reports that while the national delinquency rate on conventional mortgages rose 58 basis points in the year ending third-quarter 2001, the delinquency rate on FHA mortgages shot up by 234 basis points, to 11.4 percent (see Chart 4). This growing gap between

⁸ “Automated Appraisals Require Caution by Lenders,” *American Banker*, October 10, 2001.

⁹ Based on dollar volumes, data from Inside Mortgage Finance Publications, Bethesda, MD.

¹⁰ Ron Feldman and Jason Schmidt, “Why All Concerns About Subprime Lending Are Not Created Equal,” *Fedgazette*, Minneapolis Federal Reserve, July 1999.

CHART 4



delinquency rates on conventional and government-insured mortgages suggests that marginal and subprime borrowers are facing growing repayment difficulties.

A database of more than 6.5 million subprime loans tracked by *Loan Performance Corporation* (formerly *Mortgage Information Corporation*) reported similar trends. The nationwide third quarter 2001 ratio of seriously delinquent subprime mortgages was 7.3 percent, up from 5.5 percent one year earlier.¹¹ Moreover, subprime delinquencies significantly exceeded those found among prime mortgages, as just under 0.5 percent of conventional prime mortgages were seriously delinquent.¹² Also of possible concern are vintage data trends, which show how pools of primary and junior-lien subprime mortgages perform over time. Mortgages originated in 2000 are performing poorly in relation to previous years' vintages.¹³ This simply could reflect the impact of the current recession. Alternatively, *Loan Performance Corporation* analysts have suggested that the 2001 refinancing boom might have created some adverse selection in mortgage pools originated during the relatively higher interest rate environment of late 1999 and early 2000.¹⁴ Because high-

¹¹ *The Market Pulse*, Loan Performance Corporation (formerly Mortgage Information Corporation), Winter 2001 and Fall 2001.

¹² *The Market Pulse*, Loan Performance Corporation, Fall 2001.

¹³ Per Loan Performance Corporation delinquency data, subprime primary mortgages originated in 2000 displayed higher delinquency ratios for their age compared with similarly seasoned subprime loans originated in 1996, 1997, 1998, or 1999. Moody's second-quarter 2001 *Home Equity Index Update* found the same to be true of subprime home equity loans.

¹⁴ "Another Look at the 2000 Book," *The Market Pulse*, Loan Performance Corporation (formerly Mortgage Information Corporation), Winter 2001.

er-coupon and variable-rate loans comprised a significant share of mortgage originations during that period, overall prepayment rates on the 2000 vintage might have been unusually high during 2001. Consequently, the best-quality loans in the 2000 pool might have refinanced, leaving loans of lesser credit quality behind and elevating the residual delinquency experience in that pool.

Given these trends, an important issue for subprime lenders is their ability to anticipate and plan for the impact of an economic slump on their operations. Some institutions clearly adopt subprime lending as part of an overall business strategy, setting up monitoring and collection departments geared to dealing with such loans. Among large, national lenders, for example, one institution that makes 5 to 10 percent of its loans to subprime borrowers recently provided additional resources to its loan services and default management departments. This action followed a period when one-third of its increase in nonperforming single-family mortgage loans was associated with loans to subprime borrowers.¹⁵

C&D Lending Risks May Be Elevated in MSAs with Potential Supply/Demand Imbalances

Historically, lending to finance housing construction is riskier than mortgage lending on existing structures. Insured institutions report construction and development (C&D) lending in a single category that includes both commercial and residential construction. While it is thus impossible to ascertain from quarterly call reports the extent of bank involvement in financing housing construction, anecdotal evidence suggests that, although smaller insured institutions engage to some degree in commercial property development, their C&D lending largely finances single-family construction. If markets with an oversupply of housing see weaker economic performance, insured institutions engaged in financing residential real estate development may be at risk. This could result in an increase in C&D loan delinquencies, losses, and other-real-estate-owned (OREO).

Demand for housing can be affected by two distinct trends: secular, or longer term; and cyclical, or shorter term. Over the long term, demographic trends, such as population growth rates and concentrations of households by age cohort, can affect overall demand for housing, as well as the types of homes demanded. Demand in local housing markets also can be affected by more cyclical factors such as recent changes in economic

¹⁵ Calmetta Coleman, "Default Worries on Home Loans Escalate as Lenders Report Delinquency," *Wall Street Journal*, October 29, 2001.

conditions, including interest rates. New supply of homes in local housing markets is produced in response to perceived or estimated future demand. Correct interpretation of market and economic signals is critical to the success of builders in metropolitan areas; however, this activity is complicated by the lags associated with developing, permitting, and constructing properties. The effect of overestimating future demand could be multiplied if several builders inaccurately gauge changes in demand. Consequently, a construction market with numerous smaller developers, such as **Atlanta**, may see amplified swings in construction activity and may experience excess supply during certain periods.

Although conceptually straightforward, measuring the balance between housing demand and supply is challenging, particularly at lower geographic levels. Shortcomings in data availability, quality, and timeliness can limit the effectiveness of this type of analysis. As already mentioned, some insight about current housing market conditions in specific metropolitan areas may be gained by analyzing both secular and cyclical trends. However, given the onset of recession last year, the role of cyclical factors is of prime concern at this time.

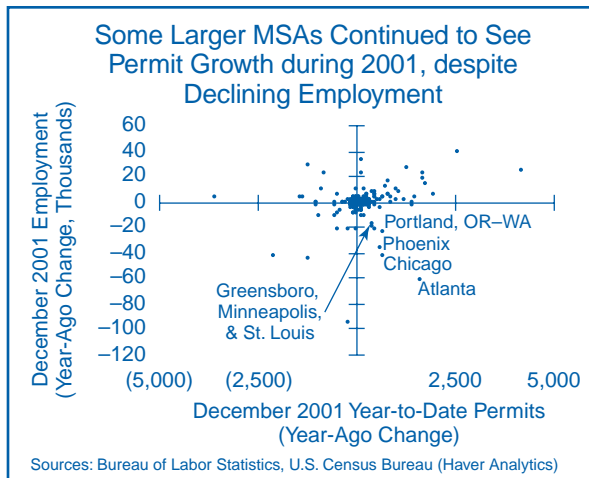
To measure the cyclical aspect of the relationship between a market's supply and demand, some analysts rely heavily on the concept of employment-driven demand.¹⁶ Such analysis involves tracking a demand/supply ratio based on employment growth and permit issuance. Areas where permitting activity continues to accelerate while employment levels decrease may produce an increasing imbalance in the local housing market.¹⁷

Using a simplified version of employment-driven demand, we identified a number of metropolitan areas as being at risk for a rising imbalance in their housing markets (see Chart 5), the largest of which are **Chicago, Greensboro (NC), Minneapolis, Phoenix, Portland (OR-WA), St. Louis**, and, most notably, **Atlanta**. These markets are displaying signs that residential

¹⁶ For example, see www.myersgroup.com.

¹⁷ This approach, although more reflective of recent economic events than perhaps more secular measures, is not without its drawbacks. For example, employment data from the Bureau of Labor Statistics' establishment survey are frequently revised, and, consequently, employment-driven demand may need to be reexamined.

CHART 5



construction activity may not be responding in kind to local economies that have started to contract during this recession. Further, Phoenix, Portland, and Atlanta were identified previously as banking markets exhibiting elevated risk profiles.¹⁸

Chart 6 displays the level (y axis) and trend (x axis) in C&D lending exposures for the top 25 MSAs by median C&D concentration as a share of assets.¹⁹ It is apparent that some markets identified in Chart 5 as having significant banking exposure to C&D lending also may have a cyclical imbalance in home building. Atlanta, for example, demonstrates one of the highest exposures, with a ratio of median C&D to total assets of 17 percent in third-quarter 2001, a roughly 100-basis-point increase from year-end 2000. In other words, while employment-driven demand has softened in the metropolitan area, single-family construction activity has continued, and community bank lenders may have increased their level of residential financing commitments.

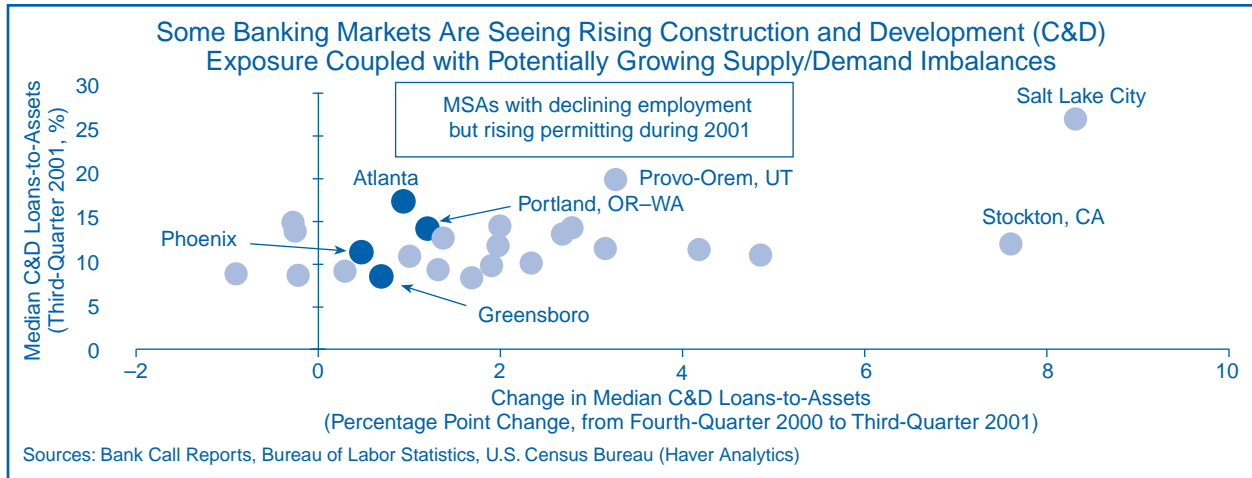
Cyclical Risks May Be Developing with Respect to Home Prices

Popular comparisons have been made recently between the healthy run-up in housing prices during

¹⁸ See "In Focus This Quarter," *Regional Outlook*, Fourth-Quarter 2001.

¹⁹ We considered only MSAs that had at least six locally headquartered community banks that engaged in C&D lending activity and then charted the top 25 MSAs ranked by September 2001 median C&D/assets.

CHART 6



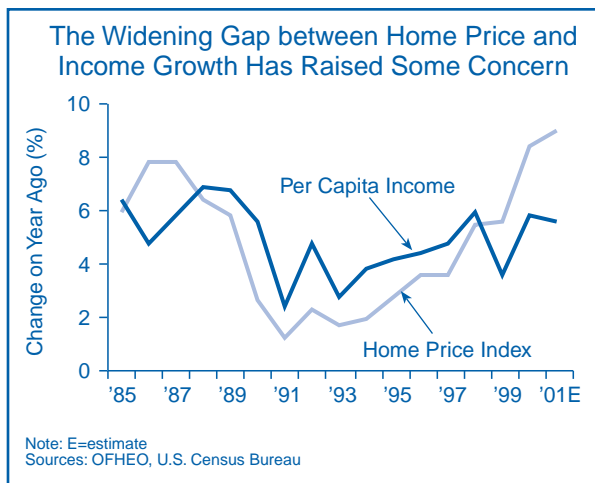
the past several years and the technology stock-fed speculative “bubble” in equity prices that persisted through early 2000. The subsequent bursting of this bubble and the resulting economic distress have raised concerns of a sequel featuring housing prices.

According to the OFHEO repeat sales price index, there has never been an instance of outright declines in aggregate U.S. existing home prices.²⁰ However, home prices do exhibit strong cyclical tendencies, with the rate of appreciation slowing during national recessions. In addition, there have been some decidedly

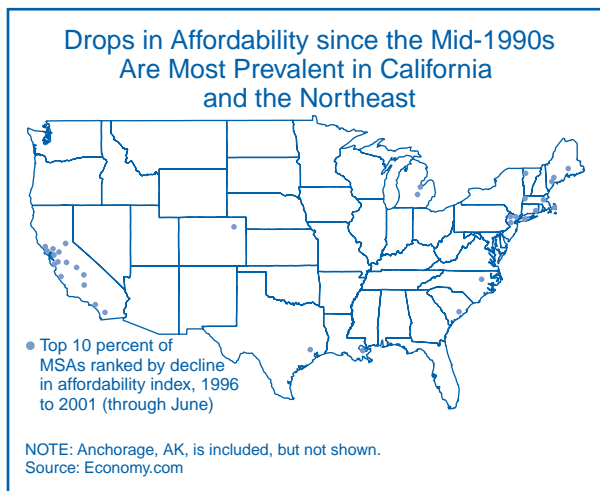
negative episodes during the past few decades in various metropolitan markets. At the national level, existing-home price growth historically has followed trends in population-adjusted personal income growth,²¹ and some have pointed to a growing imbalance between the two as a sign that home prices may weaken as the effects of the recession take hold (see Chart 7).

Given that home price bubbles have occurred in the past, most notably in **Texas**, California, and the Northeast during the 1980s, and that their ultimate deflation

CHART 7



MAP 1



²⁰ According to the National Association of Realtors’ U.S. median price, a few episodes of price declines (on a quarterly, year-ago basis) are present in the time series—specifically first- and second-quarter 1989; fourth-quarter 1990; and first-quarter 1993—only the 1990 episode occurred during a recession. Also, as shown in Chart 1, U.S. median *new* home prices have experienced meaningful declines.

²¹ This relationship is generally true at the metropolitan level as well.

resulted in significant negative fallout for these areas' economies and insured institutions, it is useful to look at these historical examples as a potential "worst-case" scenario (with very low probability) for residential real estate markets during the current recession. It is unlikely that significant, systemic risks from home price bubbles have arisen yet for residential lenders. Of course, this situation could change if the current recession deepens or is protracted, or if growth during the subsequent recovery is anemic. Further, national trends can obscure dramatic variations in local markets, and a handful of MSAs today are coming off several years of rapid home price growth and falling affordability. These markets, and the residential lenders targeting them, may be more at risk as local economic growth falters.

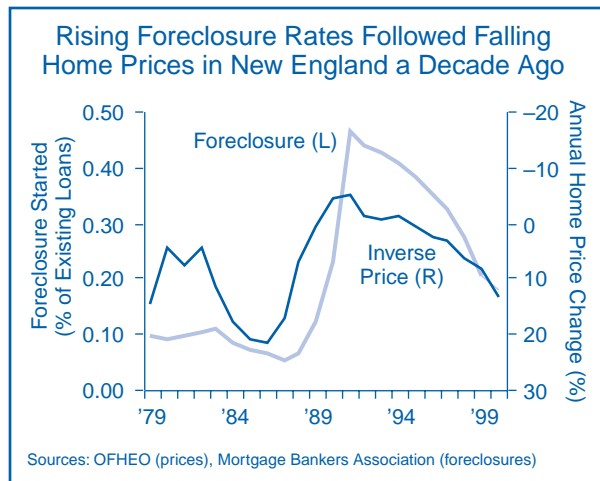
Map 1 shows markets that have seen the most significant reductions in affordability (sharp price gains) during the past several years. Not surprisingly, many of them—namely larger cities in California and the Northeast—are those that historically have seen the biggest swings in prices and a penchant for speculative excess.

In markets with rapidly declining affordability, credit risk arises from the increasing likelihood that new borrowers will commit a greater share of household financial resources to meet monthly payments. Credit problems could become more readily apparent given any subsequent disruptions to employment or income in these markets—especially among households with limited wealth or that require multiple job holders to meet mortgage payments. These risks may be amplified by the increased underwriting of HLTV and sub-prime mortgages during the past decade.

Disruptions to aggregate household liquidity from lost employment or decreased income can result in rising mortgage *delinquencies*. With respect to *foreclosures*, however, some research has suggested that the decline in prices relative to the balance owed on the mortgage (rising loan-to-value ratio) is the most significant factor.²² Even in instances of prolonged job/income loss, owners with positive equity are likely able to sell their

²² For instance, "Mortgage Default Risk and Real Estate Prices: The Use of Index-Based Futures and Options in Real Estate," Case, Shiller, & Weiss, NBER Working Paper #5078, NBER, April 1995, finds this to be the case, while citing past work that identified the link between rising LTVs and foreclosure rates.

CHART 8



homes profitably, thus avoiding foreclosure. Chart 8 shows the strong relationship between declining home prices and increasing foreclosure rates in **New England** a decade ago (the chart plots the inverse price change in order to emphasize the relationship).²³

The data available through late 2001 were mixed with respect to home resale price trends at the MSA level. On the one hand, while existing home prices as measured by the OFHEO home price index showed no markets with year-over-year price declines in fourth-quarter 2001, NAR's median resale price metric did show about a dozen markets with year-over-year declines, none exceeding four percent. A *deceleration* in year-over-year home price growth was evident for many markets (and the nation) using either measure. It should be noted that the OFHEO data do not include sales of high-priced homes and are less influenced by changes in the mix of homes sold than are average and median prices;²⁴ this issue is more meaningful in the nation's most expensive markets, such as MSAs in the

²³ In states where dominant metro areas have seen large price declines in past years, such as Massachusetts, this relationship is more pronounced than in larger states or the nation as a whole. For example, the two-decade correlation between foreclosures started and price change is -78 percent in Massachusetts versus roughly -60 percent in both California and the nation.

²⁴ Data are obtained from aggregating repeat sales or refinancings of the same properties over time and using statistical methods to calculate an overall rate of home price appreciation for each market. Sampled properties are confined to those whose mortgages are "conventional" and do not exceed a conforming loan limit (set at \$275,000 in 2001) required for securitization through Fannie Mae and Freddie Mac. For more information, see www.ofheo.gov/house/.

TABLE 1

AS RECESSION EVOLVED, HOME PRICE APPRECIATION WANED THROUGH 2001 ...FURTHER DECELERATION IN GROWTH (OR DECLINES) MAY BE POSSIBLE IN 2002							
MSAs RANKED BY DECELERATION IN HOME PRICE INDEX FROM 1Q01 TO 4Q01	ANNUAL PERCENT CHANGES						
	OFHEO HOME PRICE INDEX					NONFARM EMPLOYMENT	
	1998- 2000	1Q01	2Q01	3Q01	4Q01	1998- 2000	2001
UNITED STATES	6.3	9.6	9.1	8.8	6.9	2.4	0.3
SAN JOSE CA PMSA	17.7	24.4	16.9	8.4	0.6	3.4	-0.4
SANTA CRUZ-WATSONVILLE CA PMSA	16.8	25.7	17.3	11.9	5.9	N/A	N/A
SAN FRANCISCO CA PMSA	16.5	19.4	13.9	9.1	3.5	3.3	1.3
SALINAS CA MSA	13.7	24.3	22.4	19.0	9.4	3.3	0.9
SANTA ROSA CA PMSA	14.8	22.7	19.6	13.6	8.6	4.1	1.6
OAKLAND CA PMSA	14.7	22.3	18.0	14.1	8.2	3.4	2.0
AUSTIN-SAN MARCOS TX MSA	9.4	15.2	12.1	7.7	5.0	5.9	2.1
MERCED CA MSA	6.4	24.6	21.8	17.3	15.7	N/A	N/A
JAMESTOWN NY MSA	4.9	9.9	0.8	7.4	1.6	N/A	N/A
STOCKTON-LODI CA MSA	9.0	22.8	25.2	20.6	14.9	3.7	3.0
WHEELING WV-OH MSA	4.1	10.8	7.7	11.7	3.7	1.1	-0.5
GOLDSBORO NC MSA	4.0	7.9	3.2	1.6	0.9	N/A	N/A
CUMBERLAND MD-WV MSA	2.7	8.6	8.4	8.1	1.8	N/A	N/A
LEWISTON-AUBURN ME NECMA	4.2	14.0	8.6	10.1	7.1	4.4	-0.4
BANGOR ME NECMA	3.7	13.2	7.4	9.3	6.5	N/A	N/A
FARGO-MOORHEAD ND-MN MSA	4.0	11.1	6.5	5.4	4.6	2.1	-0.3
BARNSTABLE-YARMOUTH MA NECMA	12.8	17.6	14.5	14.6	12.5	3.9	1.3
PINE BLUFF AR MSA	2.2	6.6	9.7	5.0	0.3	0.8	-1.7
DUBUQUE IA MSA	3.9	8.8	6.0	6.9	2.5	1.1	-0.6
BOULDER-LONGMONT CO PMSA	10.9	14.6	11.7	11.7	8.3	5.1	3.2
DENVER CO PMSA	11.1	13.7	11.8	10.9	7.9	3.8	2.3
UTICA-ROME NY MSA	3.5	14.6	9.5	8.4	9.1	2.4	0.1
VALLEJO-FAIRFIELD-NAPA CA PMSA	11.8	20.0	19.1	16.6	14.7	4.7	2.8
BRYAN-COLLEGE STATION TX MSA	4.8	11.1	2.1	5.6	5.8	4.0	0.7
SAN DIEGO CA MSA	11.8	15.6	13.8	12.9	10.4	4.3	2.7
SAN LUIS OBISPO-ATASCADERO- PASO ROBLES CA MSA	11.4	19.2	18.0	17.8	14.2	N/A	N/A
TUCSON AZ MSA	3.3	8.6	8.0	6.8	3.6	3.5	0.8
JERSEY CITY NJ PMSA	8.0	11.1	17.6	13.7	6.2	2.1	2.7
CLARKSVILLE-HOPKINSVILLE TN- KY MSA	3.3	9.1	4.2	6.5	4.2	N/A	N/A
RAPID CITY SD MSA	6.2	8.9	9.3	7.7	4.1	3.1	0.1
LA CROSSE WI-MN MSA	5.7	7.4	5.8	5.1	2.6	2.3	1.0
ST. CLOUD MN MSA	6.9	10.4	8.5	9.4	5.7	3.8	1.4

SOURCES: OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT (OFHEO), BUREAU OF LABOR STATISTICS

San Francisco Bay Area²⁵ and parts of the Northeast, since prices for high-end homes (typically financed by jumbo mortgages) may be more volatile over the economic cycle.

Table 1 lists markets whose 2001 deceleration in home price growth was in the top 10 percent of the more than 300 metro areas for which the OFHEO statistic is available. The table also provides (where available) each MSA's recent employment trend as an indicator of overall economic conditions. These markets may yet see even more pronounced deceleration in home price growth or even declines in home prices this year (as may others not shown). This possibility will be determined for the most part by the performance of each market's local economy.



The metro areas in the table are ordered by the magnitude of their deceleration in home price growth over the initial quarters of this recession. As a result, the marked deceleration in year-over-year price growth in the recently overheated

San Francisco Bay Area puts many of its MSAs near the top of the list. In the table, **San Jose**, **San Francisco**, **Oakland**, **Denver**, and **San Diego** also previously were identified as banking markets with elevated risk profiles.²⁶ For some of the smaller MSAs in Table 1 with more volatile appreciation rates, such as **Utica** and **Fargo**, comparisons of recent price trends are more appropriate using the 1998–2000 average as a benchmark, as these markets experienced pronounced spikes in year-ago price growth during first-quarter 2001.

It is hard to generalize about which markets will see the most pronounced home price weakness as the recession continues. However, certain markets have shown a tendency in the past to be driven to a greater degree by speculative, rather than fundamental, factors. These markets are more likely to see significant downward corrections in price when economic activity falls for a prolonged period or by a sufficient magnitude. One study from the mid-1990s found, in comparing 14 cities in the **North-east** and **West** with 16 inland cities, that while both groups tended to respond similarly to local and national

economic forces (fundamental, or “equilibrium,” price drivers), prices in the former group tended to be influenced to a greater degree by speculative, or “disequilibrium,” variables, including recent trends in price appreciation.²⁷ Cities along the nation's coasts also have tended to see the most significant price swings over the past 20 years.

History also provides some insights into the nature and extent of any price declines in markets where economic conditions deteriorate. A study of two significant examples, Boston and Los Angeles in the 1980s and early 1990s, concluded that declines differed by property type (i.e., condos versus single-family) and price class (i.e., high-end versus entry-level).²⁸ This dispersion in price declines arose from differing rates of appreciation (properties that experienced the greatest inflation during the boom saw the largest deflation) and from the nature of each city's economic decline, which differed according to concentrations of job losses by industry and wage type, underlying demographic factors, and housing supply trends.

Looking at recent developments, it seems that the greatest near-term risk of a significant downward adjustment in housing prices is in the San Francisco Bay area. In recent years, this area witnessed double-digit home price appreciation that exceeded growth in per capita income by a wide margin. A recent analysis from the *University of California-Berkeley's Haas School of Business* forecast that prices in the Bay Area housing market will decline by 15 percent overall (and by 30 percent for luxury homes) by the time the local economy's recession ends late this year.²⁹ Meanwhile, the larger MSAs in **Southern California** have not seen as significant a disparity between home price appreciation and personal income growth during this cycle as during the 1980s. Also in contrast to the 1980s, New England (and the Northeast generally) has seen little speculative purchase or construction activity in recent years, which should help to mitigate any price weakness through the current recession in these markets.³⁰

²⁵ As considered here, this includes the following MSAs: San Jose, Santa Cruz-Watsonville, San Francisco, Santa Rosa, Oakland, Salinas, and Vallejo-Fairfield-Napa.

²⁶ See “In Focus This Quarter,” *Regional Outlook*, Fourth Quarter 2001.

²⁷ Jesse M. Abraham and Patric H. Hendershott, “Bubbles in Metropolitan Housing Markets,” Working Paper #4774, NBER, June 1994.

²⁸ Karl E. Case and Robert J. Shiller, “A Decade of Boom and Bust in the Prices of Single-Family Homes: Boston and Los Angeles, 1983 to 1993,” *New England Economic Review*, March/April 1994.

²⁹ David Goll, “Bay Area Housing Market Will Remain Slow,” *East Bay Business Times*, January 23, 2002.

³⁰ “Regional Perspectives,” Boston Region, *Regional Outlook*, First Quarter 2002.

Conclusion

Home prices are holding up in most markets, and, generally, permanent residential mortgages have fared well in prior recessions. However, history might understate credit risks for insured institutions during this cycle because the mortgage lending business has changed since the last recession. Chief among these changes are robust mortgage market competition, which has contributed to narrower collateral margins; increased reliance on underwriting automation; and expanded involvement in the subprime credit market. In addition, residential C&D lenders in certain markets might be particularly vulnerable, since C&D cred-

its typically undergo higher loss rates and some areas are experiencing continued construction despite a cyclical slowdown (as measured by employment trends). Permanent mortgage lenders in certain areas, such as the San Francisco Bay area, could also face higher loss rates and foreclosures going forward, as the current economic weakness places downward pressure on home prices and dampens the ability of households to meet mortgage payments.

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Atlanta Regional Perspectives

The nation's economic landscape has altered dramatically over the past year, creating possibly the most challenging environment in a decade for insured institutions. Unlike the 1990/1991 recession, which was preceded by regional economic downturns in many areas of the country, the current recession is being felt both domestically and globally. This global economic weakness may affect the depth and duration of the current national recession and the timing and strength of a recovery. The uncertainty and subsequent disruptions caused by the events of September 11 intensified the economic downturn that began last spring.

Various sectors of the economy face many challenges. Business investment may be slow to revive because of reduced corporate profits and underutilized plants and equipment. Near-record consumer debt levels and service burdens, along with a lack of pent-up demand, may forestall a surge in consumer spending. Weak global growth coupled with continued strength in the trade-weighted value of the U.S. dollar could restrict export opportunities. Fiscal stimulus at the federal level may be offset by budget cuts or tax increases by states or municipalities facing budget shortfalls. Monetary policy may take some time to spur economic growth as real short-term interest rates (federal funds rate less inflation rate) remain positive. Consequently, a quick and robust recovery may prove elusive. A persistent disinflationary or outright deflationary environment could present insured institutions with significant challenges. Loan quality could be affected in two ways: collateral asset values could decline, and borrowers' ability to service debt could be reduced if incomes and cash flow fall.

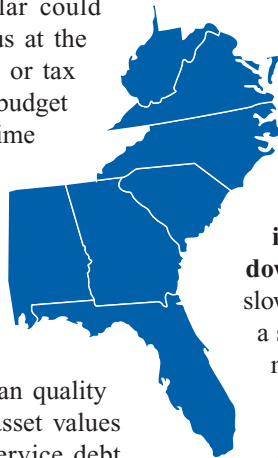
The Region's insured institutions that hold large lending concentrations (at least 15 percent of assets) in traditionally higher-risk categories may be more vulnerable to the effects of the current economic downturn. Within the Region, 361 community banks (assets less than \$1 billion) held large concentrations in

construction and development loans or commercial and industrial loans at third-quarter 2001. During the last recession, community banks with a high lending concentration in these categories were twice as likely to receive a problem bank rating.

Although the capital cushion at Atlanta Region community banks with a high lending concentration has declined modestly, capital levels among other community banks have increased. Community banks in the Region with a high lending concentration report an average equity-to-asset ratio of 10.68 percent. In contrast, the average equity-to-asset ratio among other community banks has increased 88 basis points to 12.51 percent since the last recession.

The Region's new insured institutions also may be at greater risk during the current downturn. About 25 percent of the nation's "non-recession-tested" insured institutions are headquartered in the Atlanta Region. Historically, such institutions are more likely to receive a problem bank rating or fail when they first experience an economic downturn.

Historically strong financial conditions among many of the Region's insured institutions may erode if the economic downturn continues. A prolonged period of slow or negative economic growth combined with a softening in asset prices, particularly for commercial and residential real estate, could have significant repercussions for certain types of the Region's insured institutions. Such an environment would likely be more challenging for community banks with high lending concentrations and startups experiencing their first recession. Typically, these types of institutions perform best in a rapidly growing economy. For this reason, banks with concentrations in traditionally higher-risk assets or that have adopted a business model that relies on rapid economic growth should evaluate their ability to operate during a period of slow economic growth.



Boston Regional Perspectives

The current economic environment in the Region differs from the recession in the early 1990s, when cyclical weakness was compounded by downsizing in the defense industry and overbuilding in the commercial real estate sector. However, certain white-collar industries, such as software and telecommunications, have been more significantly affected than other sectors of the economy during the current recession. A recent study conducted by *Northeastern University* reported that layoff announcements in Massachusetts have been concentrated among information technology (IT) companies, and that unemployment claims in the third quarter were rising three to five times faster in areas with concentrations in IT employment.

The Region's housing market is cooling but remains a faint bright spot in the economy.

Existing home sales growth in the Region was weak through third-quarter 2001 compared with the nation, but remained positive. New home construction, as measured by building permit issuance, slowed in the Region through 2001 following strong gains in the late 1990s. Despite the softening economy, home price appreciation continued in metropolitan areas throughout the Region in 2001, suggesting that the weakness in sales was not due to a softening in demand.

The fundamentals of the current housing market are stronger than during the previous recession. Residential real estate markets in the Boston Region boast little speculative building and a generally limited inventory of unsold homes. However, should the economic downturn continue for some time, softening in housing prices could become widespread.

For many of the Region's insured institutions, the growing concentration of investment in long-term assets may be heightening interest rate risk. The rising exposure is particularly pronounced among the Region's small savings institutions (total assets < \$1 billion); however, many of the trends noted for these institutions are present in large savings banks and commercial banks as well, albeit to a lesser degree.

The persistent decline in net interest margins that has eroded earnings steadily over the past few years appears to be a major contributing factor to the growing concentration in long-term assets. As a result, many institutions are holding higher-yielding, long-term fixed-rate

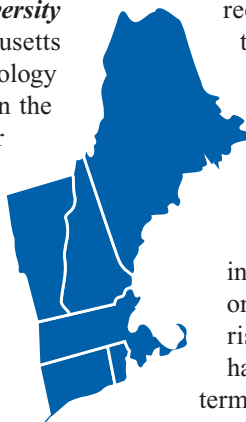
assets in an effort to keep margins from falling further. These efforts to protect the current earnings stream may place longer-term earnings at risk if interest rate risk management does not contain exposure to rising interest rates. In 1995, just 10 percent of savings institutions reported that long-term assets exceeded 40 percent of earning assets. As of September 30, 2001, more than half reported a similar concentration level. The record level of refinancing that occurred in the fourth quarter of 2001 will likely result in higher long-term asset concentrations in the short term.

While asset maturities continue to lengthen, liabilities remain short.

Of all time deposits in the Region's savings institutions, 75 percent mature or reprice in one year or less. This percentage actually has risen over the past few years as customers have become less willing to invest in longer-term instruments.

Longer-dated borrowings are being reported by the Region's savings institutions; however, this lengthening of maturities may not be reducing exposure to higher interest rates. The Federal Home Loan Bank of Boston, the primary source of term borrowings for the Region's savings institutions, reported that as of year-end 2000, approximately 63 percent of longer-term advances (with remaining stated maturity of more than three years) could be redeemed early at the lender's option, with most callable within one year. This fact suggests that a high percentage of the longer-maturity borrowings reported on Call Reports are, in effect, short-maturity liabilities in the event of a rising rate environment.

Clearly, interest rate risk is rising among the Region's savings institutions. Asset maturities continue to lengthen while liabilities remain short. Optionality is becoming a key funding issue, and measuring and projecting the sensitivity of core deposits to rising rates will prove difficult. As a result, interest rate risk measurement and management are becoming increasingly complex. Steps can be taken to mitigate some of the risk; however, there will be a trade-off between short-term profits and long-term earnings stability. Now is a good time for institutions to take action. When the rate cycle begins to turn, risk reduction strategies may be much more difficult to implement.



Chicago Regional Perspectives

The effects of the national recession are keenly felt. The Chicago Region's unemployment rate of 5.4 percent in December 2001 was noticeably higher than its 3.8 to 4.0 percent range during the past three years. However, unlike most prior recessions, recent deterioration in the Region's labor markets has not been more severe than in the national market. This dissimilarity reflects, in part, the fact that the current economic slump involves such sectors as computers, air transportation, and tourism, which are not heavily concentrated in the Region. Even so, output of durable goods manufacturers, which are concentrated locally, continues to decline sharply. Consequently, year-end 2001 employment in the Region was 1 percent lower than a year earlier, with manufacturing employment 5 percent lower.

Lower interest rates are helping sustain demand for interest-sensitive items and enhancing borrowers' repayment ability despite slower growth in personal income and corporate profits. Even so, corporate bankruptcies rose noticeably in the past year, and signs of repayment problems are emerging among households. Should government payments to farmers, a major income source in some agricultural communities, be reduced under the provisions of a new farm bill, signs of stress also could become evident among the Region's small farmers.

Rapid declines in interest rates are affecting net interest margins (NIMs) and asset and liability management. Insured-institution NIMs generally have been shrinking over the past decade. Recently, however, short-term rates have fallen, causing the yield curve to change from inverted in late 2000 to steep and upward sloping by the end of 2001. Consequently, margin compression has reversed in recent quarters amid changing customer preferences and a substantially altered asset and liability management environment.

Falling mortgage rates triggered a surge in refinancing activity and spurred borrower preference for longer-term, fixed-rate mortgages. Higher volumes of mortgage origination activity have been a boon for many lenders, generating more fee income. However, unanticipated principal prepayments can present challenges for banks and thrifts. As long as interest rates remain low,

borrowers are expected to maintain a preference for fixed-rate mortgages.

Securities portfolio trends are helping boost asset yields; however, these trends also increase portfolio sensitivity to changes in interest rates. Securities continue to represent a declining percentage of insured institutions' assets, and there has been a shift toward mortgage-backed securities and U.S. Agencies away from U.S. Treasuries. Also, a general lengthening of maturities or earliest repricing dates among mortgage-backed and corporate debt securities has occurred. Generally speaking, although current NIMs should be helped by these moves, a higher share of longer-term and mortgage-backed securities is expected to increase the sensitivity of securities portfolios to interest-rate fluctuations.



Retail customers now appear to favor shorter-term time deposits as well as nonmaturity money market deposit accounts and savings accounts. Accompanying this change is a move toward longer-term funding in situations where management has the most control over funding maturities, such as brokered deposits and Federal Home Loan Bank borrowings. Depositor movement toward shorter-term instruments will generally help margins in the near term, but this type of funding may reprice quickly when short-term rates increase.

Balance sheet changes associated with falling short-term interest rates in 2001 may have increased the exposure of certain insured institutions to rising rates. Banks and thrifts seeking to maximize current NIMs by increasing long-term, fixed-rate assets and shifting toward earlier repricing and shorter-term liabilities may be vulnerable should short-term interest rates rise or the yield curve flatten. Prudent interest rate risk decisions can be made only by reviewing the totality of an individual institution's rate-sensitive assets and liabilities. To that end, bank management now can review how well interest rate risk management systems performed during the recent period of substantial interest rate changes. In addition, management has the opportunity to ensure that their institutions are well positioned should interest rates either rise or experience significant, nonparallel shifts, such as happened in 2001.

Dallas Regional Perspectives

Potential exists for weakening housing price growth in key Dallas Region metropolitan markets. Denver and Austin were two of the nation's fastest-growing metropolitan economies during the past ten years. In addition to robust employment levels, housing activity in these markets has been strong, spurred more recently by declining mortgage interest rates. However, economic weakening, whether the result of the aftermath of the September 11, 2001, attacks or of the slowing national economy, or both, is undermining the strength of these housing markets. Both metropolitan statistical areas (MSAs) may be vulnerable to weakening housing price growth because of overbuilding and sharp declines in employment growth.

Denver's housing market appears more vulnerable to flagging housing price growth. Since mid-2001, the Denver economy has been adversely affected by the slowing U.S. economy and the effects of September 11. Year-to-year job growth rates have decelerated every month since April 2001, and employment declined 0.3 percent in fourth-quarter 2001 from a year ago. Employment losses have spread beyond the metro area's ailing telecommunications, manufacturing, and travel industries and now are occurring among industries that represent 55 percent of Denver's total nonfarm employment.

Rapidly rising home prices during a period of deteriorating employment growth are unsustainable and could portend significant slowing in housing price growth in the Denver market. The decline in housing affordability could be particularly problematic for the first-time buyer and could dampen trade-up markets. Denver's housing market is overbuilt, and a substantial slowing in residential construction through 2002 is expected. Poor economic fundamentals (deteriorating employment conditions), declining housing affordability, and residential overbuilding are expected to contribute to considerable softening in home price growth in 2002.

The Austin MSA also experienced a deceleration in employment and home price growth in 2001. The Austin economy has been adversely affected by weakness in the computer, telecommunications, and semiconductor sectors, as well as the serious decline in the dot-com industry. However, housing affordability in the Austin metropolitan area remains comparable to the

national average. Still, a growing supply/demand imbalance in residential construction exists.

Housing price growth in the Austin metropolitan area is slowing, particularly for high-priced homes. This sector of the real estate market had been hit hard by weakening in the high-tech sector and the failure of many Internet startup companies. Although housing prices are not expected to depreciate this year, prolonged difficulties in the high-tech sector could change the outlook for home prices in this MSA.



The Dallas, Fort Worth, and Houston economies are characterized by relatively moderate employment growth rates and do not show any serious signs of overbuilding. As a result, home prices are not expected to decline in these housing markets. Employment growth and affordable housing are likely to support some housing price appreciation in these markets in 2002, albeit at a slower pace.

Recent developments affecting collateral values suggest that risk in mortgage lending may be growing. The loan-to-value ratio of many new mortgages is increasing. More than 20 percent of all mortgages originated nationwide in 2001, almost three times the level in 1990, were for more than 90 percent of the value of the house. In addition, the increasing volume of cash-out refinancings has reduced homeowners' equity. Although home prices in these MSAs have not shown widespread declines, anecdotal reports suggest that high-end home prices are coming under pressure, especially in markets that experienced substantial growth in the high-tech sector in the late 1990s but have slowed since.

Recent rapid growth in mortgage portfolios among insured institutions in the five MSAs examined in this article suggests that many of these mortgages are not seasoned and are based on relatively high real estate values. Should home prices decline, many of these mortgages would be left with leaner collateral positions.

Kansas City Regional Perspectives

Wichita could be the Region's metropolitan statistical area (MSA) most affected by the aftermath of the terrorist attacks. Demand for airline travel dropped precipitously following the September 11, 2001, attacks. The travel industry and related companies, such as aircraft manufacturers, were affected most adversely.

The health of the **Wichita** economy is strongly tied to the aircraft manufacturing sector, which includes the area's top four employers; these companies announced significant layoffs or other employment changes following the attacks. Layoffs and any ripple effects could contribute to as much as a 1.6 percent rise in the unemployment rate in 2002.¹

A weakened economy may make it more difficult for businesses and individuals to repay loans at a time when insured institutions headquartered in the Wichita area have heightened credit risk. In the aggregate, institutions in Wichita experienced significant growth during the past three years in construction and development, nonresidential commercial property, and business lending, all of which are traditionally higher-risk forms of lending.

Fortunately, Wichita's insured institutions currently report solid financial conditions. Asset quality indicators remain favorable compared with historical levels. The number of problem institutions and those with troubled asset portfolios is small.

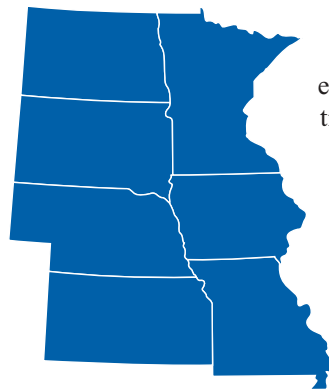
The Region's commercial real estate markets have experienced the brunt of the recession. Data suggest that all commercial real estate (CRE) submarkets—office, industrial, retail, multifamily, and hotel—have weakened to some degree in the Kansas City Region's three major metropolitan areas: **Minneapolis-St. Paul** (Minneapolis), **St. Louis**, and **Kansas City**.

Office and industrial markets show high vacancy rates. *Torto Wheaton Research* data show that the office vacancy rate for Kansas City significantly exceeds the national rate (which increased 4 percentage points during the first three quarters of 2001). Vacancy

rates for the Minneapolis and St. Louis markets are in line with the nation's.

Minneapolis, St. Louis, and Kansas City industrial markets are experiencing rising vacancy rates, but rates remain below the national level. Minneapolis appears to be the most vulnerable to the high-tech sector slowdown in large part because of higher concentration in research and development industrial space.

Retail space and multifamily housing vacancy rates have risen but are not alarming. Vacancy rates for retail space in Minneapolis, St. Louis, and Kansas City, although they reached historically low levels in first-quarter 2000, are expected to rise through much of 2002, but not to levels that may cause concern.



The Minneapolis apartment market remains extremely tight. By contrast, the multifamily housing markets in St. Louis and Kansas City are characterized by significant new supply and sagging demand, a situation most pronounced in Kansas City.

Insured institution exposure to CRE stands at the highest level in a decade. Insured institutions in the Region's three major MSAs are reporting rapid growth in CRE lending and relatively high exposures to this loan type. This growth is occurring as property markets have begun to weaken, suggesting that institutions hold the highest level of new, or "unseasoned," CRE loans in the past decade.

However, current insured institution CRE exposures remain at or below the national level. In addition, although the CRE markets in Kansas City, Minneapolis, and St. Louis have weakened somewhat, they are not among the weakest in the country. Therefore, although insured institutions in these three MSAs face greater challenges related to CRE lending, banks and thrifts in other metropolitan areas could experience greater deterioration in loan quality.

¹ Center For Economic Development and Business Research, W. Frank Barton School of Business, Wichita State University, *Wichita's Economic Outlook 2001 Review and 2002 Forecast*.

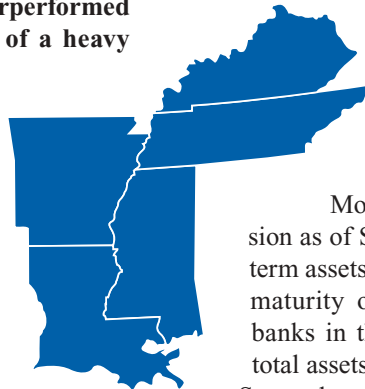
Memphis Regional Perspectives

The mid-South entered a period of economic decline prior to the national recession and underperformed the national economy in 2001 because of a heavy reliance on a weak manufacturing sector. The Region's apparel, automotive parts producers, furniture and fixtures, and lumber industries were among the sectors most affected by the overall slump in manufacturing.

As a result of the disparate economic weakness, banks and thrifts in the Region faced greater credit quality deterioration than those in many other areas of the country. Not surprisingly, banks and thrifts operating in those parts of the mid-South with the highest exposure to the manufacturing sector reported the most significant drop in credit quality.

The Region's manufacturing sector may be slow to recover when the nation's economy begins to improve. By year-end 2001, national manufacturing activity had begun to improve. However, the Region's manufacturing problems stem from structural and cyclical changes, suggesting that improvement in the regional manufacturing sector may lag that of the nation. For example, job losses in the apparel sector, which are likely to continue, appear to be permanent. Also, a previously strong automobile production sector has begun to weaken. Production volume, distinct from industry profitability, remained stable largely because of strong incentives, such as rebates and zero percent financing. The possibility that these incentives pulled automobile sales in 2001 from future sales and an increasing global overcapacity appears likely to lead to reduced automobile production.

Interest rate risk appears to have increased as banks and thrifts faced incentives to increase exposure levels in 2001. Incentives include the need to mitigate margin erosion, rapid balance sheet turnover, and a progressive steepening of the yield curve. The current steepness of the yield curve indicates that most market participants expect interest rates, particularly short-term rates, to rise. Rising short-term rates are likely to have an adverse effect on already depressed margins. The extent of the drain on an institution's earnings performance will be influenced largely by current asset/liability management. *Managers must carefully weigh*



the trade-off of extending assets in an effort to improve margins against the potential adverse effects such asset extension could have on future earnings during a period of rising interest rates.

Most banks reported limited asset extension as of September 30, 2001. The level of long-term assets (assets with more than five years until maturity or repricing) held by all community banks in the Region rose from 15.8 percent of total assets at year-end 2000 to 16.4 percent as of September 30, 2001. Some institutions, many of which were already facing earning pressures, accepted much greater asset extension.

The incentive to extend intensified as the yield curve steepened sharply in late 2001. The asset extension that occurred during the first nine months of 2001 could continue at some institutions because a potential rate "trap" developed in late 2001. Short-term rates (3-, 6-, and 12-month rates) dropped by 140 to 170 basis points from August 31 to December 30. By comparison, long-term rates (10- and 30-year rates) rose slightly during this period. By year-end 2001, managers faced the alternatives of investing short-term at less than 2 percent or gaining 250 to 300 basis points by investing in intermediate- or long-term loans or securities.

Even as assets extended during the first nine months of 2001, depositors migrated to shorter-term products, leading to a modest contraction in liability maturities and repricing intervals. This change in customer preferences included an increase in aggregate balances of money market demand accounts and savings accounts and a switch from longer-maturity certificates of deposits to those with maturities of one year or less.

Interest rate risk management will likely become more complex and important in 2002. The potential for continuing interest rate volatility, this time in a rising rate environment, suggests that sound asset/liability management will be particularly critical to future earnings performance. *At a minimum, managers should ensure that measurement processes accurately assess the effects of changing interest rates on performance, and that institutions operate within sound risk tolerances established by policy or board direction.*

New York Regional Perspectives

The September 11 attacks contributed to weakening in the Region's economy. Before the attacks, the Region's economy, although slowing primarily because of deterioration in the manufacturing sector, was stronger than the nation's. However, the aftermath of September 11, 2001, contributed to weakening in the Region's key sectors, including the financial, airline, and tourism industries. Furthermore, slowing in the national economy following the attacks contributed to additional job losses in the Region's manufacturing sector.

Post-September 11 conditions may result in more layoffs in the Region than in the nation, particularly in areas that depend on industries adversely affected by the attacks. The Region's rate of job growth, while keeping pace with the nation's before September 11, also may lag the nation in the post-attack period because of the economic weight of **New York City**. Though the Region's economic recovery may not match the nation's in timing or strength, it is unlikely to be as prolonged or painful as the Region's recovery in the early 1990s. The pace and vitality of any recovery is likely to depend on several factors, including the industrial mix of local economies and the "pull" effect from the national economy.

The Region's office market conditions weakened moderately in 2001, primarily reflecting reduced demand rather than excess supply as was the case a decade ago. Office vacancy rates increased in most of the Region's major cities in 2001, consistent with national trends, but remained below or near the national average. Vacancy rates rose sharply in downtown **Manhattan** as tenants flooded the market with sublet space.¹ Despite migration of businesses from lower Manhattan, vacancy rates also increased in midtown Manhattan and in northern and central **New Jersey** because of the influx of sublet space. Unlike Manhattan, however, which has added minimal new space, northern New Jersey is facing reduced demand for office space while a moderate amount of construction is nearing completion.²

¹ According to C.B. Richard Ellis, lower Manhattan's office vacancy rate tripled, to 10.6 percent in fourth-quarter 2001 compared with 11.0 percent for the nation.

² Gordon, Sally, January 4, 2002. "CMBS: Red-Yellow-Green Update Fourth Quarter 2001 Quarterly Assessment of U.S. Property Markets," *Moody's Investor Service*.

Banks are better positioned now than during the last recession, but challenges lie ahead. Though credit quality ratios reported by the Region's insured institutions are more favorable than a decade ago, weakness is becoming more widespread. In third-quarter 2001, one-third of the Region's banks reported at least a 25-basis-point quarter-to-quarter increase in the past-due ratio, a slightly higher percentage than a year ago.



The Region's large banks (total assets over \$10 billion) reported continued credit quality deterioration, primarily in commercial and industrial (C&I) loans. Community and regional banks³ reported slightly higher C&I delinquencies, which suggests that weakness, to some extent, has migrated to small- and middle-market businesses. Community and regional banks also reported moderately higher commercial real estate (CRE) loan delinquencies, although past-due ratios are much lower than a decade ago. However, the Region's banks holding the highest CRE loan concentrations are headquartered in large metropolitan areas that have experienced softening CRE markets, such as New York City and northern New Jersey. Moreover, banks with riskier business strategies may be more vulnerable during the downturn. Subprime lenders, in particular, are experiencing greater credit quality and earnings pressures, reflecting the weaker credit profile of subprime borrowers.

Changes in the level and shape of the yield curve have implications for bank margins and interest rate risk management. During most of 2001, community bank funding costs declined to a lesser degree than did asset yields, in part because of deposit maturity schedules. Funding costs are poised to decline further as a large percentage of time deposits are scheduled to mature in the first half of 2002. Margins will likely rise in 2002, benefiting from a steeper yield curve, but competition may constrain margin improvement. Record mortgage refinancings in 2001 may increase concentrations of long-term assets, underscoring the importance of interest rate risk management, particularly for banks that focus on residential mortgage lending.

³ Community banks are defined as insured institutions with total assets less than \$1 billion. Regional banks are insured institutions with total assets between \$1 and \$10 billion.

San Francisco Regional Perspectives

Softening demand for real estate, coupled with increased construction and development (C&D) loan concentrations, could challenge the Region's construction lenders. In addition, community construction lenders headquartered in markets that are highly dependent on cyclical construction employment could see weakening in other segments of the loan portfolio.

The economic downturn in high-tech areas adversely affected the Region's office and industrial markets. The slowdown pushed up office vacancy rates in those metropolitan statistical areas (MSAs) with high exposures to the dot-com and semiconductor manufacturing industries. Several of these high-tech-dependent markets, including **San Francisco, San Jose, Seattle, Oakland,** and **Phoenix**, also have experienced significant office space construction that has continued through much of 2001. Many industrial property markets have also seen softening. Of particular note, **Sacramento** experienced a significant increase in industrial vacancy rates and also had a relatively high proportion of industrial space under construction. Slowed company relocation from the **Bay Area** and falling manufacturing employment adversely affected the outlook for industrial development in Sacramento.

A steep decline in tourism following the September 11 attacks further dampened hotel demand at several of the Region's tourist destinations. For instance, the Bay Area, **Las Vegas**, and Phoenix markets reported above-average annual declines in revenue per available room for third-quarter 2001, as lower occupancies in the final days of September 2001 prompted aggressive room-rate cuts. The San Francisco MSA may be one of the more vulnerable areas given its depressed revenue, lower occupancy levels, and high relative volume of ongoing construction. Relatively robust hotel construction pipelines also characterized several other California MSAs.

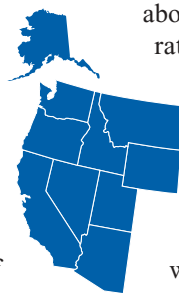
Consumer pressures have affected demand for retail space adversely. Net absorption of retail space was negative in the second and third quarters of 2001 in all of the Region's major MSAs except **Salt Lake City**, as declines in consumer confidence and employment adversely affected retail sales. A considerable increase in the retail vacancy rate combined with a relatively significant volume of construction starts could challenge

C&D lenders in certain high-growth retail markets, such as Las Vegas and Phoenix. Las Vegas experienced lower visitor volumes and tourism employment, while the Phoenix MSA shed high-tech-related jobs.

Employment and affordability issues heighten residential construction concerns. Demand for real estate weakened in some Bay Area submarkets following a softening in the high-tech sector. Meanwhile, the Phoenix, **San Diego**, Sacramento, and **Orange County** apartment markets have experienced rising vacancies and are expected to face significant additions to stock. Many MSAs with significant exposure to the high-tech sector, as well as the Las Vegas market, have reported above-average annual increases in the unemployment rate, a development that could dampen demand for housing. Moreover, home price increases have outstripped personal income growth significantly over the past five years in several California markets. Consequently, insured institutions with C&D loan exposures that are lending in areas of rapidly deteriorating employment, or in markets with affordability pressures, could experience deteriorating C&D credit quality.

Insured institutions that specialize in construction lending could be challenged by the decline in real estate demand. Median C&D loan-to-Tier 1 capital ratios were particularly high among community construction lenders based in the **Provo**, San Jose, Las Vegas, Oakland, **Portland**, Sacramento, Salt Lake City, **Riverside**, and Phoenix MSAs. Insured institutions headquartered in several of these markets reported relatively high C&D loan delinquency ratios as of third-quarter 2001. Lenders typically fund or defer interest payments on C&D loans, thereby avoiding borrower arrearages. Thus, C&D delinquencies could signal serious, unforeseen building delays or other difficulties.

Lenders active in areas dependent on construction employment face additional challenges. Median C&D loan concentration levels tend to be greatest in markets with relatively high levels of construction employment. Consequently, if waning construction activity leads to employment declines, insured institutions active in markets such as Las Vegas, Riverside, Phoenix, Salt Lake City, and **Santa Rosa** could experience deterioration not only in C&D loans but in other segments of the loan portfolio as well.



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