Regional Outlook

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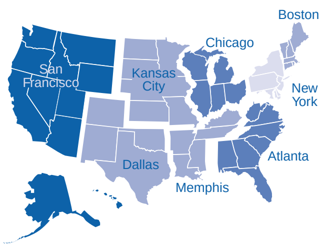

DIVISION OF
INSURANCE

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. Insured depository institutions have reasserted their role as primary sources of capital for this construction boom in the wake of the 1998 financial markets crisis. Recent data 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 3.*

By Thomas A. Murray, Senior Financial Analyst

◆ ***Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate***—**Rising home prices and high levels of activity in the single-family housing market have been supported by excellent economic conditions and generally low interest rates. However, as interest rates have begun to rise, housing market activity has slowed. Historically, residential real estate has been one of the best-performing asset classes at insured institutions. Concerns have recently arisen, however, that new, higher-risk lending lines of business could adversely affect the future credit quality of residential real estate portfolios.** *See page 24.*

By Alan Deaton, Financial Economist

Regional Perspectives

◆ ***Atlanta***—**The expansion of the high-tech industry represents a key component of the economic momentum in many Atlanta Region metropolitan areas.** *See page 30.*

◆ ***Boston***—**The trend of declining capital ratios in many of the Region's insured institutions bears watching, given that some indicators of risk are increasing and new risks are emerging.** *See page 31.*

◆ ***Chicago***—**Broad liquidity measures point to heightened liquidity risk among the Region's insured institutions and emphasize the need for careful funds management.** *See page 32.*

◆ ***Dallas***—**Small insured institutions in the Region's economically robust high-tech MSAs have reported rapid growth, but also increased competition.** *See page 33.*

◆ ***Kansas City***—**The farm bill of 2002 will mark a crossroads in U.S. farm policy, and could have far-reaching implications for farmers and the bankers who lend to them.** *See page 34.*

◆ ***Memphis***—**Although real estate markets have begun to slow, construction loan exposure at the Region's insured institutions continues to rise.** *See page 35.*

◆ ***New York***—**Despite limited office construction and strong demand throughout the Region, the percentage of banks that specialize in commercial real estate lending modestly exceeds levels of the early 1990s.** *See page 36.*

◆ ***San Francisco***—**The high-tech sector boosted economic growth in several of the Region's MSAs. However, insured financial institutions may have increased exposure to more volatile assets.** *See page 37.*

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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.

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

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

Recent Developments

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

[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.

ropolitan 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.

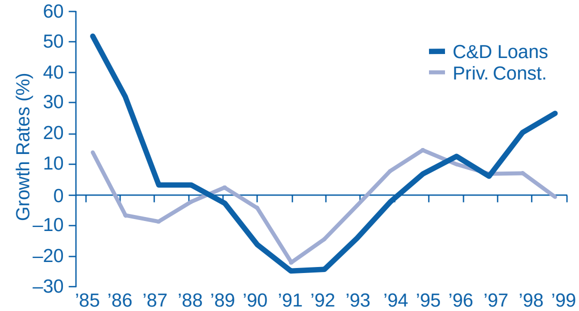
As the capital markets pulled back from CRE investments, insured banks and thrifts stepped in to fill the void. Chart 1 shows that the total volume of C&D loans on the balance sheets of FDIC-insured institutions rose by more than 20 percent per year in both 1998 and 1999, even as growth in U.S. private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

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

[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.

CHART 1

Growth Rates of Private Construction Expenditures and C&D Loans Diverge during the Past Two Years



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.**

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

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

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

Most Active Construction Markets

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

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

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

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

CHART 2

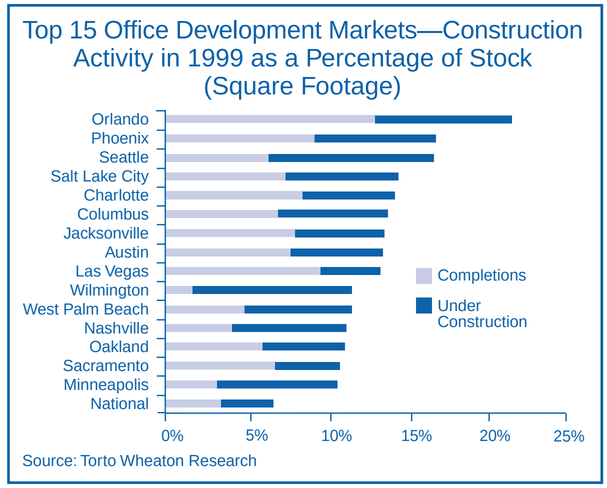


CHART 3

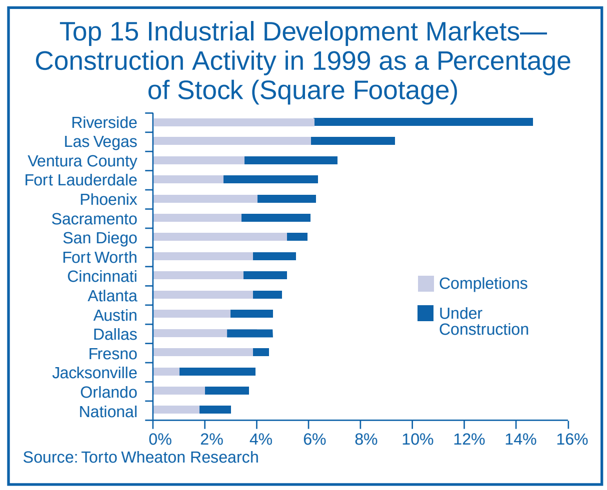
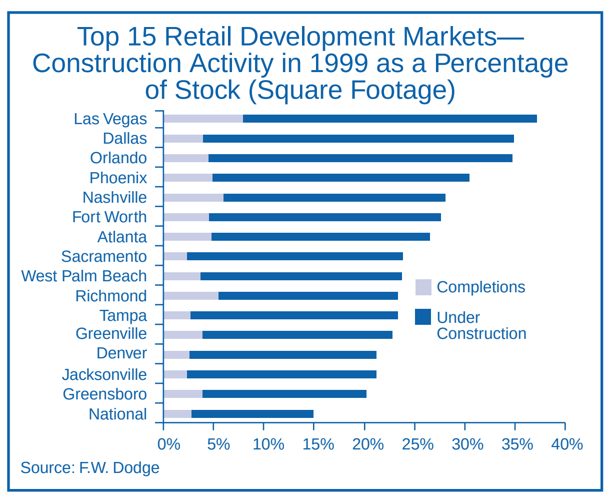


CHART 4



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

C&D Loan Concentrations

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

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

Construction Employment Concentrations

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

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

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

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

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

CHART 5

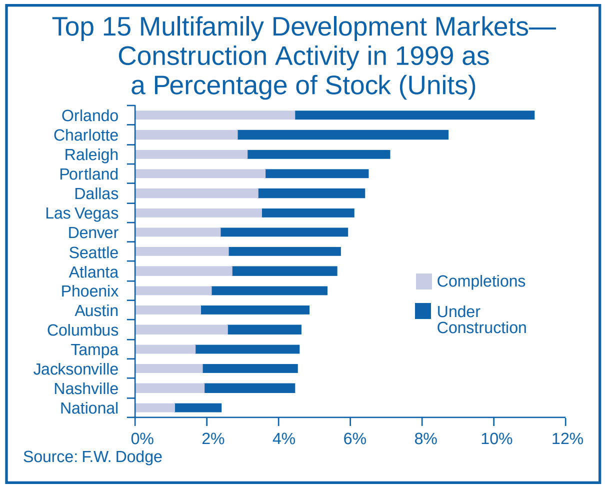


CHART 6

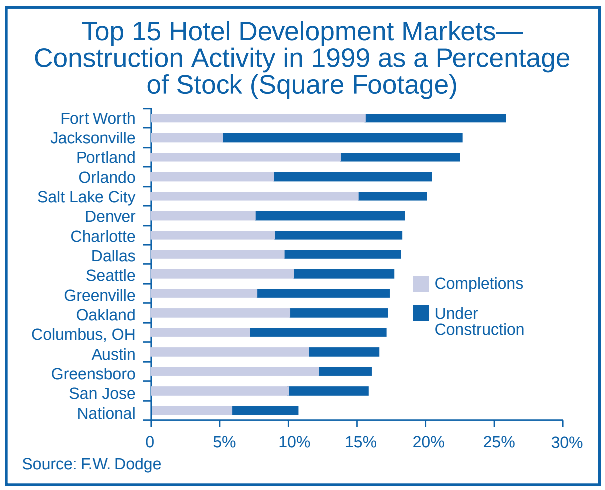
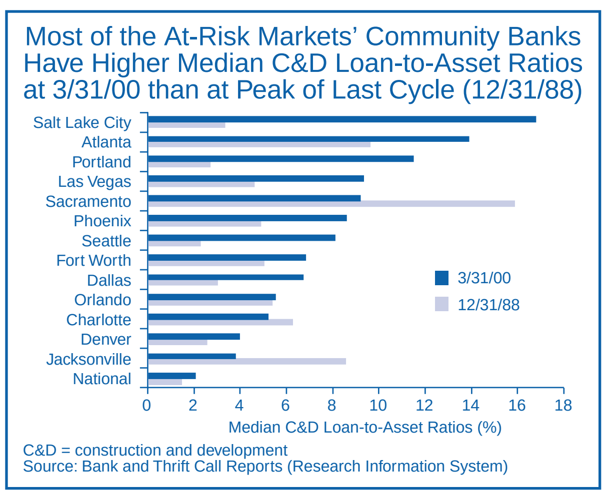


CHART 7



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

High Construction Activity and High Vacancy Levels

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

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

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

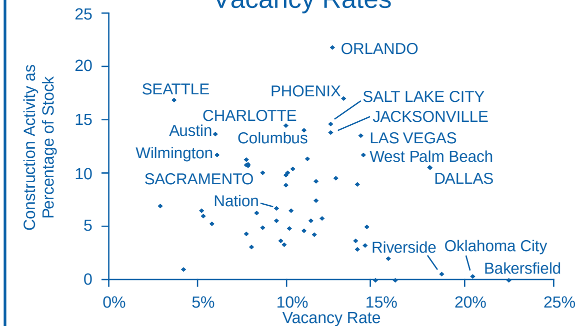
Chart 8

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

Source: Bureau of Labor Statistics (Haver Analytics)

Chart 9

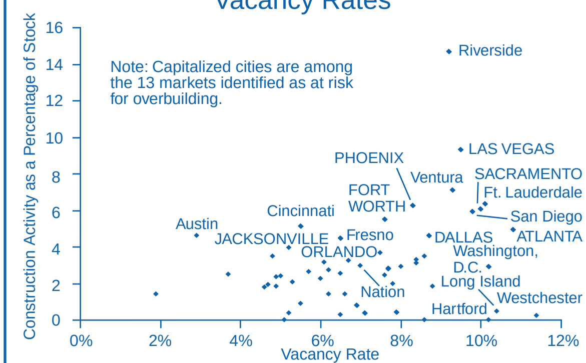
Many of the 13 At-Risk Markets Report High Office Construction Activity and High Office Vacancy Rates



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

Chart 10

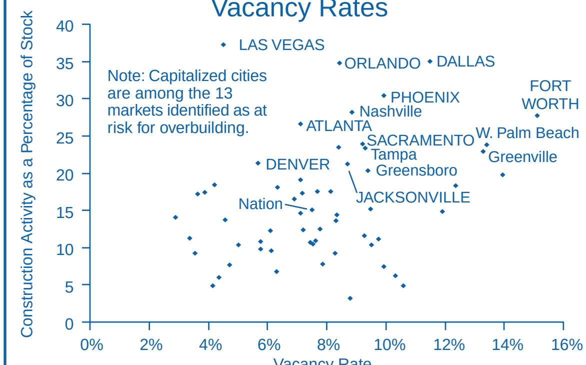
Many of the 13 At-Risk Markets Report High Industrial Construction Activity and High Industrial Vacancy Rates



Source: Torto Wheaton Research

Chart 11

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



Source: F.W. Dodge

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

What Market Analysts Are Saying

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

Office

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

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

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

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

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

Multifamily

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

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

Industrial

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

Retail

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

Hotel

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

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

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

CHART 12

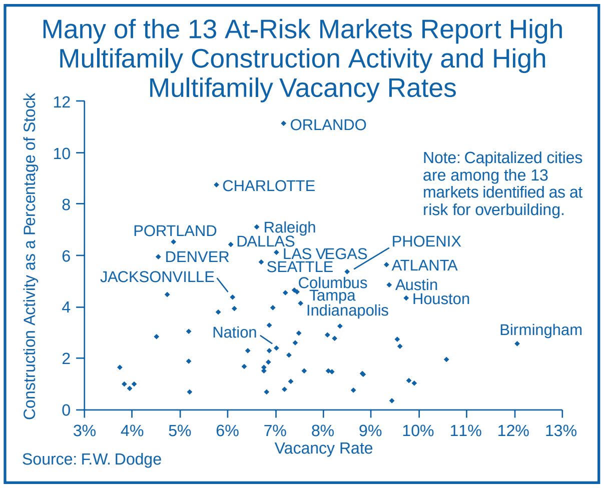
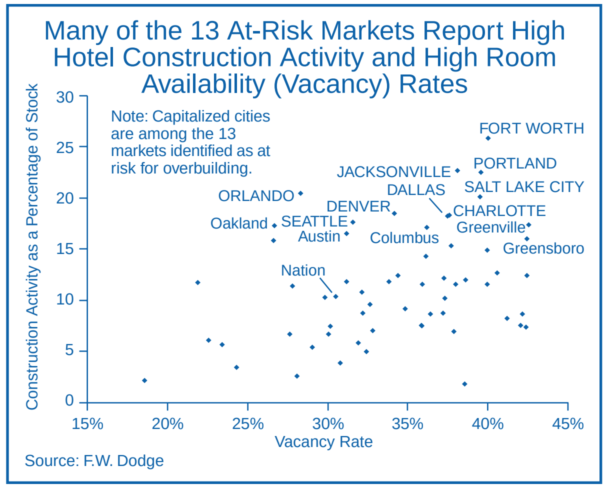


CHART 13



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.

On the basis of the preceding information, the following 13 markets are considered to be most at risk for broad-based overbuilding: Atlanta, Charlotte, Dallas, Denver, Fort Worth, Jacksonville, Las Vegas, Orlando, Phoenix, Portland, Sacramento, Salt Lake City, and Seattle. See page 11.

Thomas A. Murray, Senior Financial Analyst

Markets Most Vulnerable to Overbuilding

Atlanta

Atlanta has enjoyed rapid economic growth for several years and is among the top economic metropolitan area performers in the nation. The essential driver of the growth is the service sector, accounting for half of the jobs created. Atlanta is rapidly becoming a hub for Internet companies. ***Economy.com, Inc.,***[27] estimates the Atlanta high-tech employment at 3.7 percent of the workforce. The Atlanta metropolitan area ranks in the top ten for most active construction retail sectors.

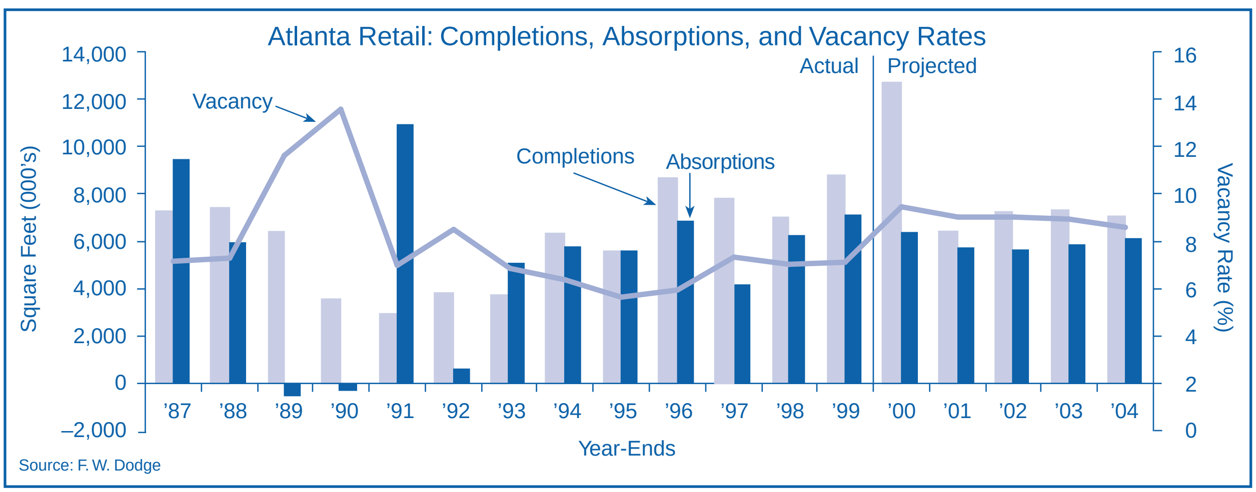
The Atlanta metropolitan market added 8.8 million square feet (or 4.8 percent) to retail inventory during 1999, according to ***F.W. Dodge.***[28] With two new regional malls coming on line, the increase was the largest since the 1980s. Although substantial space remains under construction, F.W. Dodge reports that starts in the first quarter of 2000 were down from one year earlier.

Rapid population and income growth can help support demand for retail space development. Evidence for this can be seen in Atlanta, where population growth averaged 3.0 percent annually during the 1990s. In 1999, the ***U.S. Bureau of the Census*** estimated that Atlanta's population increased by 113,000—the largest increase in a metropolitan area in the nation. Similarly, since 1993, per capita income growth in Atlanta has exceeded the national average. Fueled by the metropolitan area's continued strong growth, retail space absorption in 1999 reached a level last exceeded in 1991 (see chart).

Although Atlanta's retail market continues to expand, new space construction has outpaced absorption (see chart). Consequently, vacancy rates may increase slightly and effective rents, which increased by 3.4 percent in 1999, may see lower gains this year. Unanticipated weakening in consumer demand, economic growth, or net in-migration could adversely affect absorption rates and result in higher vacancy rates.

Many of the 88 community banks (those with assets less than $1 billion) headquartered in Atlanta are actively engaged in local CRE lending. According to first quarter 2000 bank and thrift call report data, C&D loans accounted for 13.5 percent of this peer group's total assets, the highest among the Atlanta Region's metropolitan areas. Nearly one-third of these institutions reported C&D exposures in excess of 20 percent of assets, and several have not been tested by a market or economic downturn. A retrenchment in Atlanta's real estate market could compromise the viability of development projects and consequently affect these institutions' asset quality.

Atlanta Region Staff



[27] Economy.com, Inc., (formerly RFA, Dismal Science), July 2000. *Precis: Metro 2000.*
[28] F.W. Dodge. *REAPS.* Fourth Quarter 1999.

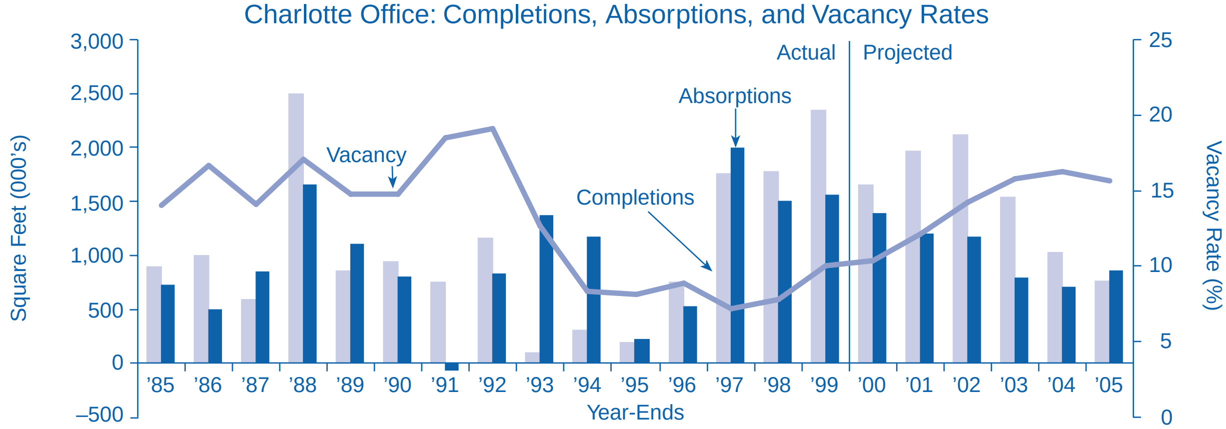
Charlotte

Banking is a critical component of Charlotte's economy and its office real estate market. According to ***Economy.com, Inc.,***[29] the two large bank companies headquartered in the metropolitan area and associated service industries account for 50 percent of office space in the uptown market area. Since 1993, strong absorption due to growth at these two financial institutions helped support increased office space development. The Charlotte metropolitan area ranks in the top ten for most active construction in the office sector. In 1999, a near-record 2.3 million square feet of office space was completed in Charlotte (see chart). However, given the recent decreases in the financial sector's job growth, absorption is expected to decline this year. Recently announced planned cost-cutting and workforce-cutting in the financial sector may exacerbate the threat of weaker absorption and could create the potential for office market oversupply.

Community bank exposure in commercial real estate lending is limited, with C&D loans accounting for 5.5 percent of total assets in first quarter 2000, according to bank and thrift call reports. Of the 22 banks comprising this peer group, only two have C&D loan exposure in excess of 10 percent. Reported past-due C&D loans are low as well. Local bank asset quality may be affected more by the indirect economic effects of cost-cutting and job losses in the financial sector.

Atlanta Region Staff

Charlotte Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

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

Dallas

The Dallas metropolitan statistical area (MSA) is active in all commercial property sectors and ranks in the top ten most-active construction markets in three sectors and twelfth in the industrial sector. Dallas has high vacancy rates in the office sector and moderately high rates in the industrial, retail, and hotel sectors. Office vacancy rates increased from 14.4 percent to 18 percent from year-end 1998 to 1999 (see chart). Rents increased over the period but followed a continued three-year declining growth trend. As of year-end 1999, downtown Dallas had a 29 percent office vacancy rate; its suburban rate was 9.2 percent.

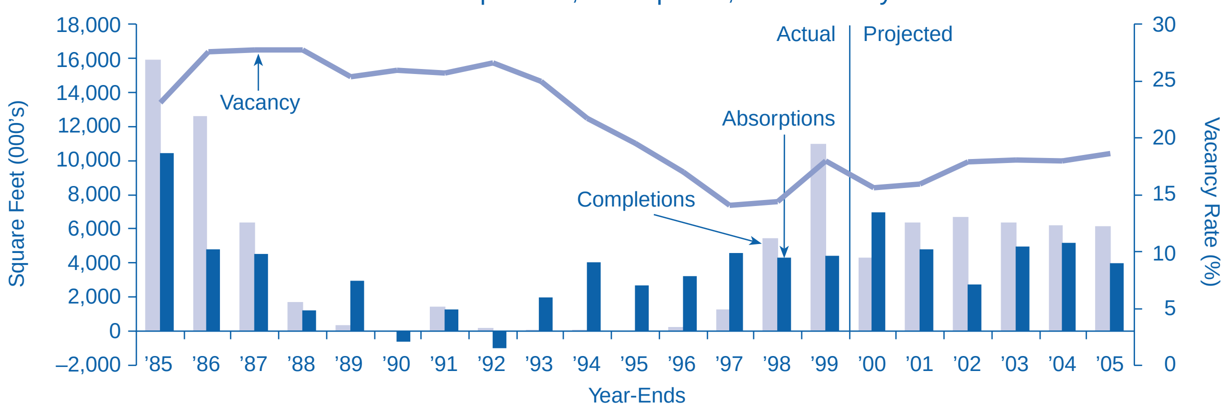
In 1999, Dallas posted its lowest employment growth rate since 1994. Net in-migration in 1999 has also slowed from the previous year. The Dallas MSA boasts an unemployment rate of 3.1 percent, lower than the national rate of 4.2 percent.

Although the Dallas MSA ranks fifth in overall apartment construction, current demand is strong. A number of factors support high levels of demand for apartments. Most notably, rising interest rates made home purchases less attractive for some renters, and employment growth in Dallas regained the momentum that it had lost in the second half of 1999.

Of the 81 community banks in the Dallas MSA at March 31, 2000, over half have CRE portfolios in excess of 100 percent of Tier 1 capital. Reported asset quality for institutions in the Dallas MSA remains strong.

Dallas Region Staff

Dallas Office: Completions, Absorptions, and Vacancy Rates



Source: Torto Wheaton Research

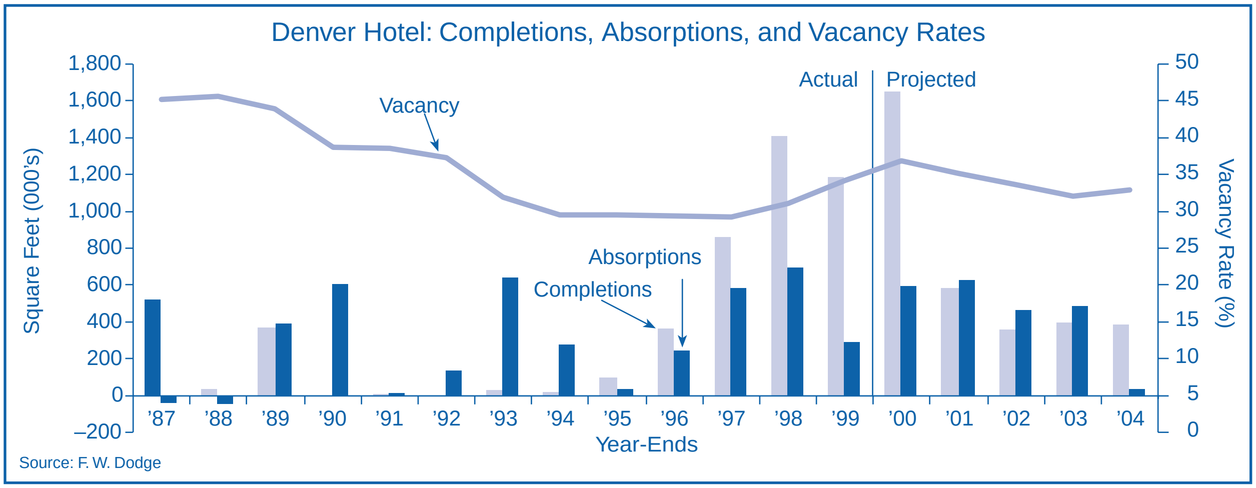
Denver

The Denver metropolitan statistical area (MSA) ranks in the top ten most active for construction for the retail, hotel (see chart), and multifamily sectors. Denver has relatively moderate vacancy levels for each property sector. Analysts have raised concern about the rapidly growing construction in the Denver MSA. The past two years' double-digit growth parallels the growth level last achieved in Denver in the early 1980s, which was followed by a prolonged downturn in its real estate market.

Employment growth in Denver has outpaced the national average since 1991. In 1991, for the second year in a row, Denver posted 3.8 percent growth in total employment, mainly because of the growing telecommunications and construction industries. The boom in Denver employment has been made possible in part by increasing net in-migration levels. Continued employment expansion has pushed 1999 unemployment to a rate of 2.4 percent, with forecasts suggesting a lower rate of 2.1 percent for 2000, creating labor shortages especially in retail businesses.

Of the 54 community banks headquartered in the Denver MSA at March 31, 2000, 36 have CRE portfolios in excess of 100 percent of Tier 1 capital. CRE loans grew 150 percent between December 31, 1995, and March 31, 2000. Reported asset quality for institutions in the Denver MSA remains strong.

Dallas Region Staff



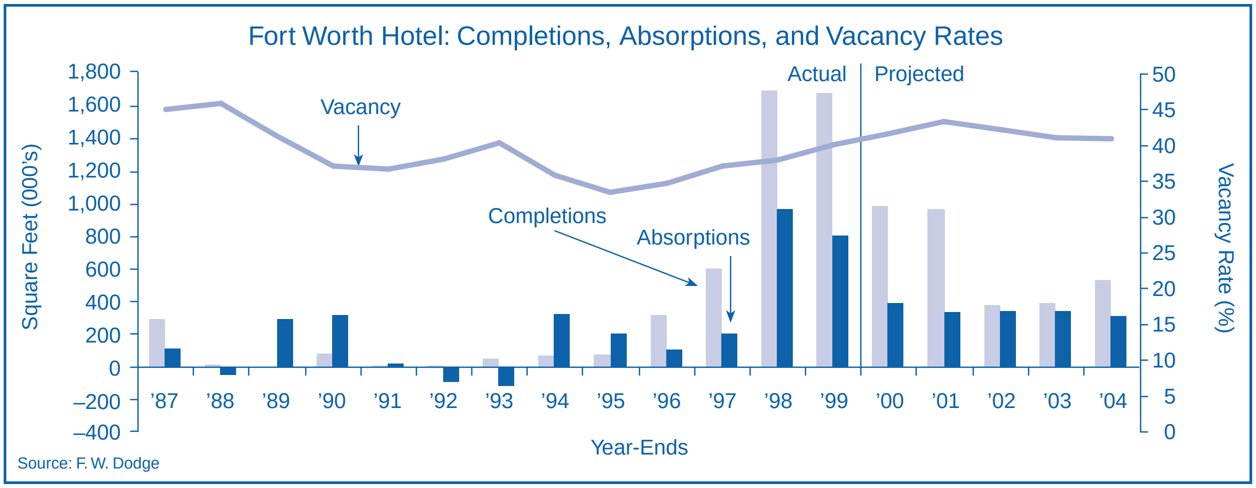
Fort Worth

The Fort Worth metropolitan statistical area (MSA) ranks among the ten most active markets in construction for industrial, retail, and hotel properties. Employment growth in Fort Worth has outperformed the national average since 1993. The robust job market and a favorable cost of living continue to draw high in-migration levels. For year-end 1999, Fort Worth was first in the country for construction activity for new hotels as measured by new rooms as a percentage of existing stock.

Fort Worth has made a significant effort to develop a stock of entertainment and tourist attractions, while manufacturing and distribution remain the economy's strongest drivers. Fort Worth's 1999 employment growth was the ninth highest of the country's metropolitan areas. Hotel occupancy rates have fallen steadily in this MSA since 1995 because of an abundance of limited-service and extended-stay hotels (see chart). A 1,500-room Opryland-Grapevine Hotel is scheduled to open in 2002.

Of the 38 community banks located in the Fort Worth MSA at March 31, 2000, 33 have CRE portfolios in excess of 100 percent of Tier 1 capital. Reported asset quality for institutions in the Fort Worth MSA remains strong.

Dallas Region Staff



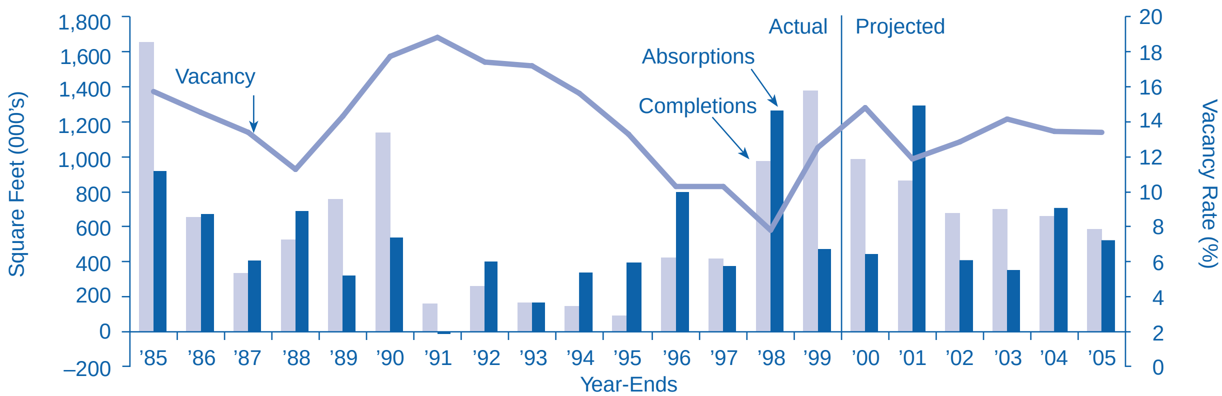
Jacksonville

The Jacksonville metropolitan area ranks in the top 14 most active construction markets for all five property sectors. It ranks second and seventh highest for hotel and office construction. At the same time, Jacksonville has moderately high vacancy levels for office (see chart), retail, and hotel spaces. Jacksonville's office rental rates fell 3.2 percent between year-end 1998 and year-end 1999 at the same time as the suburban office vacancy rate jumped from 8 percent to 15.3 percent. One of the greatest concerns in the metropolitan area's CRE market is too much new office supply coming on-line. Population growth has slowed, primarily because of the closing of a naval base and employee relocations. Analysts report the hospitality sector as having a static occupancy level as a result of a large number of new properties, and report that more are in the pipeline.

Jacksonville's 13 community banks have limited exposure to CRE development lending. In first quarter 2000, construction and development loans accounted for 2.2 percent of this group's total assets.

Atlanta Region Staff

Jacksonville Office: Completions, Absorptions, and Vacancy Rates



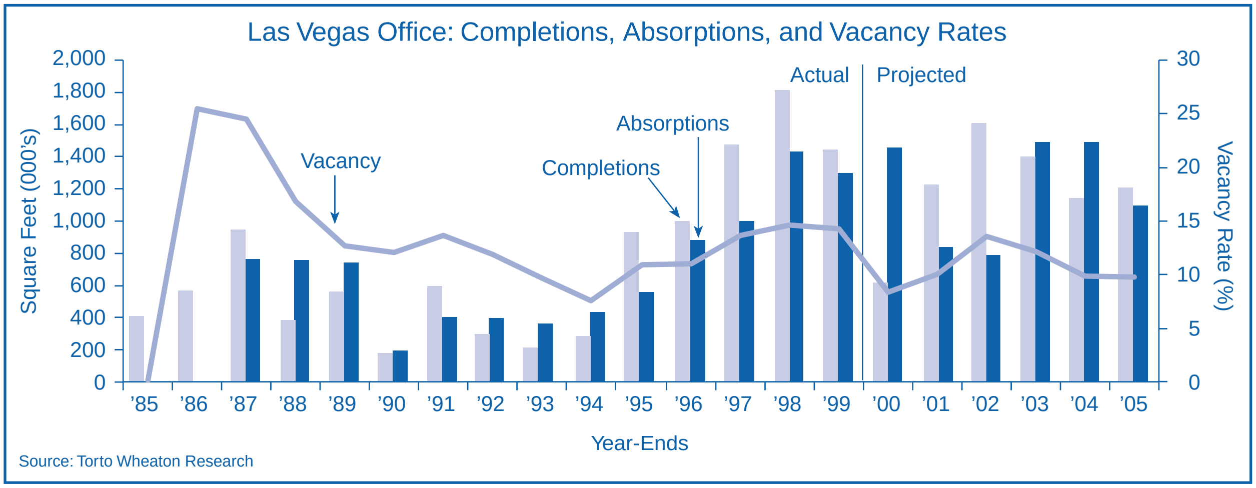
Source: Torto Wheaton Research

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



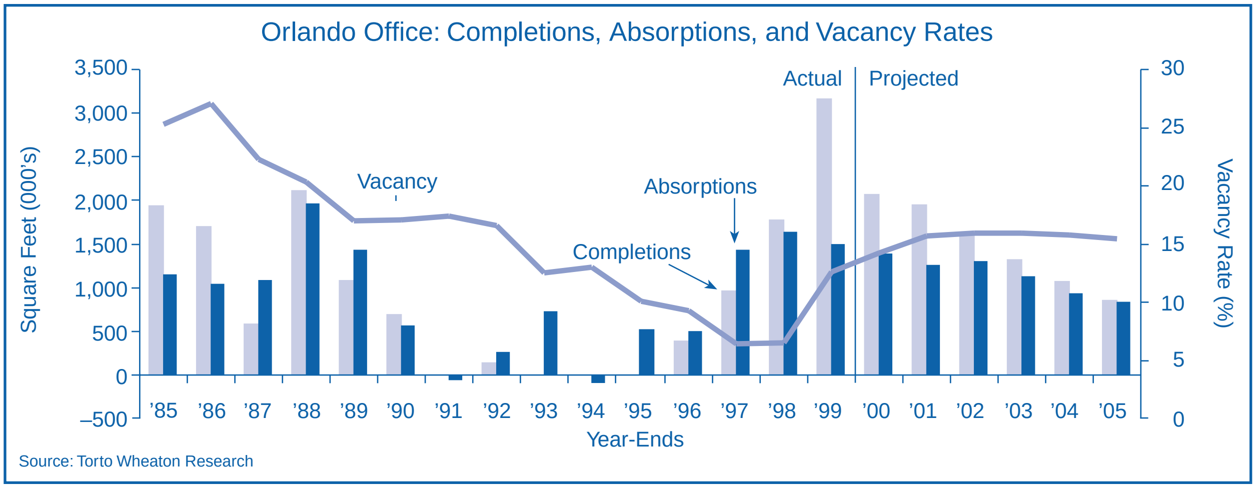
Orlando

High levels of in-migration and a rapidly expanding economy have helped foster a favorable environment for CRE development. Orlando has the most active construction market in the nation as a percentage of stock. It is first in both office and multifamily construction and third and fourth, respectively, for retail and hotel construction. Office construction has increased over the past three years, and 1999 saw a record 3.16 million square feet in completions delivered to market, according to ***Torto Wheaton Research***[30] (see chart). Many analysts expect 2000 to be a pivotal year in Orlando's office market as completions could rise to nearly 3.5 million square feet.

Orlando is more dependent than perhaps any other metropolitan area on continued high levels of economic growth to generate sufficient demand to absorb the large supply of new construction products. However, net absorption is expected to moderate this year, while completions continue to increase substantially.

The majority of Orlando's 26 community banks have limited exposure to local CRE lending. According to first quarter 2000 bank and thrift call report data, C&D loans accounted for 6.8 percent of this peer group's total assets.

Atlanta Region Staff



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

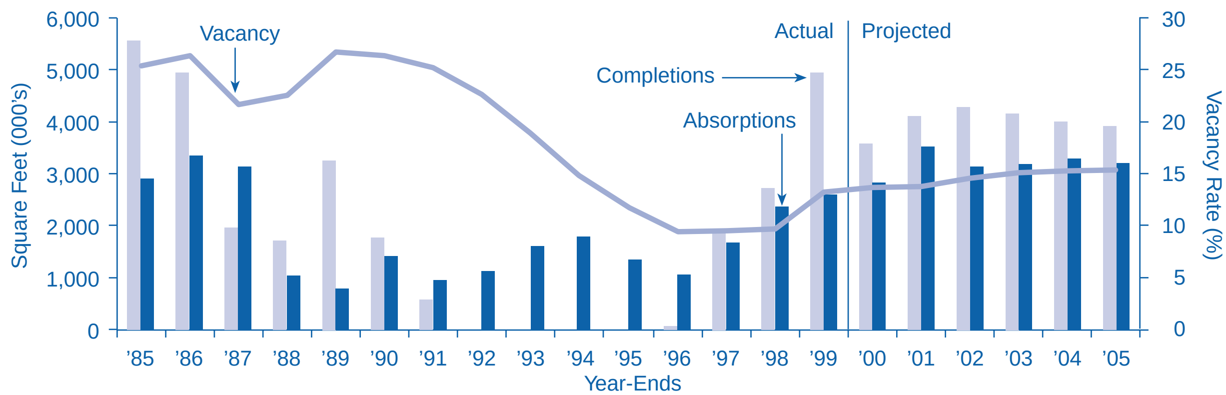
Phoenix

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***[31] 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

[31] 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.***[32]

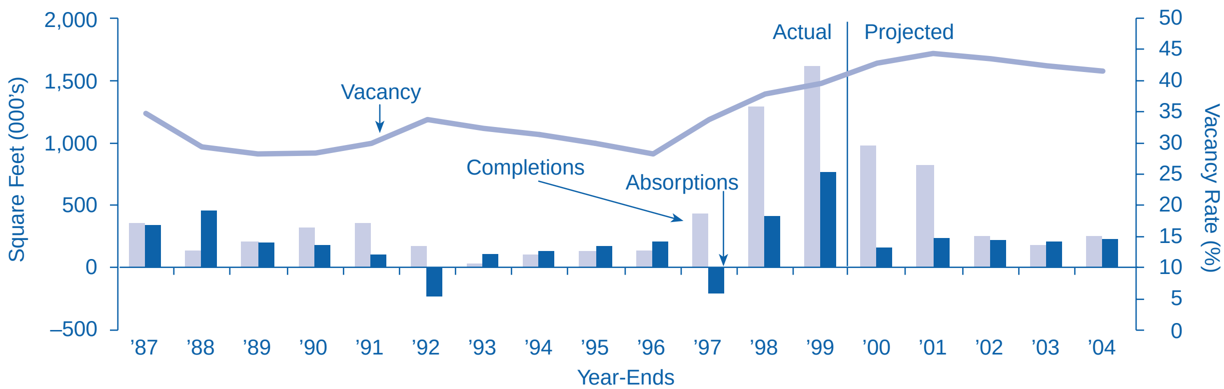
With recently improved demand from Asia, job gains in Portland's high-tech sectors have offset the slowing employment growth in the services and lumber sectors. Payrolls in high-tech subsectors, such as the electronic and electrical equipment industry, saw significant growth during first quarter 2000. 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

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

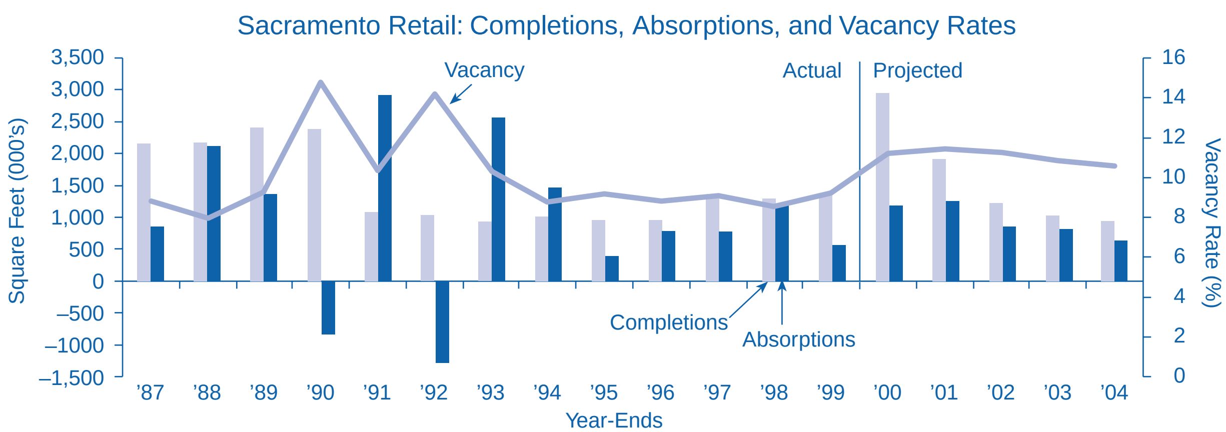
Sacramento

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***[33] 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***[34] 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.

Phil Vincent, Regional Economist



Source: F. W. Dodge

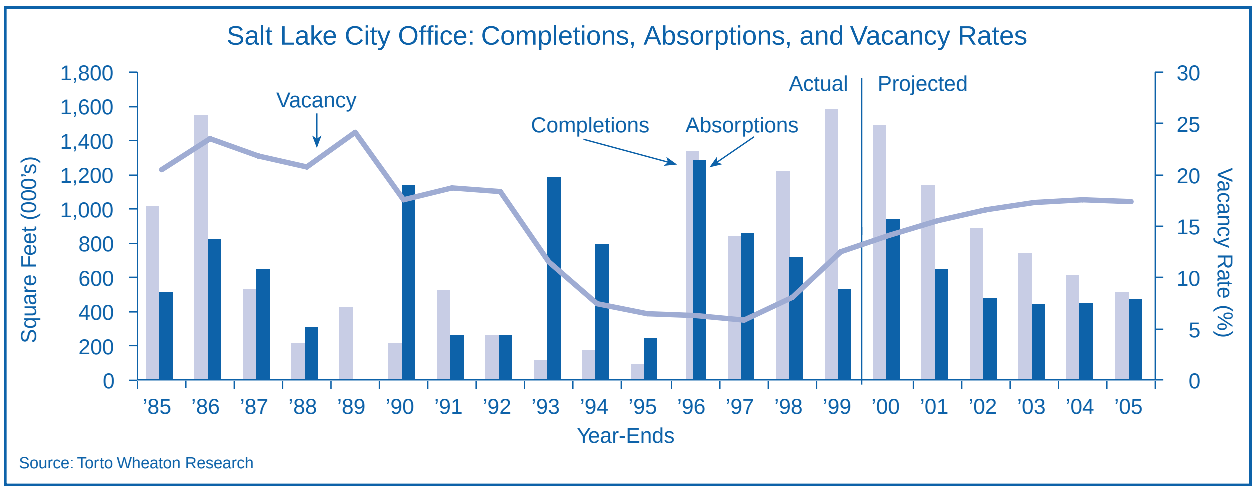
[33] F.W. Dodge. *REAPS.* Fourth Quarter 1999.
[34] Torto Wheaton Research. Spring 2000. *Office Outlook.*

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



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.

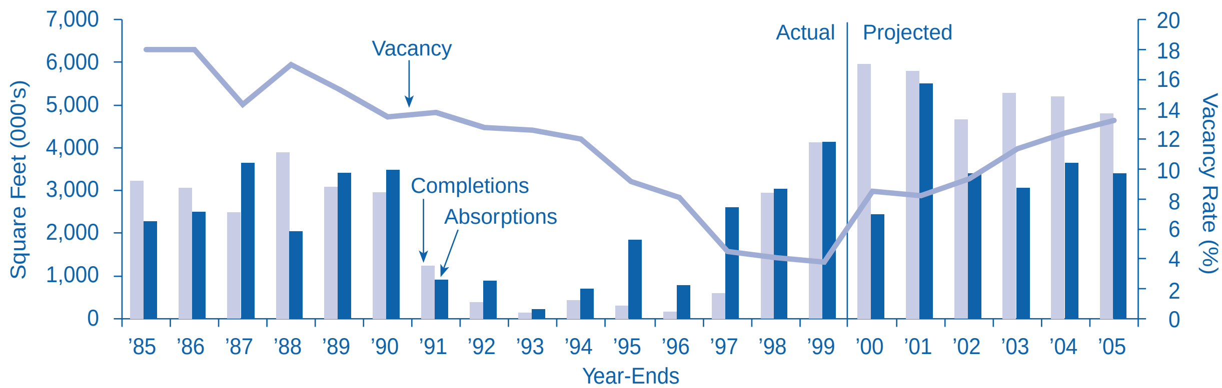
The vacancy levels for all five property sectors in Seattle are below national averages. The downtown Seattle office market has an enviable vacancy rate of only 1.4 percent and over 100 percent absorption for the past four years. A recent study by ***Torto Wheaton Research,***[35] however, predicts much 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

[35] 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.

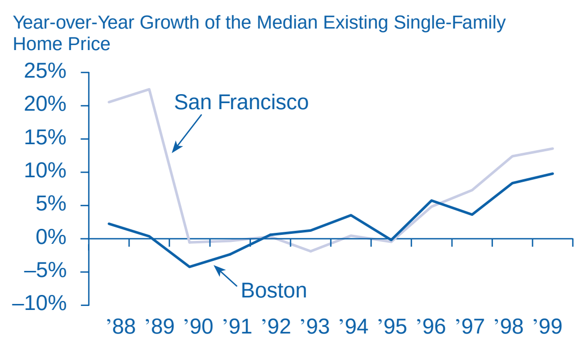
Home Prices in Some Local Markets Are Soaring

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.

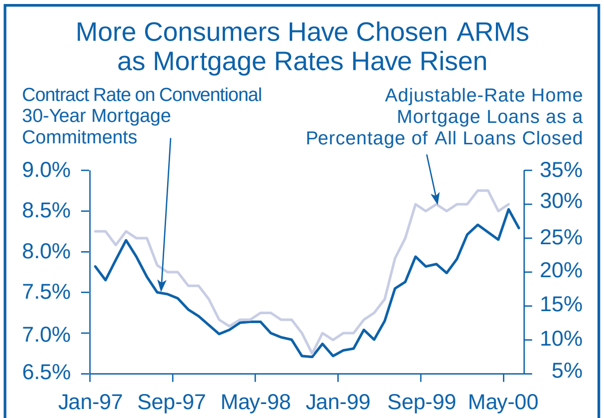
One of the only negative aspects for consumers has been the recent rise in interest rates, which has increased the cost of borrowing. From the end of 1998 to June 2000, both the bank prime lending rate and the average mortgage contract rate for purchase of a previously occupied home rose by more than 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]

CHART 2



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

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).

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

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

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

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

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

CHART 3

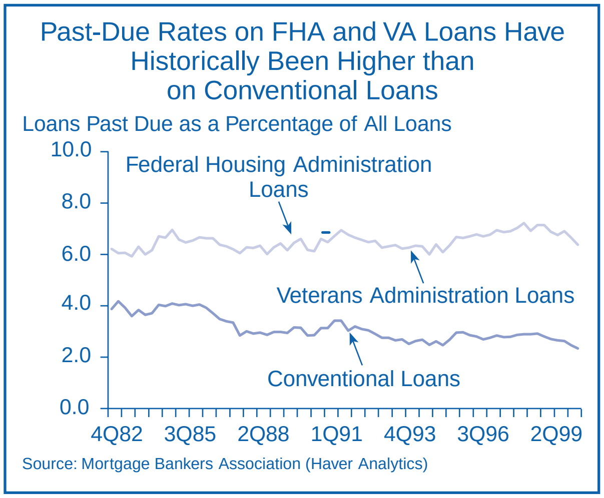
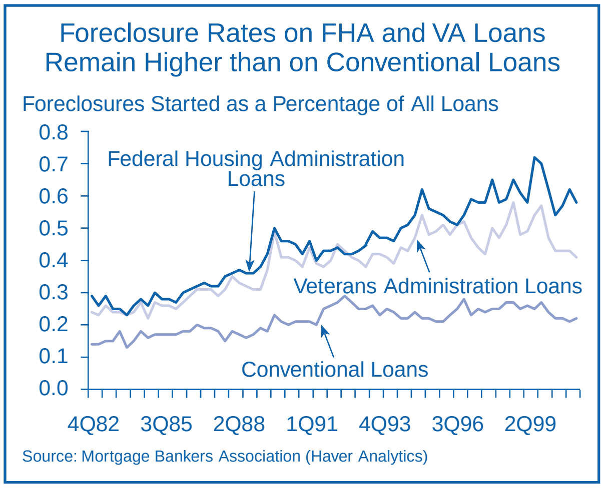


CHART 4

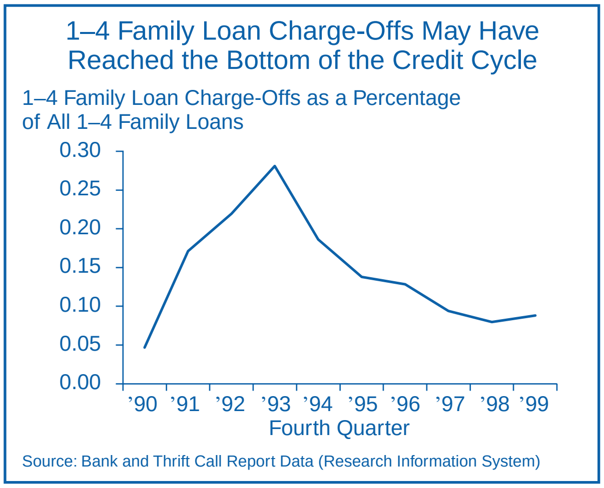


A trend toward higher charge-off rates might be cause for concern at a time when conditions in the consumer sector seem to be excellent. Moreover, as with regional problems that surfaced in the late 1980s and early 1990s, the aggregate data may still mask evolving submarket residential real estate problems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

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

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

CHART 5



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

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

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

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

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

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

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

Table 2

Pockets of Risk May Be Forming Where the LTV Is Highest

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

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

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

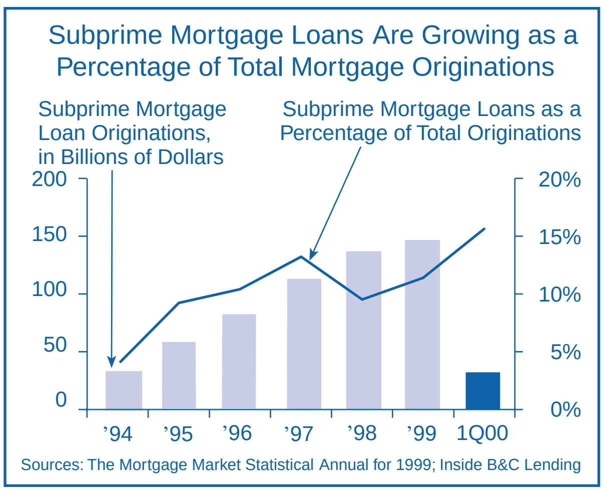
[9] See also Kathy R. Kalser and Debra L. Novak. **"Subprime Lending: A Time for Caution."** ***Regional Outlook,*** third quarter 1997; http://www.fdic.gov/bank/analytical/regional/ro19973q/pdf/roa1997.pdf.

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

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

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

CHART 6



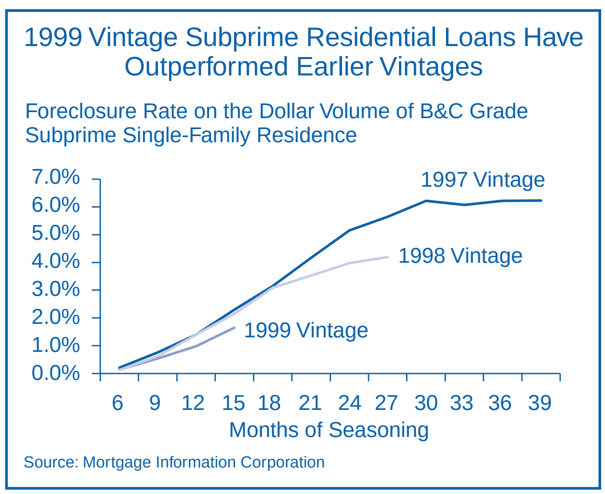
Conclusion

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

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

Alan Deaton, Financial Economist

CHART 7



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

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

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

Atlanta Regional Perspectives

The expansion of the high-tech industry has represented a key component of the economic momentum in many Atlanta Region metropolitan areas. A perception that high-tech growth is the key to guaranteed, rapid, and sustained economic development may be emerging. The addition of over one-quarter million new, high-paying, high-tech jobs to the Atlanta Region during the 1990s has undoubtedly helped fuel economic growth. The higher incomes have helped boost demand for local goods and services, including real estate development, generating a positive spillover effect in the rest of the economy. However, factors could coalesce and make it problematic for the high-tech industry to continue its strong performance. Slower economic growth could result in declining real estate absorption or weakening credit quality if layoffs occurred. Lenders should be aware that, as growth becomes more dependent on high-tech development, setbacks in the industry could reverberate throughout the rest of the economy and potentially affect insured institutions' asset quality.

De novo bank activity in the Southwest Florida market increases. The analysis presented in ***Atlanta Regional Outlook,*** first quarter 2000, suggested that economic and demographic growth and industry mergers and acquisitions (M&As) are correlated with the incidence of new bank charters. Southwest **Florida's** population increased significantly with the addition of approximately 300,000 new residents during the 1990s. The area's average annual population growth of 2.2 percent from 1990 to 1999 was one-half percentage point above the average for Florida and over twice that of the nation. M&A activity has been robust, as 27 of the 41 insured institutions headquartered in the area in 1991 have been acquired. A majority—22 institutions—have been acquired by out-of-state banking organizations.

During the 1990s, 25 new institutions were chartered in Southwest Florida, including six in 1999. As of fourth quarter 1999, a total of 39 community institutions, each with assets less than $1 billion, were headquartered in Southwest Florida. Over 60 percent of these insured financial institutions, accounting for 33 percent or $1.7 billion of the area's total assets, have never experienced an economic downturn.

The rapid pace of new institution openings and the large number of merger transactions have changed the competitive landscape for deposits in Southwest Florida. The M&A activity has resulted in out-of-state acquirers holding more than 73 percent of deposits in Southwest Florida, compared with only 42 percent in 1991. The preponderance of out-of-state institutions may affect competitive aspects of the local market through the types of services and products offered and differences in corporate cultures.

In general, the new entrants to the market have pursued different lending strategies than have established players. The differences may result because established firms may have long-standing customer relationships, gained a reputation, or developed a niche or a risk preference that results in domination of certain segments of the local lending market. Alternatively, differences in loan portfolio structure could derive from new firms trying to reach the break-even point more quickly by focusing on originating larger or higher-yielding loans. For example, a majority of the non-recession-tested institutions are engaged more heavily in construction and development lending. Anecdotal reports also suggest that new entrants are engaging in out-of-territory lending by purchasing loan participations or establishing loan production offices outside Southwest Florida because of intense lending competition.

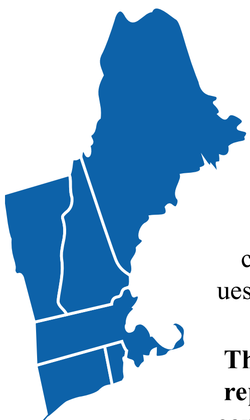
Given the preponderance of real estate-related lending among new entrants, continued expansion and absorption in local real estate markets may be critical to the prospects of Southwest Florida's non-recession-tested banks. Despite recent strong performance, Southwest Florida's economy and, consequently, real estate markets are not without risk. A weaker real estate market combined with greater competition in the local banking industry, as new entrants increase, could affect institution earnings.

In addition to the risks facing the Southwest Florida real estate market, the local banking industry may face challenges simply by virtue of the pace of new institution chartering activity—is the market deep enough for these new entrants to gain market share at reasonable costs?

Boston Regional Perspectives

The Boston Region continued to experience healthy job growth through the first six months of 2000. Labor markets generally continued to tighten. The Region's 1999 per capita income growth again exceeded the nation's.

The Region's insured institutions continue to report stable conditions. Excluding credit card specialists, the aggregate return on assets for the Region's banks in first quarter 2000 was up modestly from the prior year. Net interest margins of larger institutions (assets greater than $1 billion) continued to decline, while margins at smaller institutions remained relatively flat. Core deposits as a percentage of assets continued to decline for all asset categories in the Region's insured institutions. Commercial and industrial lending continues to be brisk and widespread.



The Region's insured institutions report relatively high levels of capital; however, aggregate capital ratios have been declining in publicly held institutions. The trend of declining capital ratios bears watching given that some indicators of risk are increasing and new risks are emerging.

One indicator of heightened credit risk is the increase in the ratio of risk-weighted assets to assets. Two factors appear to contribute to the higher level of risk-weighted assets. First, the mix of assets that insured institutions maintain on the balance sheet is evolving away from lower-risk residential loans and U.S. Treasury and government agency securities. Second, growth in two off-balance-sheet items may be raising the level of risk-weighted assets. These items are increases in unfunded commitments and increasing levels of asset securitization. Other factors affecting capital adequacy include rising interest rate risk; funding pressures; regulatory changes; certain advancements in technology that may jeopardize future earnings growth; shrinking loan loss reserve levels; and the expansion into new business ventures, such as insurance and securities underwriting and sales.

In the past few years, large public institutions have adopted a greater degree of operating leverage to improve shareholder returns. This strategy has improved short-term equity returns during the current period of prosperity but may exacerbate poor returns during a period of financial hardship.

In New England the general surge in equity valuations in the latter half of the 1990s most likely significantly boosted household income, wealth, and business hiring and investment. This linkage could pose a risk to the Region's economic growth in the event of a significant, sustained market correction. Many U.S. households have enjoyed increased employment opportunities, income (through higher pay, bonuses, and stock options), and investment gains thanks to the rising stock market. Appreciation in home equity has also benefited household wealth. These factors likely have led to increased consumer spending. The strong stock market also has boosted business spending and investment by providing many firms with a lower cost of capital, decreased pension funding costs, and increased product demand. For example, certain industries, such as securities/asset management, usually increase employment and pay concurrent with any escalation in equity markets. Others, such as information technology, rely to a great extent on equity gains or venture capital funding to support ongoing operations. Growth at these companies is also financed primarily through equity.

Most insured institutions in the Region have very modest exposure to highly valued equity markets, either in terms of directly held equities or through merchant banking operations. However, should the Region's economy falter because of weakness in the stock market, consumer and business credit lines could be negatively affected. Yet any such weakness would likely need to be severe, prolonged, and accompanied by other significant factors (such as a national recession) in order to result in an outright recession in the Region's economy.

Also of concern is that some homes and commercial properties currently may be experiencing levels of valuation that are sustainable only under a scenario of strong equity markets. Thus, property values could fall abruptly should a severe correction in equity markets occur that results in significant job or income losses by employees at area financial services or information technology firms.

Chicago Regional Perspectives

Despite rising interest rates, economic conditions remained healthy at midyear 2000, and activity in some industries strengthened in the past year. Growth in the Midwest Manufacturing Index[1] accelerated after mid-1999 despite rising interest rates. Meanwhile, the Region's 3.7 percent unemployment rate hovered near its record low. Banks and thrifts in the Region reported median loan growth of 11 percent during the year ending March 31, 2000.

Recent conditions, however, do not mean that the Region's economy has become noticeably less sensitive to interest rates. Rather, other factors apparently tempered the effect of rising interest rates through mid-2000:

- About half of the recent increase in interest rates merely reversed the 1998 decline during a period of financial market turmoil.
- The results of tighter monetary policy may be slow to manifest themselves. The economy's strength in early 2000 may reflect the tail end of stimulus from interest rate reductions in 1998. Conversely, the effect of a 50-basis-point increase in short-term rates in mid-May 2000 may not yet be evident.
- Interest rates are not the sole driver of economic growth. To date, for example, the dampening effect of rising interest rates may have been mitigated by continuing job growth and reviving foreign demand for the Region's output.
- Consumer confidence in the Region has continued to rise, suggesting that interest rate increases have not seriously crimped households' purchasing power or attitudes.

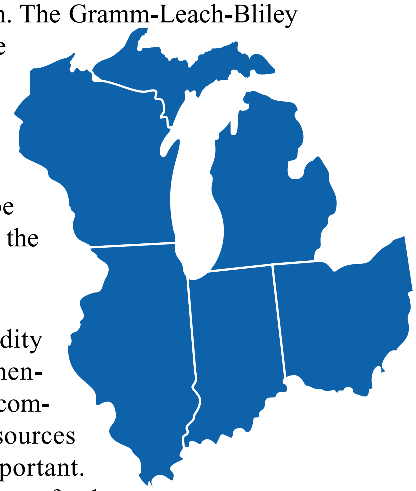
Although the Region weathered rising interest rates without slowing significantly through mid-2000, it remains more vulnerable than elsewhere in the country to manufacturing sector weakness, which could be triggered by rising rates and financing costs. The Region is more diversified than it was 15 years ago, but the manufacturing sector remains relatively more dominant in the Chicago Region than in other parts of the nation.

[1] The Midwest Manufacturing Index is compiled by the Federal Reserve Bank of Chicago to reflect activity in manufacturing industries important in the Region's economy.

Liquidity management is becoming increasingly important in the Chicago Region. Aggregate loan-to-asset levels and noncore funding are increasing, leading to declining liquidity trends. Insured institutions are reporting lower levels of marketable and short-term securities, while time deposits have trended toward shorter maturities. Borrowings and brokered deposits have increased, and unused commitment levels have risen. Profitability declines may continue to pressure institutions to operate with lower liquidity levels.

Although the number remains historically low, recent examination information has shown an increase in the number of institutions with weak liquidity ratings. The number of relatively new institutions that have weak liquidity ratings has risen as well. Institutions that are maintaining less liquidity are exposed to the possibility that potential financial difficulties, such as asset quality or earnings problems, will be exacerbated. There is now an increasing likelihood that liquidity problems may move to the forefront.

Federal Home Loan Bank (FHLB) advances have grown at a rapid rate in the Region and appear poised for continued strong growth. The Gramm-Leach-Bliley Act broadened access to the FHLB system for institutions with less than $500 million in assets. As a result, nearly all institutions in the Region will be eligible for membership in the FHLB.

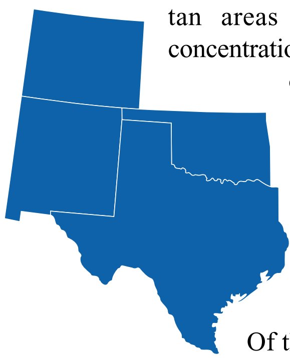


In light of recent liquidity trends, maintenance of unencumbered liquid assets and communication with funding sources are becoming more important. Institutions that rely on noncore funding should be aware of the potential for heightened reputation risk because many noncore funding sources are volatile and susceptible to withdrawal when signals point to financial difficulties. If a bank's reputation is tarnished, the availability of unpledged securities or other marketable assets will become increasingly important. These "name neutral" assets may prove an important source of funds for institutions with liquidity problems.

Dallas Regional Perspectives

The robust high-tech sector of the 1990s contributed significantly to strong employment and economic growth in the Region's leading high-tech metropolitan statistical areas (MSAs). However, the volatility of technology stock prices, typified by wide swings in the NASDAQ earlier this spring, suggests that the high-tech sector, like other sectors, is vulnerable to fluctuations in the overall economy.

What constitutes a high-tech center? The ***Milken Institute's*** July 1999 study "America's High-Tech Economy" identified five Dallas Region MSAs—**Dallas, Albuquerque, Denver, Austin,** and **Houston**—as ranking among the top 25 high-tech metropolitan areas in the nation, based on concentrations and relative growth rates of high-tech industries. These five high-tech metropolitan areas have outperformed the United States in almost every economic indicator going back five and ten years.



Of the five MSAs, Albuquerque is perhaps the most vulnerable to a downturn in the high-tech sector because of its large concentration of information technology industries, the federal government's huge presence in and around Albuquerque, and the MSA's dependence on foreign trade. Austin's economy, like Albuquerque's, is home to a large concentration of high-tech industries and is also vulnerable to a downturn in the high-tech sector. A lack of venture capital funding, a sustained stock market correction, and the drying up of the initial public offering market could affect Austin's high-tech economy adversely.

Denver's vulnerability to a high-tech downturn is similar to Austin's. High-tech industries employ over 90,000 Denver workers, or about 8 percent of nonfarm employment (1998), producing $8.9 billion in output in 1992 dollars, nearly 13 percent of the MSA's total output. A greater degree of sensitivity to swings in the money and capital markets, in addition to a thriving financial services industry that is closely linked to financial market conditions, increases the vulnerability of the Denver MSA to a high-tech downturn accompanied by a prolonged bear market.

Although Houston is home to a rapidly growing high-tech sector, the energy industry continues to dominate the local economy. Consequently, a prolonged downturn in the national economy or in oil prices is likely to have a greater negative effect on Houston's economy than would a high-tech recession. Dallas has the most diversified high-tech base in the Region. This diversity makes the probability of a high-tech recession alone pulling down the Dallas economy somewhat remote. However, a national recession could result in a sharper and more protracted recession for the Dallas metropolitan area because of the increased sensitivity of high-tech output to declines in national output.

Implications for insured institutions in high-tech markets. Bank data suggest a close connection between the robust economic activity within the Region's high-tech MSAs and insured institutions' balance-sheet growth. Insured financial institutions with assets less than $1 billion headquartered in these MSAs showed substantial loan growth rates over the past five years, with loan portfolios placing greater emphasis on historically riskier forms of lending (e.g., construction and development and commercial real estate). This rapid loan growth and greater exposure to historically riskier areas of lending could elevate the overall credit risk profile of these institutions, particularly in the event of a high-tech downturn or a slowing of the economy. At the same time, large out-of-area banks are capturing greater market share. As the presence of large out-of-area institutions becomes more prominent in these high-tech MSAs, small banks and thrifts could experience increased competition that would have implications for profitability levels.

Kansas City Regional Perspectives

U.S. farm policy: which direction after 2002? Bankers who participated in the FDIC's Agricultural Bankers' Roundtable in **Kansas City** in March 2000 were unanimous in their opinion that federal government supplemental payments to farmers and federal crop insurance were crucial to maintaining the financial health of farm borrowers in 1998 and 1999. The United States Department of Agriculture's forecast suggests this will be true again in 2000, as government payments are projected to be nearly half of net farm income.

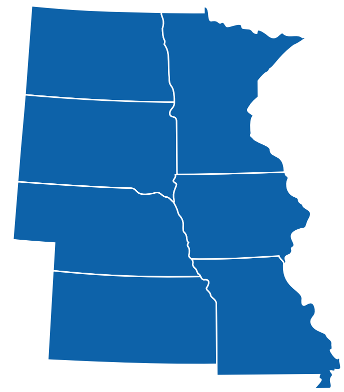
In 2002, the current farm policy legislation, known as the Federal Agriculture Improvement and Reform (FAIR) Act of 1996, will expire, and Congress must write a new farm bill. Before passage of the 1996 FAIR Act, the farm program included a system of deficiency payments for major crops. The 1996 legislation introduced a number of fundamental changes in farm policy, including:

- decoupling program payments from most production decisions, thereby ending the practice of paying farmers deficiency payments when prices of commodities fell below target prices;
- eliminating federal authority to control the supply of program commodities by limiting planted acreage; and
- establishing a schedule of fixed income support payments known as "production flexibility payments," based on farmers' historical pattern of production, that would be phased out during the 1996–2002 period.

If proponents of the FAIR Act saw it as a phase-out of the government's support of agriculture, events since 1996 have worked against that intention. Responding to declining farm incomes, Congress has passed emergency supplemental legislation in each of the past three years.

While federal farm policy has often been justified as a means of protecting the health of small farms, the continuing significant decline in the farm population suggests that the strategy has had little long-term effect on the continuing out-migration from farms. The goal of improving farm incomes relative to urban incomes may no longer be as relevant as it was when income support programs were instituted. In the 1920s, the standard of living of farm people was significantly below that of urban dwellers. Today, however, although there is considerable disparity across farm producers, average incomes of farm households generally equal or exceed those of nonfarm households, and the wealth of farm households averages several times that of all households.

International trade issues will continue to constrain the direction of U.S. farm policy. Trade discussions are complicated by conflicts between the stated goals of domestic farm policy and the objectives of improving the conditions of international trade policy. Most countries follow policies that benefit their own farmers but cause significant distortions in international agricultural markets.



The other major issue affecting the future direction of U.S. farm policy is the evolving relationship between rural development and agricultural policy. Farmers now make up only a small minority of the population of rural areas, so some analysts see the need for a rural development policy separate from agricultural policy.

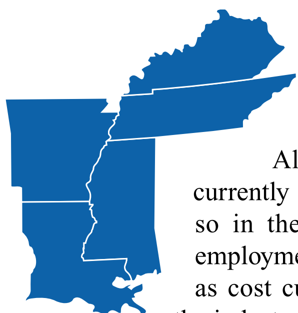
Possible directions of U.S. farm policy. Many analysts believe that three scenarios are possible. Under one scenario, the market-oriented features of the FAIR Act would be retained, a schedule would be set for ending any remaining payments to export crop producers, and permanent farm program legislation would be repealed. However, if commodity prices are low during the 2000–2002 period, a significant retreat from the framework of the 1996 FAIR Act is possible. This second approach could restore past techniques of intervention, including target prices, increased use of export subsidies, and resurrection of supply control authority.

A third scenario would retain the core reforms of the FAIR Act, including the end of deficiency payments and supply controls, but extend or enhance a variety of intervention strategies. These could include increased reliance on crop insurance, expansion of the Conservation Reservation Program, targeting aid to farmers based on their incomes instead of crop production, and integrating agricultural policy with a broader program of rural development.

Memphis Regional Perspectives

Memphis Region employment growth continues to lag that of the nation. Although job growth accelerated slightly during the first half of 2000, the Region's 1.7 percent gain is well below the nation's 2.4 percent annual job growth rate. **Arkansas** and **Kentucky** report strong employment growth driven by the construction and service sectors. Kentucky also benefited from growth in automobile industry employment, but these gains may have peaked as higher interest rates and high gasoline prices point to a potential slowing of automobile sales.

Louisiana's economy continues to be constrained by retrenchment in the oil and gas industry. Despite a sharp upturn in oil prices since early 1999 and an increase in the number of operating oil rigs in 1999, employment growth in Louisiana's energy sector has remained flat as companies have tried to reduce expenses by eliminating administrative jobs. Although gasoline prices are currently high and likely will remain so in the near future, oil industry employment may continue to decline as cost cutting and consolidation in the industry persist.



Real estate markets throughout the Region are in transition. Population and employment growth, increasing income and wealth levels, along with an environment of low interest rates, contributed to booming residential development in the late 1990s. Likewise, a strong economy and expanding labor markets fueled growth in commercial real estate. Although overall construction activity in the Region remains fairly robust by historical standards, development is beginning to slow as interest rates have risen and demand has begun to wane.

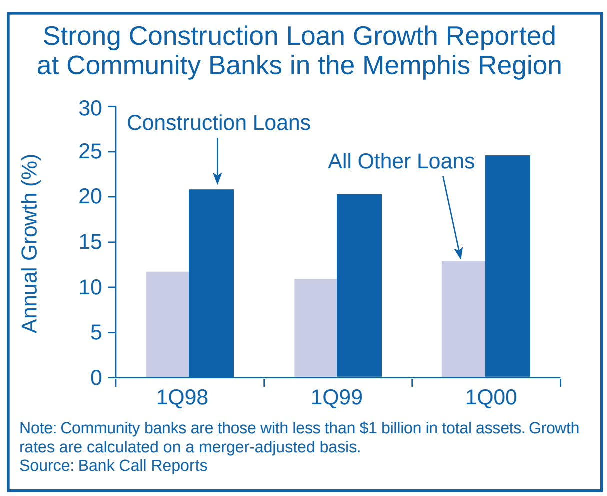
Even as construction activity has begun to moderate, many banks and thrifts in the Memphis Region continue to grow construction loan portfolios aggressively. Construction loans constituted the fastest-growing segment of loan portfolios at community banks and thrifts (those with total assets of less than $1 billion) over the preceding three years. Furthermore, growth in construction loans for the 12-month period ending March 31, 2000, a period including 9 months of rising interest rates and slowing real estate development, was higher than in either of the preceding two years (see Chart 1).

Community bank exposure to construction and development lending at the end of the first quarter of 2000 was almost double the exposure levels reported by these banks immediately prior to the 1990–91 recession. Not surprisingly, exposure is highest among community banks headquartered in metropolitan areas. Community banks in **Baton Rouge, Memphis,** and **Nashville,** in particular, reported average aggregate construction loan exposure well above levels reported in other metropolitan areas in the nation. Exposure levels in the Memphis metropolitan area were the third highest among all metropolitan areas nationwide, behind only **Atlanta** and **Portland.**

Although slight deterioration has occurred recently, construction loan credit quality remains favorable. Also, construction credit underwriting standards are considered much stronger than in prior periods of robust real estate activity, such as that preceding the 1980s real estate crisis. One common theme for both periods, however, is intense competition among lenders.

Construction lending is generally considered the most complex and labor-intensive type of lending performed by most community banks and can represent the greatest degree of risk. Prudent management must evaluate credit standards continuously and adjust to changing economic and market conditions. Although asset quality indicators remain strong, the high volume of recent construction loan originations and growing exposure at community banks during a period of generally slowing real estate markets are cause for some concern.

CHART 1



Strong Construction Loan Growth Reported at Community Banks in the Memphis Region

Note: Community banks are those with less than $1 billion in total assets. Growth rates are calculated on a merger-adjusted basis.
Source: Bank Call Reports

New York Regional Perspectives

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

The Region's insured institutions[2] reported sound financial conditions in the first quarter of 2000, exhibiting higher levels of profitability, favorable credit quality, and stable capital ratios, compared with the same period one year earlier. While the average return on assets (ROA) improved for the Region's large, medium, and small institutions compared with the first quarter of 1999, factors contributing to improved profitability differed according to asset size. Large banks benefited from increased noninterest income, while small banks reported higher net interest margins. Commercial and industrial loan portfolios in the Region's banks, however, showed modest signs of credit quality deterioration.

The Region's banks showed signs of strained liquidity as more institutions reported securities depreciation and deposit outflow. Furthermore, the number of the Region's commercial banks that reported the combination of securities depreciation, deposit outflow, and yearly loan growth of greater than 5 percent also increased. Depending on the degree of depreciation and liquidity needs, banks may use alternative methods to offset deposit outflow while funding loan demand. Banks with securities depreciation may be inclined to counter deposit outflow by raising deposit rates or increasing borrowings, rather than selling securities at a loss. As alternative funding options are considered, assumptions underlying banks' asset/liability management models should reflect changes in market conditions, core deposit behavior, and funding strategies.

In contrast to the late 1980s, the Region's office markets are experiencing stable or declining office vacancy rates and limited new construction. In the 1980s, high levels of inflation stimulated a wave of speculative demand for commercial real estate, and the office sector experienced an unprecedented building boom. The recession of the early 1990s hit the Region's real estate markets harder than other parts of the nation, in part because new office construction and vacancy rates were climbing as the Region's economy started to contract.

Despite a recent resurgence of office construction in the Region, the amount of new office space added in the 1990s is substantially less than the amount developed in the 1980s. New office construction between 1995 and 1999 totaled only 16 percent of the construction between 1986 and 1990. Furthermore, vacancy rates are declining in most of the Region's cities, both large and small. As a result, the Region's commercial real estate (CRE) markets appear better positioned today to weather an economic downturn than a decade ago.

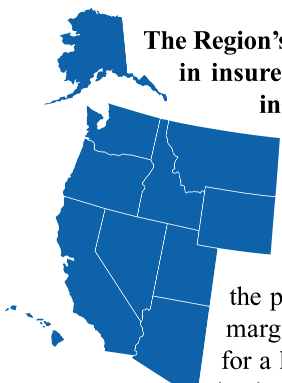
While the Region's banks on average reported sound CRE credit quality measures in the first quarter of 2000, a larger share of banks reported a concentration in CRE loans. Small banks (with assets less than $500 million) represented almost three-quarters of the Region's banks that reported at least 20 percent of total assets as CRE loans as of March 31, 2000. In some of the Region's cities, small banks that specialize in CRE lending have increased their proportion of CRE loans to assets to levels above those reported prior to the 1990–91 recession. Smaller banks with more localized exposure to CRE markets may be more susceptible to softness in local economies or problems in specific industry segments, such as the Internet or health care. As banks expand CRE portfolios, lenders should be vigilant in monitoring economic conditions that could affect CRE loan quality.

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

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

San Francisco Regional Perspectives

The San Francisco Region's nonfarm payroll employment growth continued to outpace the nation's during the first five months of 2000. However, performance of the Region's industry sectors has been mixed. Construction sector employment growth has been strong, with most activity occurring in commercial and residential projects. High-tech manufacturing employment in the Region has slowed; many of the job losses have occurred in the aerospace industry. In **Washington** and **California,** Boeing alone laid off 35,000 employees between midyear 1998 and midyear 2000. While California's agricultural sector is performing well, some of the Rocky Mountain states—particularly **Montana**—are experiencing very dry conditions. The Region's international trade outlook is improving as export volume has grown recently.



The Region's strong economy is reflected in insured institutions' robust earnings and loan growth and good asset quality. Combined annualized return on assets (ROA) for first quarter 2000 was 1.35 percent, slightly lower than performance over the past four quarters. Net interest margins held steady or increased for a large majority of the Region's institutions during the first quarter compared with one year earlier. Asset quality was strong, as evidenced by the total past-due loan ratio of 1.69 percent and loan charge-off levels, which were essentially unchanged from prior periods. Loan portfolios at the Region's institutions have grown rapidly, particularly in the commercial real estate (CRE) category. The median ratio of CRE loans to total assets was almost 25 percent at the end of first quarter 2000, compared with less than 20 percent one year earlier. Construction and development (C&D) lending as a share of total assets, which increased at all but 15 percent of the Region's institutions, was a primary driver of this increase.

The Region's high-tech sector has created jobs, contributed to gains in the Region's exports, and stimulated growth in commercial and residential housing markets. Between 1993 and 1998, the high-tech sector created approximately 304,000 jobs, primarily in California, Washington, **Oregon,** and **Arizona.** Several of the largest high-tech companies in the nation, including Intel, Microsoft, Hewlett-Packard, Sun Microsystems, and Oracle, are located in the Region. While many of the Region's states are leaders in the high-tech sector, 13 metropolitan statistical areas (MSAs) report particularly strong concentrations of high-tech activity: **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. These MSAs report higher levels of venture capital issuance, per capita personal income growth, and residential and commercial real estate activity than do other MSAs in the Region.

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; most of the financing is in the San Francisco Bay Area and Seattle MSAs. Companies receiving financing are concentrated in the software, networking, and telecommunications subsectors. While high levels of venture capital provide a means for continued growth in payrolls or business expansion, this situation may link the financial success of firms in these areas more closely with the performance of the stock market.

Currently, economic indicators suggest that the Region's high-tech MSAs are thriving. Higher-paying technology jobs and generous stock option compensation contributed to growth in per capita personal income in high-tech MSAs that has exceeded growth in non-high-tech MSAs since 1996. Growth in the high-tech sector has also affected the Region's residential housing markets: median home prices and housing permit issuance have increased more rapidly in the 13 high-tech MSAs since 1993. Commercial real estate markets in high-tech MSAs experienced higher rents and construction levels and lower vacancy rates in recent years as a result of new high-tech business growth.

Although few of the Region's insured institutions lend directly to large high-tech companies, many operate in at least one of the high-tech MSAs. In recent years, institutions in high-tech MSAs have increased concentrations in CRE and C&D lending, traditionally higher-risk forms of lending. Growth in these loan types has outpaced the national rate each year since 1997. Institutions in high-tech MSAs reported lower ROA levels, in part because of higher premises and salary expenses. However, stronger reported asset quality among banks in the Region's high-tech MSAs may mitigate any heightened levels of risk.

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