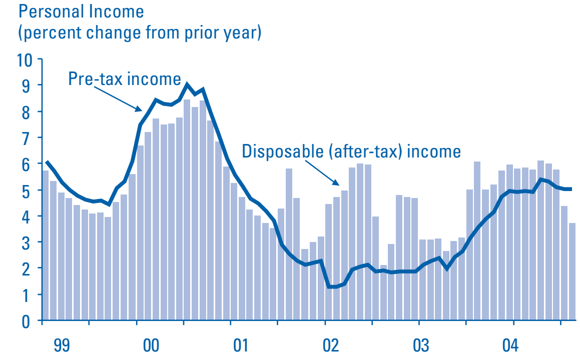
FDIC Outlook

WINTER 2004

In Focus This Quarter: The U.S. Consumer Sector

The consumer sector is the powerhouse behind the U.S. economy, accounting for more than two-thirds of total economic activity. This issue of ***FDIC Outlook*** examines the near-term prospects for the U.S. consumer in terms of spending, job growth, and consumer credit quality in the current environment of rising short-term interest rates. This issue also reviews national and regional housing markets and the related home equity lending area, as well as auto financing and the up-and-coming market represented by Hispanic households.

Tax Cuts Are No Longer Boosting Marginal Gains in Take-Home Pay



Source: Bureau of Economic Analysis.

Consumer Sector Outlook for 2005

Although consumer incomes and spending have been supported in recent years by the temporary effects of lower taxes and the liquidation of homeowner equity, consumer spending going forward will be more dependent on the growth of jobs and incomes. While most consumers seem able to manage their debt load, weaker borrowers and those with substantial leverage, especially to variable-rate debt, could be at risk as interest rates begin to rise. *See page 3.*

A Turning Point Ahead? National and Regional Trends in Residential Real Estate Markets

Residential real estate has been a leading sector of the U.S. economy for the past three years running. Homeowners have helped keep consumer spending strong, thanks in part to the approximately $312 billion in equity they extracted from their homes in 2003. But the ongoing boom in real estate prices leaves many wondering whether prices and market activity are poised to level off or even decline in coming months. This article revisits recent housing market trends from both a national and regional perspective. *See page 9.*

Home Equity Lending: Growth and Innovation Alter the Risk Profile

Home equity lending continues at a strong pace, particularly for home equity lines of credit, and there is concern for heightened credit risk as this lending area expands. Current challenges for home equity lenders include rising short-term interest rates, increasing consumer indebtedness, and the likelihood that home price gains will level off eventually. *See page 17.*

Lending Practices of Captive Auto Lenders Are Driving Risks in Bank Auto Paper

The auto finance market is highly competitive. Banks must contend with aggressive terms offered by captive finance companies while vying with credit unions and other insured financial institutions for market share. As a result, some banks may have loosened auto loan underwriting standards, leaving them vulnerable if interest rates continue to rise or if economic fundamentals weaken. Auto loans to marginal or subprime borrowers in particular may be more vulnerable to credit quality deterioration, particularly in a rising interest rate environment. *See page 24.*

Banks Are Still Sizing Up Opportunities in the Growing Hispanic Market

The purchasing power of the Hispanic market is already strong and growing, and an assessment of the future potential of this market points to continued expansion. The financial needs of the Hispanic population are categorized into stages as they gain wealth and their demand for services evolves. In addition, analysis of demographic data and bank activity in this area shows that high-growth Hispanic areas experienced substantially faster growth in both deposits and branch formation than did either highly concentrated Hispanic areas or the nation as a whole. Large banks and community banks alike will find new and welcome sources of revenue if they can customize their products to the unique needs of the Hispanic marketplace. *See page 30.*

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Consumer Sector Outlook for 2005

It is widely recognized that the consumer is the powerhouse behind the U.S. economy, accounting for more than two-thirds of total economic activity. And, despite the 2001 recession and a relatively weak labor market since then, the consumer has proven to be far more resilient than many would have expected. In recent years, growth in after-tax income and consumer spending has been much stronger than has historically been the case around recessions, especially given the lackluster pace of hiring. In addition, consumer credit growth has been robust during a period when a retrenchment would have been expected. To stoke their spending, consumers have drawn on the increasing equity in their homes and the proceeds of substantial tax cuts during both 2001 and 2003. However, as the stimulus of the tax cuts has been absorbed and the refinancing wave appears to have abated, it is now uncertain how fast consumer spending can continue to grow.

This article reviews the various factors that will determine the pace of consumer spending and credit growth going forward. It also briefly assesses how higher energy costs may be affecting spending and concludes with an evaluation of the overall credit health of the consumer.

Job Growth Drives Income

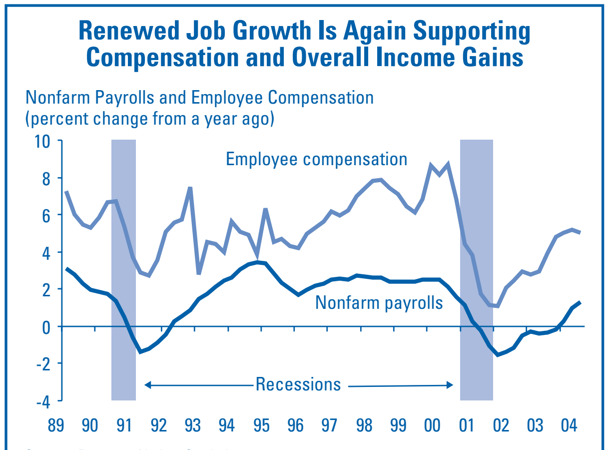
After a few rocky years, renewed job growth is again supporting income gains. During the 2001 recession and for almost two more years, total U.S. payroll employment declined. This decline weighed on growth in employee compensation and thus on total income gains. However, since August 2003, the economy has been steadily increasing its employment base, leading to renewed vigor in total employee compensation and income growth (see Chart 1). In addition to any raises offered to existing workers, job gains should continue to support overall compensation growth in 2005 and will keep incomes and consumer spending expanding. However, two other sources of income growth in recent years—tax cuts and the liquidation of homeowners' equity—are likely to play a lesser role in 2005. Also, higher energy prices may pose a risk to consumer spending.

Tax Cuts and Income Affect Spending

The tax cuts that helped support take-home pay during the 2001 recession and the subsequent episode of weak employment growth are no longer boosting income at the margin. Household incomes usually do not decline on an annual basis. In fact, since 1950, inflation-adjusted after-tax incomes only fell once, in 1974, and then only by 0.7 percent. Rather, *growth* in real after-tax income typically slows when the job market weakens substantially. Although the recent experience was no exception to this trend, the slowdown in after-tax, or so-called "disposable," income growth was much milder than the historical experience might have suggested. During the early years after the 2001 recession, disposable incomes grew largely on the strength of two well-timed tax cuts that boosted after-tax income growth for those still working.

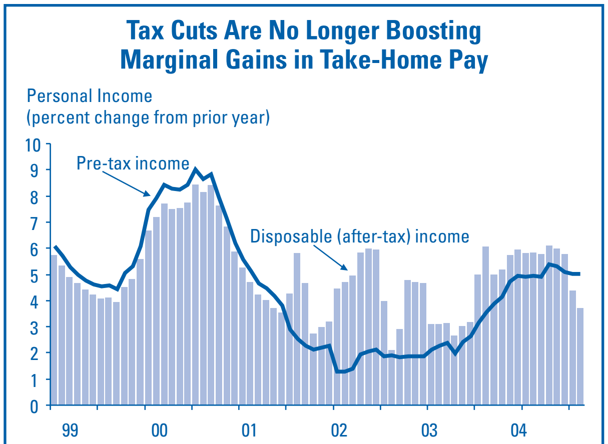
Tax rebates in the summer of 2001 and reduced tax withholdings in 2002 and 2003 increased gains in take-home pay relative to total income. Chart 2 illustrates the disparity between before- and after-tax income growth. After-tax income received a large boost beginning in late 2001 as tax cuts began to flow into the economy—a situation that carried over well into 2004. However, in July and August 2004, growth in after-tax income fell significantly below that of pre-tax income. Since the last round of payroll tax reductions was enacted a year earlier in mid-2003, the stimulative effects on growth are now diminishing. That is, while these tax cuts still provide a higher level of take-home

Chart 1



Source: Bureau of Labor Statistics.

Chart 2



Source: Bureau of Economic Analysis.

pay for many workers, the influence of the tax cuts on income growth has ended.

Although tax cuts are no longer contributing to income growth, the increased pace of hiring is having a positive effect, which highlights the significance of job growth to the outlook for consumer spending and borrowing. Without a steady pace of job growth, overall *and* take-home pay gains would be weaker.

Households Use Home Equity to Increase Cash Flow

In addition to tax cuts, the other strong factor in boosting consumer spending at the margin in recent years has been homeowners tapping into the accumulated equity in their homes. In the five-year period ended June 2004, owners' equity in household real estate rose by $3.1 trillion, or 56 percent. One factor behind the increase in home equity has been the rapid increase in homeownership. The U.S. homeownership rate was estimated at 68.9 percent in third quarter 2004, which is a nearly 2 percent increase in just five years and the equivalent of almost 3.3 million new homeowners. The other factor boosting home equity has been rising home prices. According to the House Price Index published by the ***Office of Federal Housing Enterprise Oversight*** (OFHEO), nationwide home prices as of second quarter 2004 had risen by 9.3 percent from a year ago—the fastest annual pace of growth since 1979. While prices have risen faster in some areas than in others, all 313 metropolitan areas covered by the OFHEO data have shown price increases during each of the past three years.

As total homeowner equity has risen, many households have sought to liquidate and spend a portion of the wealth tied up in their homes. One way to do so is during a mortgage refinancing transaction, where the homeowner might choose to take cash out or roll a second mortgage loan into the first mortgage. According to data provided by ***Freddie Mac,*** homeowners liquidated some $211 billion in 2003 by refinancing their mortgages. According to the ***Federal Reserve,*** another $101 billion was liquidated by increased borrowing against home equity lines of credit (HELOCs).[1] Taken together, this liquidation of home equity contributed an extra $312 billion to household cash flow during 2003, an amount of stimulus that almost equaled the $332 billion gain in after-tax income during the year.

The current combination of high home prices and historically low interest rates continues to induce homeowners to liquidate home equity, and increasingly they are doing so with HELOC borrowing. Because so many homeowners refinanced their mortgages during 2003 when interest rates were at a multi-decade low, a relatively modest rise in mortgage rates in 2004 has curbed refinancing activity substantially. The average weekly refinancing index of the Mortgage Bankers Association declined by 75 percent in the first half of 2004 from year-ago levels. Meanwhile, the total volume of home equity loans outstanding rose by 23 percent during the year ending in June, as households turned to HELOCs as a source of liquidity.

A key issue for the consumer spending outlook is whether home appreciation can continue to provide a ready source of consumer cash. During 2002 and 2003, despite the liquidation of roughly $540 billion in homeowner equity and an overall increase in household mortgage debt of $1.4 trillion, total homeowner equity still rose by $1.2 trillion. Strong home price gains depend on continued robust housing demand, but rising interest rates may cut into demand and slow the pace of price increases. Some analysts have expressed concern that the recent rapid pace of home price growth in many major markets across the country could lead ultimately to a downturn in home prices and housing market activity.[2] Should home prices decline in these

[1] See "Home Equity Lending: Growth and Innovation Alter the Risk Profile" by Cynthia Angell in this issue.
[2] See "A Turning Point Ahead? National and Regional Trends in Residential Real Estate Markets" in this issue.

markets, homeowner equity—and spending—could also be adversely affected.

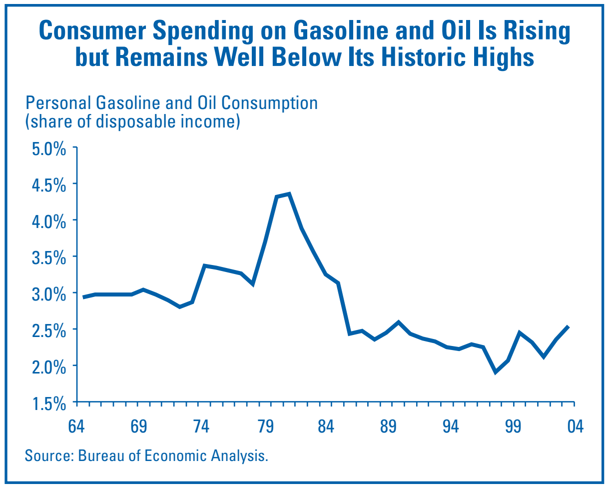
Higher Energy Costs Affect Spending

The recent run-up in energy costs may pose a downside risk to consumer spending growth in 2005. Inflation-adjusted consumer spending appeared to take a breather in second quarter 2004 after an extended period of strong growth. After advancing by roughly 3 percent in both 2002 and 2003 and then at a 4 percent annual rate in first quarter 2004, spending rose at only a 1.6 percent annualized rate in the second quarter. Sluggish real retail sales growth persisted through August, with motor vehicle sales being the weakest component. Automakers curtailed many of their incentives in early 2004 and auto loan rates rose modestly, causing weakness in auto demand. However, with the reintroduction of incentives and a brief summertime easing in energy prices, auto and overall retail sales bounced back in September. As a result, inflation-adjusted U.S. consumer spending advanced at a sturdy 4.6 percent annualized pace during the third quarter.

Higher energy prices likely played a key role in dampening consumer goods spending in mid-2004. Federal Reserve Chairman Alan Greenspan recently noted that the 2004 surge in energy costs—and the price of gasoline in particular—weighed on consumer spending growth and contributed to a mid-2004 "soft patch" in economic growth.[3] Although spending for gasoline and oil accounts for an average of only 2.5 percent of after-tax personal income (compared to 4.4 percent in 1981), lower-income households are typically more affected by rising energy costs (see Chart 3).

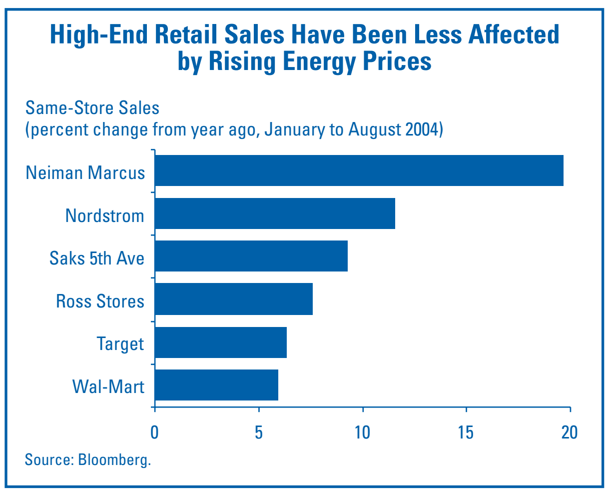
Consumer sales data offer another indication that lower-income households may be feeling a greater effect from energy price increases. Michael Niemeira, chief economist for the *International Council of Shopping Centers*, estimates that for every 10 percent increase in the price of gasoline, sales at discount retailers drop 0.66 percent, versus only 0.33 percent at department stores.[4] This may help explain why recent same-store sales data have

Chart 3



shown stronger growth among high-end retailers than among discounters (see Chart 4). Other analysts have pointed out that sales growth for high-end items, such as private aircraft and pleasure boats, was stronger this year than in the past few years. It is likely that other factors, such as the relatively faster income growth seen by higher-income households recently, have contributed to the divergence in sales trends. Nonetheless, the retail data provide some anecdotal evidence that higher oil and energy prices affect high-income households less than other income-level households.[5]

Chart 4



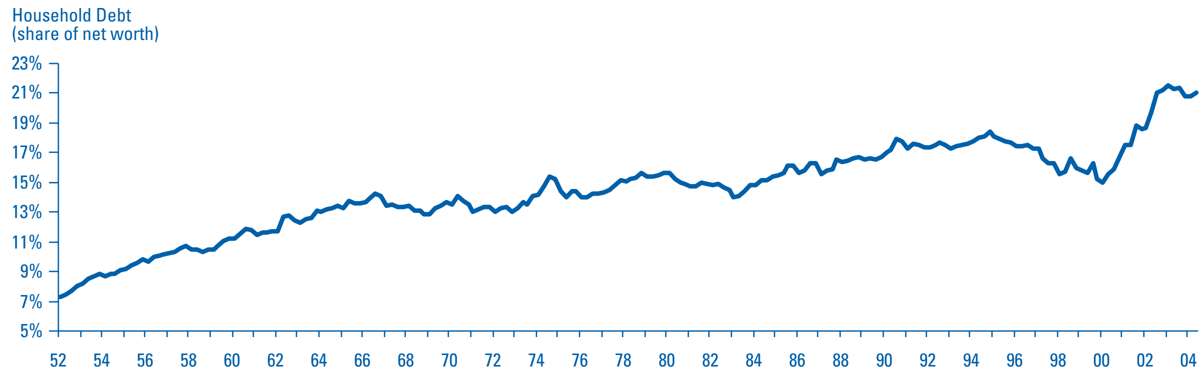
[3] Chairman Alan Greenspan of the Federal Reserve Board, "Economic Outlook," testimony before the Committee on the Budget, U.S. House of Representatives, September 8, 2004, http://www.federalreserve.gov/boarddocs/testimony/2004/200409082/default.htm.

[4] Barbara Hagenbaugh, "$50 Oil Probably Won't Cause a Huge Economic Mess," *USA Today*, September 27, 2004.

[5] Andy Kish, "What We're Doing Without," Economy.com, September 28, 2004.

Chart 5

The Overall Household Debt-to-Net-Worth Ratio Remains Near Its Historic Highs



Source: Federal Reserve.

Although the recent increase in energy costs may have weighed on consumer spending growth during the past year, consumers likely will continue to adjust their consumption patterns over time to adapt to the higher level of energy prices. Given that adjustment process, the effect of rising energy costs on consumer spending may be less severe during 2005, even if prices remain elevated.

Increasing Consumer Indebtedness and Worsening Credit Quality a Concern

The continued expansion in consumer indebtedness and the rising rate of personal bankruptcy filings in recent years has raised concern. If job or income growth were to slow or interest rates were to rise significantly, consumer credit quality could deteriorate.

Current levels of consumer debt are probably still manageable for most households. At just over 21 percent in mid-2004, consumer debt as a share of net worth was near its high point for the past 55 years (see Chart 5). This level of indebtedness has been rising steadily over the past several decades. Much of this rise is due to two factors: increasing access to credit by certain households and rising homeownership. In particular, rising homeownership seems to have played a significant role in the increase in indebtedness over the past several years. During the five years ended mid-2004, household mortgage debt increased by $2.8 trillion, which accounts for 80 percent of the total increase in consumer debt over this period. At the same time, however, the value of residential real estate owned by homeowners rose by $5.9 trillion. So the dramatic increase in mortgage debt during the past five years was accompanied by an even larger increase in net worth, the net effect of which is over $3 trillion.

Although personal bankruptcy filings have declined in recent months, they remain near their all-time highs. During 2003, personal bankruptcy filings reached a record high of 5.5 per thousand persons; however, filings declined an encouraging 4.2 percent on a year-ago basis in second quarter 2004. This was the largest year-over-year decline since mid-2000. Any sustained trend toward fewer personal bankruptcies should indicate improving consumer credit performance.

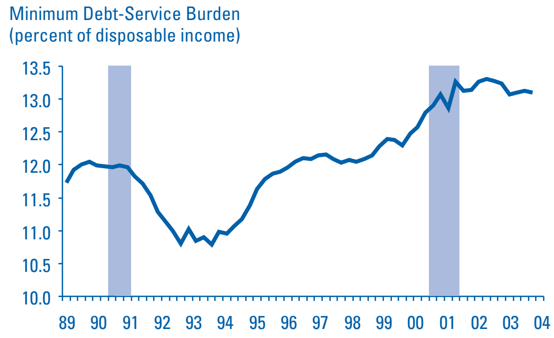
So far, the credit position of the consumer appears to be stable. According to the Federal Reserve, the aggregate consumer debt-service ratio—which reflects minimum required payments on credit cards, home mortgages, and other consumer loans (but not leases)—has been stable at around 13 percent of disposable income since the end of the 2001 recession (see Chart 6).

Although the aggregate consumer debt-service ratio remains near its all-time high, some of the reasons for this may be structural in nature. The increased availability of credit in recent years, rising homeownership, and more sophistication on the part of borrowers and lenders (which can be reflected in such developments as increased "convenience" use of credit card debt) may all be contributing to this higher ratio of minimum debt payments to income.[6] The fact that delinquency

[6] Alan Greenspan, "The Mortgage Market and Consumer Debt," speech at America's Community Bankers Annual Convention, Washington, D.C., October 19, 2004, http://www.federalreserve.gov/boarddocs/speeches/2004/20041019/default.htm.

Chart 6

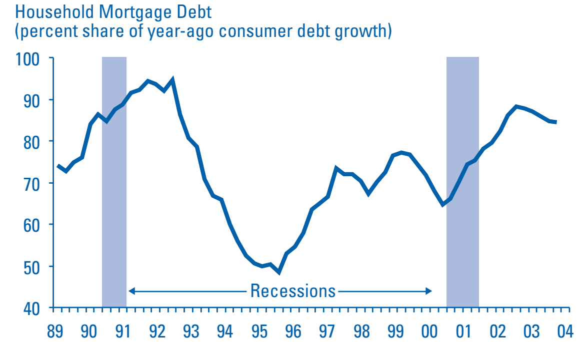
The Consumer Debt Burden Remains Near an All-Time High



Source: Federal Reserve.

Chart 7

An Abundance of Mortgage Debt May Tend to Insulate Households from the Effects of Rising Interest Rates



Source: Federal Reserve.

rates on consumer loans and credit card debt at FDIC-insured institutions have held relatively steady during the past seven years offers perhaps the strongest evidence that consumers continue to be able to service their debts. Between 1997 and mid-2004, noncurrent credit card loans ranged between 1.84 and 2.00 percent of all credit card loans, while noncurrent loans in other consumer loan categories ranged between 0.91 and 1.06 percent.[7]

Rising Interest Rates Pose a Risk

With consumer leverage near record highs, the prospect of rising interest rates naturally causes concern. The Federal Reserve began raising its interest rate target during 2004, and by October 2004, 3-month Treasury bill yields had increased by 85 basis points from one year earlier. Longer term interest rates, though, were either modestly lower or unchanged over this time. Most market analysts are expecting interest rates to continue rising over the next year. Although exposure to rising interest rates is a valid concern, much of the recent growth in consumer indebtedness has come in the form of fixed-rate mortgages. Currently, mortgages comprise 73.2 percent of total household debt, versus just under 69 percent as recently as 2000. Of the $3 trillion in additional consumer debt accumulated in the past four years through mid-2004, more than 80 percent was mortgage-related (see Chart 7). Mortgage debt is usually carried at a fixed rate, and as such, monthly debt payments are not subject to rising interest rates.

[7] *Noncurrent* loans are defined as those that are 30 to 90 days past due as well as those in nonaccrual status.

However, not all mortgage debt has a fixed rate. Freddie Mac estimates that between 15 percent and 20 percent of total outstanding mortgage debt had adjustable rates in 2003. Adjustable-rate mortgages (ARMs) have become more popular in the mortgage market, accounting for at least 30 percent of mortgage origination activity over the spring and summer of 2004.[8] While many consumers will be able to manage rising mortgage payments on ARMs, the segment of newer ARM holders that relied on the lower cost of this type of loan as their only means to afford a monthly mortgage payment may face some difficulty servicing their debt once interest rates rise.[9] Although there are many types of ARM products, a significant share of ARMs still reprice in less than a year.[10]

The potential for ongoing increases in interest rates over the next year poses another possible risk to consumer debt service capacity. Rising interest rates may hurt housing affordability, thereby curbing demand for new homes and home price appreciation. So, although many consumers have been able to substitute lower priced fixed-rate mortgage debt for higher-priced revolving debt in recent years, this may be less feasible in 2005. Should home price appreciation subside

[8] Mortgage Bankers Association, *Weekly Mortgage Applications Survey.*

[9] For a more detailed analysis of the U.S. housing market, see: Cynthia Angell, "Housing Bubble Concerns and the Outlook for Mortgage Quality," *FDIC Outlook,* Spring 2004.

[10] Based on 1993, 2000, and 2003 Federal Housing Financing Board survey data that reflect responses from its members regarding all fully amortized purchase-money conventional first-mortgage loans used to finance the purchase of single-family nonfarm homes, including individual townhouse, condominium, and cooperative units.

significantly, many households may meet their incremental credit needs by shifting back toward higher-priced revolving credit lines instead of refinancing their homes at lower fixed rates and extracting equity.

Conclusion

Consumer income and spending were supported in recent years by the temporary effects of lower taxes and the liquidation of homeowner equity. The tax cuts, however, are no longer boosting consumer income at the margin. And although homeowners may continue to liquidate accumulated equity, the risk of slower home price appreciation in a rising-rate environment could reduce the likelihood that home equity will be a significant source of additional consumer spending and borrowing in 2005. The prospects for consumer spending, therefore, are likely to depend more on job growth and the income gains of existing workers. Stronger job growth than that seen during third quarter 2004 and somewhat faster income growth may be necessary to maintain a strong advance in consumer spending during 2005. And persistently high energy prices could continue to be an important downside risk to consumer spending over the near term.

Overall household debt levels remain near all-time highs, but the recent performance of consumer loan credit quality suggests that most consumers are fully able to service their current debt loads. Although interest rates likely will keep rising, some factors will insulate many consumers from the risks of rising rates. For example, much of the growth in consumer debt in recent years came in the form of fixed-rate mortgages, where monthly payments are not subject to rising interest rates. Furthermore, many consumers have swapped more costly forms of debt, such as credit cards, for lower-cost fixed-rate mortgage debt.

Such actions have reduced overall consumer exposure to rising interest rates, but not all consumers have been able to avail themselves of these developments. Increasing interest rates could begin to strain some consumers' finances over the coming year, and it will be important to monitor certain consumer segments in 2005 for emerging signs of weakness. In particular, weaker borrowers and consumers with significant leverage and exposure to variable-rate debt will remain vulnerable to increases in interest rates.

Nathan Powell, Financial Economist

A Turning Point Ahead? National and Regional Trends in Residential Real Estate Markets

Residential real estate has been a leading sector of the U.S. economy for the past three years running. In fact, according to a recent ***Office of Federal Housing Enterprise Oversight*** (OFHEO) report, every metro area in the nation experienced positive house price appreciation in second quarter 2004 (see Table 1).[1] This strong housing market activity has helped boost U.S. construction payrolls by almost 200,000 workers in the year ending August 2004, which was almost one out of every eight jobs created during that period. Meanwhile, homeowners have helped keep consumer spending strong, thanks in part to the approximately $312 billion in equity they extracted from their homes in 2003.[2] But the ongoing boom in real estate prices leaves many wondering whether prices and market activity are poised to level off or even decline in coming months.[3] This article revisits recent housing market trends from both a national and regional perspective.

The national statistics on housing remain most impressive. Some 1.85 million housing units were started in 2003, the highest total since 1978. Monthly permits for new units continue to be issued at a rate of around 2 million per year, showing that the home construction pipeline remains strong. The value of private residential construction in second quarter 2004 was 15 percent higher than a year ago. Existing home sales have continued to climb to new records, reaching an annual rate of almost 6.8 million units in second quarter 2004. A record 69 percent of U.S. households owned their homes as of second quarter 2004, up from 64 percent a decade ago.

Market conditions have been unusually conducive to strong growth in housing activity. Interest rates for long-term fixed-rate mortgages fell to their lowest levels in more than a generation in second quarter 2003, prompting strong demand for mortgage credit from new homebuyers and existing homeowners wishing to refinance.[4] Since mid-2003, increases in mortgage rates have significantly damped mortgage refinancing activity. But the continued availability of long-term fixed-rate mortgages of around 6 percent, along with increasing reliance on lower-cost adjustable rate mortgages, has helped keep home sales and home construction at high levels.

Analysts continue to point out that home price increases have outpaced income growth for some time, a situation that cannot persist indefinitely (see

Table 1

U.S. Metropolitan Areas with Fastest Home Price Appreciation, Year Ending June 2004

Metropolitan Statistical Area	Percentage Increase in Home Price Index	Value of Home Price Index*
Las Vegas, NV-AZ	24.9	174.7
Riverside-San Bernardino, CA	24.7	213.6
Fresno, CA	23.2	186.4
Fort Pierce-Port St. Lucie, FL	21.9	197.9
Orange County, CA	21.6	230.7
Los Angeles-Long Beach, CA	21.5	215.2
Ventura, CA	21.2	228.6
Bakersfield, CA	20.5	164.2
Yuba City, CA	20.4	193.7
San Diego, CA	20.2	247.5
U.S. Average	9.4	172.5

*Index based on 1995 Q1 = 100.

Source: Office of Federal Housing Enterprise Oversight.

[1] Office of Federal Housing Enterprise Oversight, "OFHEO House Price Index Shows Largest One Year Increase since 1970's: U.S. House Prices Show Annual Rise of 9.36 Percent," news release, and House Price Index report (second quarter 2004), September 1, 2004, http://www.ofheo.gov/media/pdf/2q04hpir.pdf. The analysis based year-to-year changes on second quarter 2004. OFHEO tracks home prices for 328 metropolitan areas.

[2] The extraction of homeowners' equity is calculated as the sum of cash proceeds plus second mortgage balances rolled into refinancing ($211 billion, according to Freddie Mac) and the net change in home equity loans outstanding ($101 billion, according to the Federal Reserve Board).

[3] Cynthia Angell, "Housing Bubble Concerns and the Outlook for Mortgage Credit Quality," *FDIC Outlook,* Spring 2004, http://www.fdic.gov/bank/analytical/regional/ro20041q/na/infocus.html.

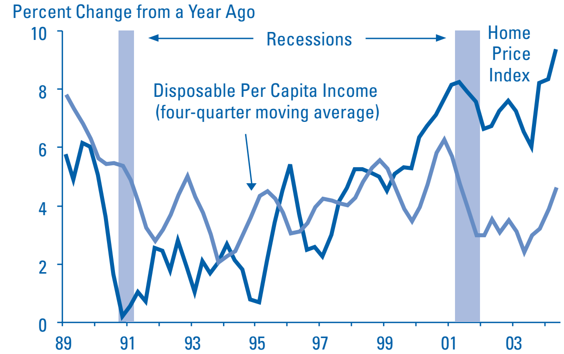
[4] The Freddie Mac contract rate for 30-year fixed-rate first mortgages fell to 5.23 percent in June 2003, the lowest monthly level recorded in the 34-year history of this series.

Chart 1). Another source of concern is a rising rental vacancy rate for residential properties, which now exceeds 10 percent of year-round rental housing units for the first time on record, led by increases in the Midwest and the South.[5]

However, as has been said about politics, residential real estate trends truly are local. Analyses of metro-area price increases versus fundamental factors continue to point to a group of cities on the west coast, the east coast, and in the southeast where prices appear to have diverged most noticeably from underlying fundamentals.[6] Still, these analyses cannot predict when or how current price discrepancies might be resolved. Of more use in this regard may be to assemble anecdotal summaries of local trends that may call attention to turning points before they become apparent in the data. What follows is commentary by analysts in each of the Federal Deposit Insurance Corporation's six regional offices and two area offices describing the most recent developments in their parts of the nation.

Chart 1

Growth in U.S. Home Prices Has Outstripped Growth in Incomes for Five Consecutive Years



Sources: Office of Federal Housing Enterprise Oversight, U.S. Census Bureau.

Atlanta Region: Southeast Housing Markets Are Still Going Strong

Record levels of home sales continue across the Atlanta Region, with home price appreciation remaining strong in many metropolitan areas. More than 20 markets in the Region—all of which were in **Florida** or **Virginia**—reported home price appreciation in the double digits over the past year. However, nearly two-thirds of the Region's metropolitan markets saw price gains below the national average, and, primarily in **Alabama** and the **Carolinas,** increases failed to keep pace with inflation.

Continued price gains have contributed to a decrease in affordability in most metropolitan areas, according to *Economy.com*. Over the past year ending second quarter 2004, affordability declined in all but five Atlanta Region metropolitan areas. Moreover, in several Florida markets as well as Northern Virginia, affordability has fallen by more than 10 percent. Anecdotal reports suggest that some speculative activity in housing is occurring in some markets, particularly in South Florida. For example, a significant number of condominium units are being delivered in the areas of South Florida, the Florida Panhandle, and the Gulf Coast of Alabama. These additions to supply are coming from two sources: new development and apartment conversions. Further, there is an active precompletion market, as some condominiums are being sold multiple times (or "flipped") before delivery. In some cases, interim buyers are leveraging their purchases by the use of standby letters of credit.[7]

Changes in underwriting practices may be contributing to ongoing rapid price appreciation in many markets. Innovative structures, such as downpayment assistance programs, interest-only mortgages, and piggyback loans, may allow buyers to purchase more expensive homes than they would otherwise be able to afford.[8] Further, credit impairment, as reflected by low FICO scores or a history of loan defaults, does not appear to be a major impediment for prospective mortgage borrowers.[9] For example, one recent news article reported that a home-

[5] Data from the U.S. Census Bureau. The rental vacancy rate is defined as vacant year-round units for rent divided by the sum of renter-occupied units plus vacant year-round units rented but awaiting occupancy, plus vacant year-round units for rent.

[6] PMI Mortgage Insurance Co., *Economic & Real Estate Trends,* Summer 2004, http://www.pmigroup.com/lenders/media_lenders/pmi_eret04v3s.pdf; and Celia Chen, "House Price Bubble Worries," Economy.com, July 16, 2004, http://corporate.dismal.com/dismal/pro/article.asp?aid=2872.

[7] Ryan Dezember, "The Condo Game," *Mobile Register,* July 6, 2004.

[8] James R. Hagerty, "For These Mortgages, Downside Comes Later," *Wall Street Journal,* October 5, 2004. A piggyback financing structure includes two or more loans at origination: for example, a first mortgage in an amount equal to 80 percent of the purchase price and a second mortgage in an amount equal to 20 percent of the purchase price. This structure eliminates a monthly payment for private mortgage insurance; hence, the borrower can qualify for a higher-priced home with the same fixed budget.

[9] Pamela Yip, "Looser Lending Blamed as Foreclosures Rise," *Dallas Morning News,* October 4, 2004.

buyer was able to secure 100 percent purchase-money financing despite having experienced a foreclosure just a year earlier.[10]

Other factors that could disrupt housing markets, particularly in Florida, include heightened storm activity and construction input shortages. Through September 2004, four major hurricanes made landfall in the Southeast, and their short- and long-term impacts are not yet fully known. Going forward, some locations could see reduced demand for housing if storm fears persist or if insurance costs become prohibitive. In addition, affordability could worsen because of higher costs associated with construction material and labor shortages. Hurricane rebuilding efforts likely will intensify the pre-existing shortfall in building inputs.

Scott Hughes, Regional Economist
Jack Phelps, Regional Manager

New York Region: Mid-Atlantic Housing Markets Still Sizzle, but Some Markets May Be Losing Steam

The strong home price appreciation observed across much of the nation is also evident in a number of Mid-Atlantic metropolitan areas. Seven Mid-Atlantic metropolitan statistical areas (MSAs) ranked among the top 50 MSAs in the nation with regard to home price appreciation: **Albany, New York; Washington, D.C.; Baltimore and Hagerstown, Maryland;** and **Atlantic City, Jersey City,** and **Monmouth-Ocean counties, New Jersey.** Moreover, half of the Mid-Atlantic's 40 metro areas tracked by OFHEO had appreciation rates in excess of the national average of 9.4 percent. Homes are appreciating at high rates in suburban areas of larger cities such as **Philadelphia,** Washington, D.C., and **New York City.** In fact, home price appreciation in and around New York City and Washington, D.C., has been so strong for more than the last five years that it is beginning to rival and even exceed the large price increases of the 1980s.

But after several years of substantial home price appreciation, there are indications that residential real estate markets in Mid-Atlantic states may be starting to cool off. In New Jersey, brokers report that while the market is still strong, multiple offers are not as commonplace as they were a few months ago, and high-priced homes are sitting on the market longer. In Baltimore, there are indications that double-digit price increases were in part responsible for a 20 percent increase in new listings, suggesting that high prices were prompting more homeowners to put their homes on the market. However, reports also suggest that houses in Baltimore, as in other parts of the Mid-Atlantic, are staying on the market longer. Absent dramatic declines in mortgage rates, the increase of housing inventories, combined with longer listing periods, may portend a slackening pace of home price appreciation.

The recent surge in home prices is attributable in part to historically low mortgage rates, which have boosted affordability and allowed households to finance increasingly expensive homes. Affordability has not improved, however, in many Mid-Atlantic housing markets, because low mortgage rates have been more than offset by price increases. According to ***Economy.com,*** areas in and around New York City have become increasingly less affordable relative to the nation, closely followed by areas around Baltimore and Washington, D.C.[11] Compared with many other areas in the nation, developable land is scarcer—and therefore more expensive—in those metropolitan areas; and with greater population density, demand for housing generally has exceeded supply.

A July 2004 study by the *Center for Housing Policy* reported that incomes were lagging substantially behind housing prices in many parts of the nation.[12] The report concluded that workers in formerly middle-class occupations such as nursing, teaching, and law enforcement could no longer afford a middle-class home in many of the nation's markets. This trend appears to apply to several Mid-Atlantic housing markets. For example, brokers and real estate analysts report that many public servants cannot afford to live in **Ann Arundel County, Maryland,** and must commute an hour to an hour and a half from less expensive homes on Maryland's eastern shore. In **Annapolis, Maryland,** housing affordability has become such an issue for first-time homebuyers that the city council voted to impose an "affordability" requirement on developers that requires them to construct low-cost units in any new subdivision with more than 30 homes. Another factor that has reduced

[10] Clint Williams, "A Hunger for Housing," *Atlanta Journal-Constitution,* August 28, 2004.

[11] Affordability refers to when median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. It is based on a 25 percent qualifying ratio for monthly housing expense to gross monthly income with a 20 percent down payment.

[12] Barbara J. Lipman, "America's Newest Working Families: Cost, Crowding and Conditions for Immigrants," *Center for Housing Policy: National Housing Conference* 4 (no. 3), July 2003.

affordability is the rapid increase in property taxes that has accompanied rising market values. Several years of rising assessments on residential property are starting to take a bite out of cash flow for many homeowners.

However, not every housing market in the Mid-Atlantic is soaring. Of 128 U.S. metropolitan areas studied by the ***National Association of Realtors*** (NAR), **Syracuse, New York,** showed the second lowest median price ($94,700) in second quarter 2004.[13] According to the NAR, the year-over-year rate of home price appreciation in Syracuse declined from 15.6 percent in third quarter 2003 to just 2 percent in second quarter 2004. However, despite slowing price appreciation, local real estate agents report that market conditions in Syracuse continue to be strong, because the level of home prices remains affordable, interest rates remain relatively low, and local economic conditions have improved. Home price appreciation also remains modest in other parts of upstate New York and in western **Pennsylvania.** As a result, residents in these areas have built up less home equity than in other areas and may have had less opportunity to convert home equity into cash.

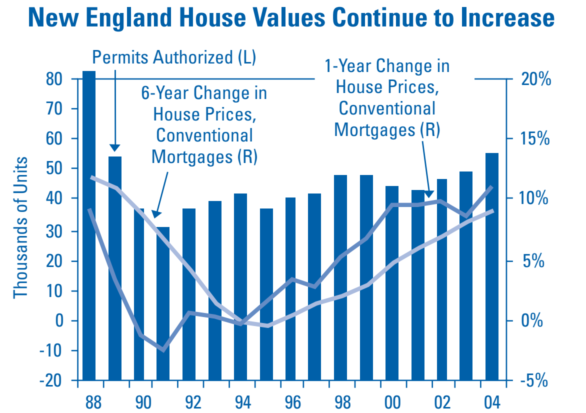
Norman Gertner, Regional Economist

Boston Area: New England Home Prices Continue Exceptional Growth for at Least the Time Being

This year is almost certain to be another strong year for housing in New England following several years of exceptional performance with sustained, sizeable price increases. Prices of conventionally financed houses in New England are likely to average more than 10 percent higher this year relative to last year.[14] While a single year of double-digit growth is impressive in its own right, it is even more remarkable that prices have risen on average almost *10 percent per year* since 1998 (see Chart 2). This six-year performance ranks second only to the 1980s housing boom in the modern history of the Region.

Partly in response to ongoing increases in house prices, new housing construction has been brisk. New housing

Chart 2



Sources: U.S. Census Bureau, Federal Home Loan Mortgage Corporation, and Federal Deposit Insurance Corporation via Haver Analytics. 2004 Annualized.

permits in the Region were issued at an annualized rate of over 50,000 during the first seven months of 2004. This is the fastest pace of issuance since 1988, a year that, coincidentally, marked the beginning of the end of the last New England housing boom. This year and 2003 also mark the return of multifamily construction as a major contributor to the supply of new housing, accounting for almost one-quarter of total new construction.[15] This new increase in supply will tend to reduce upward price pressures in the housing market.

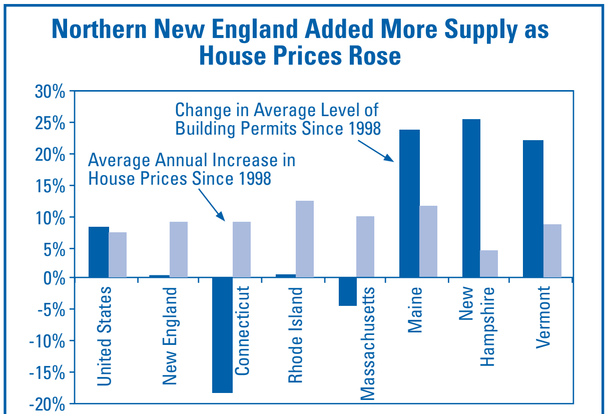
While home price increases have been distributed fairly evenly across the Region, new construction has tended to be concentrated in the relatively less expensive and less densely populated states of northern New England (see Chart 3). By contrast, southern New England has experienced little, if any, growth in the rate of new residential construction.

Housing demand in New England remained strong even as the national and regional economies entered a recession in 2001 and recovered slowly thereafter. The recession and weakness in the equity markets combined to reduce growth in total personal incomes in New England from slightly more than 10 percent per annum in early 2000 to no growth only two years later. Still, during this period of economic weakness, sales of existing single-family units dipped only in **New Hampshire** and in **Massachusetts,** which is the state most affected by the recession. Since then, new home

[13] National Association of Realtors, "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas," table, http://www.realtor.org/Research.nsf/files/REL04Q2T.pdf/$FILE/REL04Q2T.pdf.
[14] Federal Home Loan Mortgage Corporation, "Conventional Home Price Index." Prices are annualized for 2004 based on first-half results.

[15] U.S. Census Bureau via Haver Analytics, "New Privately Owned Housing Units Authorized in Permit-Issuing Places," table.

Chart 3



Sources: U.S. Census Bureau, Federal Home Loan Mortgage Corporation, and Federal Deposit Insurance Corporation via Haver Analytics, 2004 Data.

sales generally have increased within the Region, rising to near-record levels in each of the six New England states by mid-2004.

Frederick S. Breimyer, Regional Economist

Chicago Region: Housing Markets Appear Healthy, and Immigrants Play a Role

High levels of single-family home construction and resales in the Region reflect that housing demand remained strong through mid-2004.[16] The pace of home price appreciation varied among the Region's 59 MSAs but was generally moderate.[17]

Among the Region's largest MSAs, appreciation was strongest in **Chicago,** where price gains averaged 6.7 percent a year between the second quarters of 2002 and 2004. Contrasting home price trends in the Region's most industrialized states, **Indiana** and **Wisconsin,** partly may reflect the fact that manufacturing employment in Wisconsin rose by 0.9 percent in the year ending second quarter 2004 and fell by 0.6 percent in Indiana. Eight MSAs in the Region, mostly in Indiana, experienced less than 3 percent annual appreciation in the past two years. In contrast, seven of 13 MSAs with annual appreciation between 5.0 percent and 9.2 percent were in Wisconsin. In other MSAs scattered throughout the Region, home price appreciation averaged between 3.0 percent and 3.9 percent in 23 of them and between 4 percent and 5 percent in the remaining 15.

The Chicago MSA's large and growing immigrant population is helping spur local housing demand. Chicago is one of nation's major immigrant destinations, and most of the estimated 40,000 immigrants to **Illinois** each year settle in Chicago or its suburbs. This growing immigrant population provides new customer opportunities for residential developers and lenders.[18] In fact, immigrants recently have purchased up to 20 percent of newly constructed homes in some Chicago suburbs, about four times more than ten years ago.[19] Some developers, in turn, increasingly are tailoring their construction, design, and marketing to immigrant and ethnic groups, and some banks are expanding their efforts to serve this market.

Although some immigrants are considered to be undocumented, they may account for as much as $10 billion of potential mortgage lending in the Chicago area.[20] The untapped market is large and potentially profitable for lenders, who reportedly charge an additional 25 basis points to 100 basis points of interest on mortgages to undocumented persons, with the markup reflecting the size of the down payment and the lack of a secondary market for such loans.[21]

Serving this customer pool, however, may require banks to modify some long-standing practices. Some lenders have changed their policies to accept consular identification cards rather than Social Security cards as identification from depositors and loan applicants. Banks making mortgage loans to undocumented immigrants forfeit the ability to the sell mortgages in the secondary market to Fannie Mae and Freddie Mac, because such loans fail to meet their specifications.

[16] The Chicago Region consists of Illinois, Indiana, Kentucky, Michigan, Ohio, and Wisconsin.

[17] Appreciation rates are based on data from OFHEO that measure average prices of repeat sales or refinancings on the same single-family properties where the transactions involve conforming, conventional mortgages purchased or securitized by Fannie Mae or Freddie Mac.

[18] See "Banks Are Still Sizing Up Opportunities in the Growing Hispanic Market" by Jeffrey A. Ayres, Stephen L. Kiser, and Adrian R. Sanchez in this issue.

[19] John Handley, "Destination Chicago: Immigrants Put Their Stamp on Suburban Housing, Buying up to 20% of New-Construction Homes," *Chicago Tribune,* May 11, 2003.

[20] Steve Daniels, "No Documents? No Problem," *Crain's Chicago Business,* April 19, 2004.

[21] Ibid.

To the extent that banks and thrifts follow prudent risk management, operational, and underwriting standards, serving immigrants may provide a profitable channel for deposit, loan, and fee growth among insured institutions in the Chicago market and in other areas with large immigrant populations or inflows.

Joan Schneider, Regional Economist
David Van Vickle, Regional Manager

Kansas City Region: Steady Conditions Predominate

Housing markets in the Kansas City Region remain relatively stable. While home prices in metropolitan areas have increased moderately over the past couple of years, these increases are generally judged to have been in line with job growth and other economic fundamentals.

In the **Kansas City** metropolitan area, homes in **Johnson County, Kansas,** continue to have the highest average sales prices, followed closely by homes in **Platte County, Missouri.** Within Johnson County, **Olathe** continues to see particularly high levels of new home construction to meet the needs of a rapidly increasing population. **Wyandotte County, Kansas,** which has more moderate prices than Johnson County, experienced much higher increases in average new home prices over the past year (16.8 percent), as the new racetrack and shopping continue to draw residents. Outlying counties such as **Miami County, Kansas,** are seeing even higher growth in resale prices as buyers continue to move further from downtown in search of more affordable homes.

While the **Minneapolis-St. Paul** metropolitan area has experienced strong price increases over the past few years, at present, inventories of new and resale homes appear to be in balance, with the average home staying on the market for about five months before sale. However, according to the ***Minneapolis Area Association of Realtors,*** demand for higher-priced homes is beginning to wane, and selling times are expected to increase to over a year in the near future. While the median home price in the metropolitan area is higher than in the nation as a whole, the relative affordability of homes in this market is reflected in a local homeownership rate of more than 75 percent, compared with 69 percent nationwide.

In the **St. Louis** metropolitan area, current sales volume is brisk, but the pace is expected to slow over the next six months. The median home price has risen by about 5 percent during the last year, driven mostly by "move-up" sales to larger homes and by historically low interest rates. The **St. Charles** area has seen the greatest growth in new home construction, mainly due to lower land prices and a greater availability of building sites than in other parts of the metropolitan area.

One outlier market in the Region is **Wichita,** which continues to suffer job losses resulting from the struggling aircraft manufacturing industry. Existing home prices have fallen over the past year, while new home prices have increased slightly. Overall, home prices in Wichita have declined about 2 percent this year from January through August 2004.

Tight supplies of building materials are causing concerns for some builders and contractors. Recent shortages reportedly have added about 6 percent to the cost of new construction in the Region and threaten to constrain growth going forward. Delays in getting materials to job sites have reportedly increased lead times, which are the times between ordering and receiving building supplies, to three months. While such delays could hamper construction, they have not yet translated into a reduction in building permits, which remain strong in the Kansas City, St. Louis, and Minneapolis markets.

John M. Anderlik, Regional Manager
Shelly M. Yeager, Financial Analyst

Memphis Area: No Apparent Signs of Overheating in Mid-South Markets

A review of published reports and routine data series revealed no imminent signs of market-wide housing bubbles for any of the metro areas in the Mid-South, which comprises Arkansas, Louisiana, Mississippi, and Tennessee. Some factors that seem to be prominent in the national markets experiencing the most rapid price increases, such as the limited availability of building lots and cumbersome entitlement requirements, are largely absent in the Mid-South. According to data collected by ***OFHEO,*** home prices in these four states have risen 51 percent in the past ten years compared with 73 percent for the nation as a whole, and 22 percent in the past five years compared with 44 percent for the nation. Of all the major markets in the Region, **New Orleans, Monroe,** and **Houma, Louisiana,** experienced the strongest ten-year rate of home price appreciation; however, they ranked only 110th, 127th, and 128th in the nation, respectively. Housing affordability has remained fairly stable in these markets, as per capita income has grown at rates near the national average and in line with the pace of home price appreciation.

As noted in ***Money Magazine,*** "If you live in the many states where home-price gains have been more modest, the odds strongly favor more of the same. There's a much tighter relationship between home prices and incomes in Middle America than on the coasts. In California and Rhode Island, the correlation between home prices and income is ten times weaker. The main reason: There's more buildable land away from the coasts, so the balance between supply and demand rarely gets out of whack."[22]

Although it does not appear likely that housing prices will drop rapidly across the Mid-South Region, some submarkets and price ranges could experience imbalances that might result in increased inventories of unsold homes, longer selling times, and possible price declines. One area that merits close monitoring is the starter-home segment, where generational lows in mortgage rates have made owning a home more attractive than renting. However, rising interest rates could raise monthly payments beyond the capacity of many potential buyers and may also raise the debt-service costs of homebuilders, limiting their ability to continue incentive programs that have been stimulating demand.

Paul Vigil, Financial Analyst

Dallas Region: Residential Real Estate Round-Up

Residential mortgage foreclosures in **Texas** were the 12th highest in the nation as of mid-year and do not appear poised to improve anytime soon. September mortgage foreclosures in **Dallas County** were 21 percent higher than a year ago, while the increase was 22 percent in **Travis County** and 35 percent in **Bexar County.** Growth in jobs and wages remain the key drivers supporting home price appreciation, and in this regard, each market has its unique set of circumstances. Employment growth is still lackluster for most metro areas. For example, the Dallas metro area experienced two recent job loss announcements. First, Delta Airlines stated that it will discontinue operations out of Dallas/Fort Worth International Airport, cutting an estimated 3,600 direct jobs in North Texas. Electronic Data Systems (EDS) also announced a downsizing of between 13 percent and 17 percent, affecting some of the 7,700 EDS jobs in the Dallas area.

The **San Antonio** metropolitan area currently reflects a set of contradictory trends that could begin to show up in other parts of the country as well. While metro-area foreclosure rates are among the highest on record, the issuance of residential building permits is also at record high levels. One reason these seemingly contradictory trends can take place at the same time is that the city continues to grow primarily in the north, where most of the new building is taking place, while foreclosure rates have been increasing in the slower-growing southern part of the city.

In **Oklahoma,** mortgage foreclosures continue to rise to the highest level in a decade, ranking sixth highest nationwide. Personal bankruptcy filings per capita in Oklahoma are also in the top quartile among the states, suggesting that many consumers have been under significant financial pressure. Oklahoma employment growth turned positive in April for the first time since late 2001 but still ranks in the bottom half of the nation.

One Southwest Dallas Region metro area that is listed on many analyst watch lists for home price–income gaps is **Denver, Colorado.** According to ***OFHEO,*** the Denver housing price index has increased 41 percent over the past five years, which is the fastest metro rate of growth in the four-state Southwest Region. Moreover, the Denver ratio of median home price to household income is at its highest year-end level (4.66 times) since 1980.

Jeffrey A. Ayres, Senior Financial Analyst

San Francisco Region: Analysts Are Becoming More Wary of Price Increases

Strong home price appreciation in several areas of the San Francisco Region has fueled household wealth and spending and helped to keep foreclosure and bankruptcy rates low. However, home price increases in **Nevada, Hawaii,** and **California,** which reported the three highest rates of annual home price appreciation nationwide in second quarter 2004, may not be sustainable. A respondent from the banking industry

[22] Jon Birger, "What's Next for Real Estate: Another Hot Year for Home Prices Has Some Wondering Whether Real Estate Is Poised to Tumble," *Money Magazine,* March 1, 2004.

who follows the western residential market warned that at some point, the trend of increasing appreciation and decreasing affordability will have to come to an end, a sentiment echoed by several industry sources in the Region.

Nevada's rapid home price appreciation was spurred in part by robust increases in population, jobs, and new home construction costs. Speculative purchase activity may have also played a role.[23] While home prices in Nevada still remained relatively attractive when compared with several other West Coast states, a respondent in academia noted, "Recent home price appreciation has started to dry up housing affordability, and this may become an issue for Las Vegas and Nevada down the road."

Following years of sub-par home appreciation, Hawaii home prices picked up steam in 2002 and have continued to appreciate, reaching 19 percent appreciation in second quarter 2004. Recent appreciation is attributed to an improved economy, favorable interest rates, and renewed interest in home buying by both Hawaii residents and investors. Another respondent in the banking industry noted that mainland investors have driven much of the state's home price appreciation, particularly in Maui and Kauai.

In supply-constrained California, where 13 MSAs ranked in the top 20 nationally for annual price appreciation, concerns of an emerging bubble may have increased.[24] A market respondent defined a bubble as when you "buy not for the roof, but for the money, for speculation." The respondent also indicated that speculative home purchases may be on the rise in **Southern California,** although they are not evident in **Northern California.** In particular, **Orange County**'s "flipping" rate, or share of homes sold after being owned less than six months, is near its historic high.

Both single-family and construction lenders could face loan growth and asset quality challenges should markets cool as a result of rising interest rates. Some insured institutions based in areas with rapidly appreciating home prices, such as **Las Vegas, Honolulu,** and Central and Southern California could be particularly vulnerable, because they also appear to be exposed to some combination of high single-family mortgage or construction loan concentrations, significant volumes of variable-rate mortgages, and potentially speculative purchase activity.

Shayna Olesiuk, Regional Economist
Judy Plock, Senior Financial Analyst
John A. Roberts, Regional Economist

[23] "Foreclosures.com: Las Vegas Home Price Bubble Set to Deflate," *Mortgage Mag,* August 23, 2004, http://www.mortgagemag.com/n/408_032.htm.

[24] Markets reporting the fastest rates of annual price appreciation were predominantly in Southern and Central California.

Home Equity Lending: Growth and Innovation Alter the Risk Profile

As a component of the mortgage lending business, home equity lending has traditionally been characterized by low credit losses. However, recent trends reveal a rapidly changing landscape in the way that home equity lines of credit (HELOCs) are used by household borrowers and structured by mortgage lenders. Home equity debt is rapidly growing as a percentage of total household indebtedness, in part as a result of new loan programs that make HELOCs more accessible to borrowers, including groups of people who previously would not have had access to this product.

Amid these longer term changes in the marketplace, the current environment offers the additional challenges of rising short-term interest rates and the likelihood that home price gains will eventually level off in some of the nation's pricier home markets.[1] As a result of these trends, it is increasingly uncertain whether the traditionally low credit losses associated with home equity lending will remain a permanent attribute of this line of business. In any event, the changes being wrought by the marketplace are requiring both lenders and borrowers to think about home equity products in new ways. (See the inset box for information on HELOCs versus home equity loans.)

Households Shift toward Mortgage Debt

Over the past 20 years, the composition of household debt has shifted decidedly in favor of mortgage debt. Chart 1 shows that mortgage debt has risen from 64 percent of total household debt in 1985 to a new high of more than 72 percent in 2003. While the relative use of mortgage debt has risen and fallen over time in response to such factors as home prices and mortgage interest rates, the general trend since the mid-1980s has been upward. One important factor in this long-term trend was the Tax Reform Act of 1986, which eliminated the tax deduction for consumer credit and expanded the home mortgage interest deduction. Since 1986, cumulative inflation-adjusted growth in household mortgage debt has been 151 percent, compared with growth of 88 percent in nonmortgage consumer credit.

[1] See "A Turning Point Ahead? National and Regional Trends in Residential Real Estate Markets" in this issue.

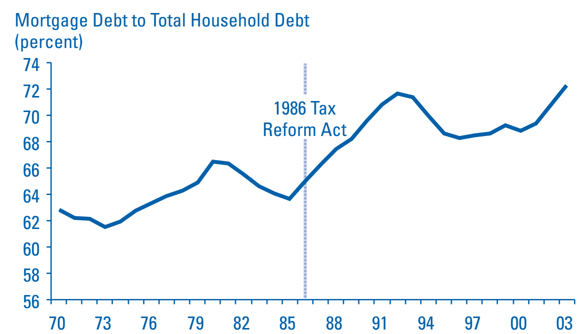
Recently, preference by households for mortgage debt has become even more pronounced. Since the end of 2000, total mortgage debt owed by households has soared by $2.25 trillion, or 47 percent. Two principal factors account for this recent increase in mortgage indebtedness: a rapid accumulation of owners' equity in residential real estate and a sustained decline in mortgage rates to historic lows.

The equity held by U.S. households in their homes has also risen sharply of late (by almost $2.2 trillion since 2000) as homeownership has spread and home prices have surged. The percentage of U.S. households that own their own homes reached a record high of 69.3 percent in second quarter 2004, reflecting the addition of more than 12 million new homeowner households in the past ten years. This increased demand for housing, in turn, has helped push home prices higher. The repeat-sale home price index of the ***Office of Federal Housing Enterprise Oversight*** (OFHEO) rose by nearly one-third from 2000 to 2003, and none of the 331 individual U.S. metropolitan areas covered by the OFHEO index has seen an annual price decline since 2000.

As home prices have surged, home construction has remained brisk. The annual number of new homes started has exceeded 1.5 million units in every year since 2000, rising steadily during that time to an 18-year high of 1.85 million units in 2003.

Chart 1

Mortgage Debt Has Risen as a Percentage of Total Household Debt, Particularly Since the Tax Reform Act of 1986



Source: Federal Reserve Flow of Funds.

Home Equity Lending: HELOCs versus Home Equity Loans

Home equity lending comprises two types of loans secured by junior or senior liens on 1–4 family residential properties: (1) HELOC, an open-end, revolving credit that is typically tied to a variable interest rate and allows borrowing of any repaid loan amounts, and (2) home equity loan (HEL), a closed-end, one-time credit with fixed interest rate and repayment amounts. Table 1 shows that home equity lending as a whole is dominated by HELOCs, which compose almost 80 percent of market share. HELOCs also account for almost all of the recent growth in home equity lending, averaging 30 percent quarterly growth since 2000, while HELs have been relatively flat. Because of their high market share, soaring growth, and exposure to interest rate risk, HELOCs are the focus of this article.

Table 1

Volume of Home Equity Lending by Type of Financial Institution *(billions of dollars)*

Year	Home Equity Loans		Home Equity Lines of Credit	
	Banks	Thrifts	Banks	Thrifts
1990	NA	NA	$69,441,439	$16,380,648
1995	$66,116,479	NA	85,027,381	12,889,414
2000	163,677,595	NA	133,271,483	17,484,625
2004 (first half)	88,428,888	$19,292,495	356,811,082	58,994,633

Notes: All FDIC-insured institutions report financial results on a quarterly basis by filing standardized forms: Banks file Reports of Condition and Income (Call Reports) and thrifts file Thrift Financial Reports (TFRs). Before 2004, TFR filers did not report home equity loans; Call Report filers began reporting home equity loans in 1991. NA = not available.

Source: Federal Deposit Insurance Corporation.

Sustained low mortgage interest rates have provided the backdrop for rising mortgage indebtedness, rising home prices, and rapid home construction. An industry standard measure of mortgage rates is the ***Freddie Mac*** contract rate for 30-year conventional mortgages. Between the inception of this series in 1971 and mid-2002, the Freddie Mac contract rate had never dipped below 6.5 percent. However, this rate has remained below 6.5 percent in *every* month since June 2002, dipping briefly to an all-time low of 5.23 percent in June 2003.

Such historically low mortgage rates not only have prompted households to take on mortgage debt to buy new homes but have spurred record volumes of mortgage refinancing. Homeowners have taken advantage of historically low interest rates to consolidate mortgages and refinance at lower rates, often taking cash out. The ***Mortgage Bankers Association*** (MBA) Mortgage Refinance Index climbed to all-time records in 2001, 2002, and 2003. As mortgage rates bottomed out, refinancing volumes peaked in June 2003, but they have fallen sharply since then. From June 2003 to June 2004, 30-year fixed mortgage rates increased more than 100 basis points, and the MBA refinance index dropped to its lowest point in two years. Indeed, the MBA recently forecast that the dollar volume of refinancings would decline 57 percent in 2004 from a record $2.5 trillion in 2003.[2]

Home Equity Lending Becomes a Preferred Vehicle

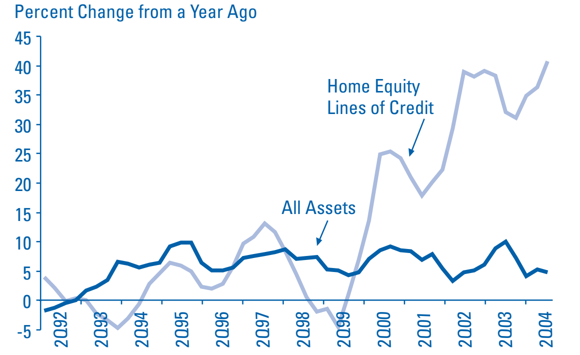
Both during and since the 2002–03 boom in mortgage refinancings, HELOCs have experienced explosive growth (see Chart 2). The average annualized quarterly rate of growth of HELOCs carried on the books of FDIC-insured institutions since the end of 2000 has been 30.2 percent. HELOCs are now the fastest growing asset class on financial institutions' balance sheets and comprise 7 percent of bank loan portfolios, up from 3 percent in 2000.

The rationale for homeowners' greater use of HELOCs is straightforward. With consumer spending outpacing income growth in the 2000s, homeowners have turned increasingly to home equity lending as a substitute for consumer credit to finance new consumption, reduce

[2] Mortgage Bankers Association, "MBA Mortgage Finance Forecast," August 13, 2004.

Chart 2

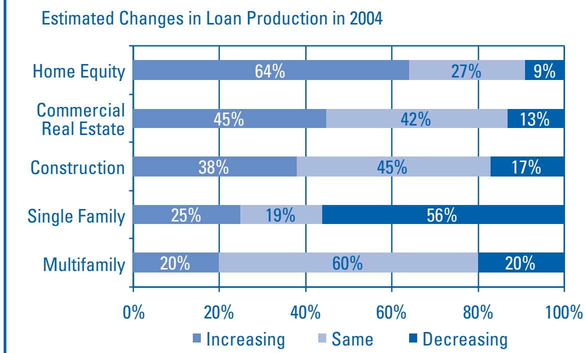
Home Equity Loans Are the Fastest Growing Asset Class on Financial Institutions' Balance Sheets



Source: Federal Deposit Insurance Corporation.

Chart 3

Loan Production Efforts Are Targeting Home Equity Lending over Other Loan Types



Source: America's Community Bankers 2004 Real Estate Lending Survey.

outstanding debt, or purchase a home in a two-loan package deal.[3] The appeal over other more costly credit alternatives derives from the significant advantages of comparatively low interest rates, tax deductibility, and easy availability, since income and cash flow tests matter less for determining credit lines than for credit cards or auto loans. Furthermore, because HELOCs offer the flexibility to draw money only as needed and the convenience of a revolving credit line, borrowers favor HELOCs more and more over closed-end home equity loans.[4] For these reasons, many homeowners are converting the equity in their home into cash through home equity borrowing and making this kind of transaction an increasingly important part of their household finances. With the dramatic decline in mortgage refinancing volumes since mid-2003, a homeowner would more likely choose to tap home equity through a draw on a HELOC rather than extract cash as part of a refinancing.

A rising volume of HELOC debt also has a rationale from the lender's perspective. Mortgage lenders are looking to home equity products to replace loan volumes that have declined in the wake of the refinancing boom. According to ***America's Community Bankers'*** 2004 Real Estate Lending Survey, 56 percent of survey respondents expected single-family residential loan production to decline this year as the refinancing boom slows; however, by a larger margin (64 percent), they expected an increase in home equity lending (see Chart 3).[5] Clearly, lenders anticipate that consumers will turn more to home equity lending as refinancing activity wanes.

The challenge for lenders in this post-refinance period is not only to lift production of new HELOCs but also to get customers to draw more against existing lines. Although HELOC outstandings totaled $415.8 billion in second quarter 2004, this represented only half of the total approved borrowing limits, or commitments, on those lines. The utilization rate for HELOCs was almost 49 percent as of second quarter 2004, leaving $435 billion sitting untapped in committed home equity lines extended by banks (see Chart 4). This untapped amount represents a substantial source of potential fee income for lenders and available cash for consumers.

New Incentives to Boost Home Equity Borrowing

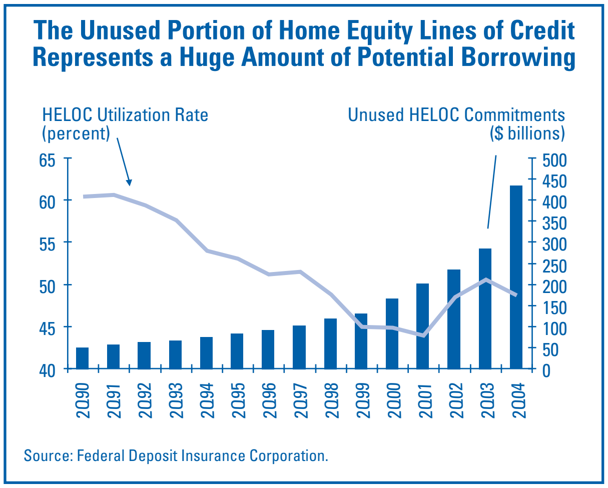
In addition to offering low introductory teaser rates common with many adjustable-rate credit products, lenders have an array of innovative products, marketing

[3] A home purchase can be transacted with a two-loan package deal, or piggyback loan, wherein a buyer typically makes a 10 percent cash down payment and finances the rest with a first-lien mortgage of 80 percent and a home equity loan for the remaining 10 percent. Borrowers who typically use piggyback loans may be financially stretched and unable to pay a 20 percent cash down payment, want to sidestep private mortgage insurance premiums, or wish to avoid a jumbo-rate first mortgage.

[4] HELOCs led home equity loans with 79 percent of market share as of June 2004 (see Table 1).

[5] The results of the America's Community Bankers' 2004 Real Estate Lending Survey correspond with those of the Office of the Comptroller of the Currency's 2003 Survey of Credit Underwriting Practices (see note 6), which reported that home equity lending has grown tremendously in recent years and that many banks plan to continue to increase this product over the next year.

Chart 4



techniques, and sales incentives to attract new HELOC borrowers and encourage increased draws by existing borrowers (see Table 2). The objectives underlying lenders' efforts to increase home equity lending are to obtain new borrowers (for whom borrowing cash by tapping into their home's equity with a cash-out refinancing becomes more costly and less appealing as rates rise) and to encourage existing HELOC borrowers to draw down their unused commitments.

Not only are many of these structures floating-rate products and thus exposed to rising interest rates, but many also have a loss experience that has been untested by a general downturn in the housing market. For example, interest-only loans often require a balloon, or lump-sum, payment when the term of the loan ends. Home equity disclosures do not require the creditor to disclose the amount of any balloon payment that will result under the terms of the plan. In addition, payments on some loans may not cover the interest due so negative amortization will occur, resulting in the loan balance increasing rather than decreasing and the borrower repaying a much larger loan amount in the long run. Lenders who extend HELOCs with a credit limit that automatically

Table 2

Creative Ways Banks Are Targeting Home Equity Line of Credit (HELOC) Loans

To Produce New HELOCs, Banks Are

- Offering loans that meet different needs, such as
  - Purchase-and-renovate loans that allow borrowers to finance a home purchase plus remodeling expenses based on the home's value after improvements are made.
  - Loans whose credit limit increases automatically as the home appreciates in value, with monthly reports of the line increase due to equity build-up.
  - Interest-only loans, which often require a balloon, or lump-sum, payment when the plan ends.
  - HELOCs with fixed rates for the first three, five, or seven years to allay fears of rising rates.
- Sending personalized mailings that estimate equity in a customer's house and the cash available through home equity products.
- Performing data analyses on mortgage portfolios to alert certain customers that they have been preapproved for a home equity product, and offering them a streamlined application with the vast majority of information prepopulated.
- Using automated valuation models outside of the origination process to identify potential borrowers with delinquent credit cards and alert them to the possibility of consolidating credit card debt with a HELOC.
- Providing online application and decisioning services that enable borrowers to receive instant online approval of their HELOC applications and obtain funds in as little as two weeks.

To Increase the Use of Existing HELOCs, Banks Are

- Charging nonuse fees on lines that are open but inactive.
- Giving discounts on interest rates if use is increased by a certain amount.
- Requiring that a certain outstanding loan balance be maintained for a period of time (e.g., 25 percent of the maximum credit line for 36 months) to receive an initial introductory rate and avoid an introductory rate reimbursement fee.
- Offering lower rates for automatic deduction of loan payments from a bank account.
- Giving rewards to loan representatives if funds are drawn within six months after a HELOC is opened.
- Allowing customers to earn reward points if they access HELOC funds with a credit card-type vehicle.

increases as the home appreciates or a credit line based on future value are gambling that home prices will continue to increase. Finally, HELOC borrowers who increase their draws may not be aware that the higher their use of this revolving line of credit, the more it negatively affects their credit score.

Underwriting Practices for HELOCs

The fact that HELOC credit losses have remained low and stable over time can be attributed largely to underwriting practices that evaluate borrowers effectively and provide the lender protections against default. Like other areas of consumer and mortgage finance, HELOC underwriting typically is based on quantitative credit models that relate credit scores and other criteria to a probability of default. While these models are by no means perfect, they offer lenders considerable insight into how well actual loan performance compares with model-based predictions. Stability in loan performance also has been greatly enhanced by the fact that HELOCs are secured by the equity in the borrower's home. Depending on the loan-to-value ratio of the credit, the presence of collateral may not offer a significant source of recovery to the lender in the case of default. Even when this is the case, however, the prospect of losing one's home remains a powerful deterrent against default.

Because of the tremendous growth of HELOC lending in recent years, concern has arisen that home equity underwriting practices have eased. Indeed, home equity products exhibited the greatest increase in risk, according to the 2003 Survey of Credit Underwriting Practices conducted by the ***Office of the Comptroller of the Currency*** (OCC). Although the performance of home equity loans remains strong, as demonstrated by low delinquency rates, the survey noted that "banks need to be alert to the risks that are introduced when high growth is coupled with liberalized underwriting."[6]

The OCC's reference to liberalized underwriting methods may allude to underwriting methods that are increasingly used by home equity lenders but may carry certain modeling risk due to the absence of a significant housing market downturn in over a decade and a mild recession in 2001. In 2003, 44 percent of lenders used auto-decisioning (defined as systematic credit decisioning with no manual intervention) in support of credit underwriting, up from 13 percent in 1999, and 84 percent used credit scoring, up from 68 percent in 1999.[7]

Lenders should be especially cognizant of underwriting practices during a period of change in the macroeconomic environment. The two biggest issues here that bring up questions are interest rates and home prices. Specifically, how fast and how far will interest rates rise during the present period of tightening monetary policy? Also, when will home prices ultimately level off, and could they actually decline in certain high-priced metropolitan areas? Because HELOC interest rates are typically tied to benchmark short-term interest rates, rising rates make it more expensive for borrowers to service their debt. Higher rates could also dampen demand on the part of new homebuyers, thereby slowing the rate of home price increases. Should home prices stagnate or fall, the most important effect for lenders could well be an erosion in the equity position of some homeowners that will marginally reduce their incentive to repay the HELOC.

Lenders should also be aware of HELOC use. Drawdown rates for HELOCs are edging up, from 44.4 percent in first quarter 2000 to 48.3 percent in first quarter 2004. However, these utilization rates remain well below the peak of 60.7 percent reached in first quarter 1991. The utilization rate is an important metric for lenders to watch, because a rise could indicate that consumers are drawing more on HELOCs for spendable cash and are in a weaker position to repay the loans.

Credit Performance Remains Strong…

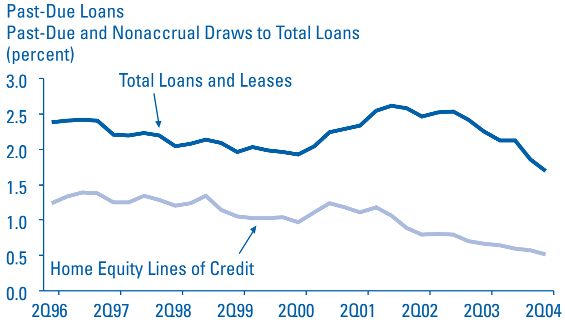
To date, loan delinquencies have remained at historically low levels due to strong housing market fundamentals and low interest rates. In the area of home equity lending, such trends are even more pronounced. As home equity lending has soared in the past five years, more than doubling its share of total loans in bank portfolios, its credit performance has shown consistent improvement. The proportion of delinquent to total HELOCs was at 0.51 percent in second quarter 2004 (see Chart 5). This was the second lowest

[6] Office of the Comptroller of the Currency, *2003 Survey of Credit Underwriting Practices,* September 2003, http://www.occ.treas.gov/2003underwriting/creditunderwriting2003.htm.

[7] Consumer Bankers Association, 2003 Home Equity Study, November 2003.

Chart 5

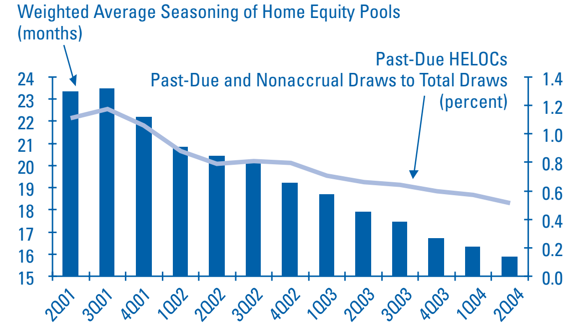
Bank Home Equity Loan Performance Continues to Strengthen and Remains Much Improved Compared with the Rest of the Industry



Source: Federal Deposit Insurance Corporation.

Chart 6

Improving Loan Performance May Indicate, However, That Home Equity Loans Are Highly Unseasoned and May Mask Credit Risk



Sources: Moody's Investors Service; Federal Deposit Insurance Corporation.

delinquency rate for all major loan categories, just behind multifamily properties at 0.53 percent, and far below 1.70 percent for all loans and leases.

…But Most Loans Are New

The rapid increase in new loans, however, has shortened the seasoning of home equity pools, or their collective "age." The weighted average seasoning of home equity pools has declined considerably, according to ***Moody's Investors Service*** quarterly home equity index. Seasoning had shortened to just 15.89 months as of second quarter 2004 (see Chart 6). Loans typically move into their peak period of delinquency risk at around 36 months of age.[8] Thus, the improving loan performance of HELOCs may merely reflect the fact that home equity loans are highly unseasoned. This situation may mask any potential increase in credit risk arising from the more aggressive loan structures introduced in recent years.

Subprime Borrowers Present Credit Concerns

Credit quality concerns are most pronounced in the case of subprime households. Among subprime HELOC borrowers, delinquencies were high at 5.43 percent in second quarter 2004, compared with only 0.51 percent for overall HELOC borrowers (see Chart 7). Rising interest rates may well propel this rate higher, particularly since lower income households, whose incomes may already be strained, account for the highest proportion of subprime home equity borrowers.[9]

Risk Management Considerations

Home equity lines account for a still small, but rapidly increasing, portion of the loan portfolios of FDIC-insured institutions. Despite the continued low credit losses that lenders are experiencing in these portfolios, changes in the marketplace are raising some concerns about future credit quality trends. Outstanding balances continue to rise rapidly as homeowners take advantage of increases in their home equity and historically low interest rates. Lenders, in turn, have targeted HELOCs as a new growth area in the aftermath of the refinancing boom. To further increase loan originations in the home equity lending area, lenders are using a number of new marketing techniques and loan structures with which they have comparatively limited experience to date.

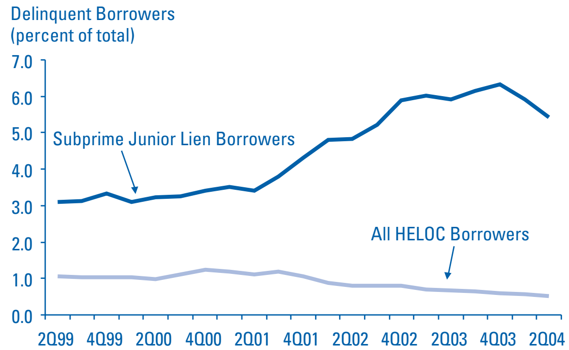
Although the underwriting techniques typically applied to HELOC loans make good use of available quantitative data and modeling techniques, there is evidence that risks are rising. Besides rapid growth and new lending techniques, a changing macroeconomic environment also poses challenges. The recent period of historically low interest rates and rapidly increasing home prices was particularly conducive to the use of HELOC credit by homeowners and to their

[8] *National Mortgage News,* October 29, 2001, citing Moody's Investors Service.

[9] Edward M. Gramlich, "Subprime Mortgage Lending: Benefits, Costs, and Challenges," at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois, Federal Reserve, May 21, 2004.

Chart 7

The Number of Seriously Delinquent Subprime Home Equity Borrowers Has Trended Up Sharply Since 2000



Sources: Federal Deposit Insurance Corporation; Loan Performance Corporation.

ability to service that debt. However, to the extent that these conditions give way to a period of higher interest rates and stable or falling home prices, loan performance could deteriorate in the future. Uncertainty about future loan performance is heightened by the fact that HELOC portfolios remain highly unseasoned at present. Given these uncertainties, lenders and borrowers should not automatically assume that their historical loss experience is an accurate guide to future repayment ability. To the extent possible, it makes sense in this environment to estimate how loss projections might change under a less advantageous set of market conditions.

Cynthia Angell, Senior Financial Economist

Lending Practices of Captive Auto Lenders Are Driving Risks in Bank Auto Paper

The auto finance market is very competitive, dominated by car manufacturers and their captive finance companies that have a direct stake in the success of the auto industry.[1] To promote sales, auto manufacturers offer a wide variety of financial incentives to entice customers into car dealership showrooms. These incentives include cash rebates, favorable financing rates (as low as 0 percent), lower down payments, and longer repayment schedules.

In the current environment, banks are competing against aggressive terms offered by captive finance companies, credit unions, and other insured institutions. As a result, banks may have loosened auto loan underwriting standards that could leave them vulnerable if interest rates continue to rise or if economic fundamentals weaken.[2] Fortunately, market conditions to date have helped banks maintain asset quality levels that are relatively low and stable.

This article will look at the keenly contested auto lending arena and how banks operate in it. The article also examines the factors that may affect auto credit loan quality going forward.

In the Competitive U.S. Auto Industry, Incentives Offered to Buyers Have Increased

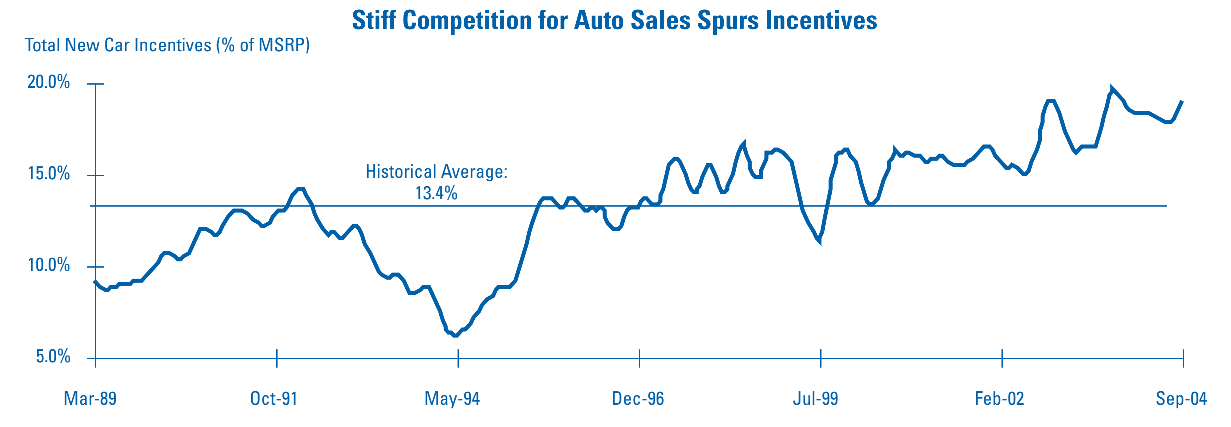
Outstanding retail auto loan balances totaled almost $740 billion as of 2003; $186 billion of that amount represents new credit extended in 2003.[3] Therefore, each tick, or increase in market share, by auto lenders is extremely valuable. A small handful of captive auto finance companies, including General Motors Acceptance Corporation (GMAC) and Ford Motor Credit Company, account for approximately 56 percent of total auto financings; the remaining 44 percent is held by banks, credit unions, and other independent financial institutions.[4] Because of the dominance of the captive finance companies, banks often have to compete with aggressive incentive programs offered by non-bank lenders.

To sustain demand for new models over the past three years, automakers have offered low prices and thousands of dollars in incentives for each car (see Chart 1). Average annual incentive amounts have increased each year since 2001, and 2004 incentives are on pace to continue that trend. The discount from the manufacturer's suggested retail price (MSRP) averaged 18.4 percent over the first nine months of 2004. These incentives, which include cash rebates, price discounts, added car extras, and interest rate and lease subsidies, contribute to pulling consumers back into the market before typical auto needs would dictate.[5] Analysts expect that after a slowing rate of growth in the first half of 2004, incentives will increase in the second half, along with prices.[6]

Financing terms have become increasingly aggressive as lenders find ways to lower borrower payments. Both subsidized interest rates and longer loan maturities have enabled consumers to afford higher levels of debt owed on cars with decreasing average monthly car payments.[7] *Federal Reserve* data show that the average maturity of a new car loan lengthened from 53 months in 1999 to 62.5 months in fourth quarter 2003, then settled back to 61 months in June 2004. According to one industry analyst, 20 percent of car buyers now choose 72-month loans.[8] Similar trends were noted on used car loans. Due in part to declining loan amounts and increasing loan maturities, the average monthly payment on car loans declined to $453 in June 2004 from $466 in June 2003 and from a cyclical peak of $493 in January 2004.[9]

[1] A *captive finance company* is usually a wholly owned finance subsidiary of a major auto producer, such as General Motors Acceptance Corporation.
[2] Delinquency and charge-off rates on auto loans are not provided in the Call Reports.
[3] Christine Pratt, "Automobile Finance Industry Overview: Do Portfolio Metrics Constrain IT Investments?" Needham, MA: TowerGroup, September 2004, http://www.towergroup.com.
[4] Deutsche Bank, "U.S. Autos: A Triple Threat," February 20, 2004.
[5] Merrill Lynch, "Auto Incentives Monthly Snapshot," September 2, 2004.
[6] Credit Suisse First Boston, "Big Three Incentives Bounced Higher in July," August 5, 2004.
[7] *Subsidized interest rates* refer to rates on auto loans that are below market interest rates, such as 0 percent financing. Captive finance companies may extend credit on car loans at below market rates to facilitate sales of cars manufactured by their parent company.
[8] Jason Stein, "Upside Down and Sinking Fast," *Automotive News,* February 16, 2004.
[9] Morgan Stanley, "Rates Rise and Consumers Buy Down," August 9, 2004.

Chart 1



Source: CNW Marketing Research.

Incentives also have been extended to borrowers who are already at the margin of affordability, which is clear from the increasing rate of publicly issued subprime and near-prime auto asset backed securities (ABS) over the past few years. ***Moody's Investors Services*** indicates subprime and near-prime auto ABS issuance hit an all-time high of $23.8 billion in 2002, up consistently from approximately $2 billion in 1994.[10] Although issuance fell to $18.5 billion in 2003, analysts expect it to rebound to $20.5 billion in 2004, based on economic and loan origination forecasts. Although issuance trends are similar for prime auto ABS, their rate of growth since 1994 does not match the rate of growth in subprime auto ABS. Favorable financing terms and dealer incentives have been offered across the pricing spectrum from luxury to economy cars, enabling consumers to purchase more car for their dollar. Borrowers whose primary concern is the dollar level of payments are often less creditworthy and may be more vulnerable to default risk should they face any adversity, including rising interest rates on other debt.

As a result of already high and increasing incentives, the volume of new car sales has been expanding. Although the rate of new car sales moderated slightly during the summer, the volume of sales is still at a historically high level. Between August 2003 and August 2004, sales of new cars grew at a 2.3 percent rate; that rate increased to a 4.8 percent rate in September 2004. In contrast to new car sales, which have been propelled by various incentives, used car sales increased at a modest 0.6 percent annualized rate through August 2004.[11]

Expanding Sales Volume and Incentives Have Pushed Down Collateral Values

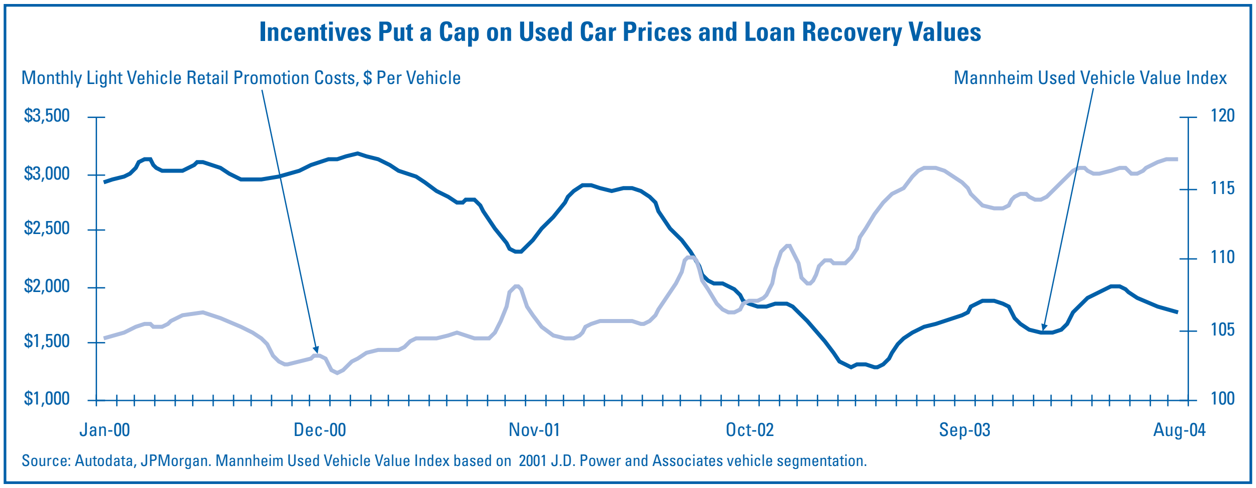
Used car values are important to auto lenders because they are key to determining recoveries in the event of vehicle repossession. Although the volatility of used car prices (versus those of new cars) makes it difficult for lenders to estimate their loss accurately, lenders can expect that an economic environment with depressed used car values will translate to lower recoveries and higher net losses. After declining approximately 13 percent since the start of the 2001 recession, used car values recovered somewhat in 2003 and stayed steady through August 2004, although values remain below pre-recession levels (see Chart 2).

The main factors that influence used car values are sales incentives for new cars and inventory levels for used cars. Higher incentives for new cars negatively affect used car values by putting an upper limit on a model's resale value. For example, the ***Power Information Network*** says a typical two-year-old sport utility vehicle declines in value by $500 for every $1,000 in incentives offered on the new model.

[10] Moody's Investors Service, "2003 Review and 2004 Outlook: Vehicle-Backed Securities Incentives Rule the Road," January 2004.

[11] Economy.com, "Vehicle Sales," October 1, 2004; and Credit Suisse First Boston, "Specialty Finance September Monthly," September 2, 2004.

Chart 2



Supply and demand factors also influence used car values. A greater volume of new car sales increases the inventory of used cars on the market, which places downward pressure on used car prices. Used car inventories in August 2004 increased by 11.6 percent over the same month one year ago. Declining used car prices in late 2003 were consistent with year-end new car sales promotions that encouraged car owners to sell their used cars in favor of brand-new models.

In addition, used car inventory is affected by fleet sales of used cars, such as sales from car rental agencies. Because fleet sales tend to be larger volume sales, used car prices tend to decline as these cars return to the used car market. Recent industry reports suggest that some major auto manufacturers have increased fleet sales, thereby boosting their sales volume, but these higher fleet sales could place pressure on used car values going forward.[12] For example, midsize cars have displayed noticeably weaker used car values, which can be attributed in large part to popularity in, and eventual disposition from, rental car fleets.[13]

Cars coming off leases also affect used car prices by adding to the used car inventory. Although leasing was popular in the late 1990s, it has become less so in recent years, because automakers have lowered their estimates of residual auto values offered on car leases. Reduced residual values, a consequence of the declining market value of used cars, have made leasing a relatively more expensive option than an outright purchase. Lower interest rates and other incentives also make purchasing the more attractive option. Some analysts expect leasing to increase in coming months as higher interest rates and a lower volume of mortgage refinancing activity make purchases more difficult for the average consumer.[14]

Negative Equity among Car Owners Has Increased

An alarming number of recent car buyers have owed more on their cars at trade-in than they are worth. Earlier this year, *J.D. Power and Associates* estimated that approximately 38 percent of new car buyers are "upside down" (that is, have negative equity) at trade-in, which contrasts with 25 percent just two years ago.[15] Using data from June 2004, one analyst estimates that the average buyer becomes "right-side up"—that is, when the buyer owes less on the loan than the car is worth—at 34 months, up from 33 months in May 2004.[16] (See the inset box for more information on the origination of auto loans with negative equity.)

The amount of time it takes for a borrower to achieve positive equity depends on a variety of factors, including the loan amount, loan-to-value ratio, loan maturity, and the vehicle's rate of depreciation. Higher loan-to-

[12] Deutsche Bank Securities, Inc., "Beware of False Dawns: March Sales Boosted by Fleet," March 2004.

[13] Fitch Ratings Ltd., "2004 Term ABS Outlook and Fourth Quarter Recap," February 2004.

[14] John Porretto, "Auto Leasing Expected to Rise in 2004, a Plus for Dealers," *Detroit News Autos Insider,* January 31, 2004.

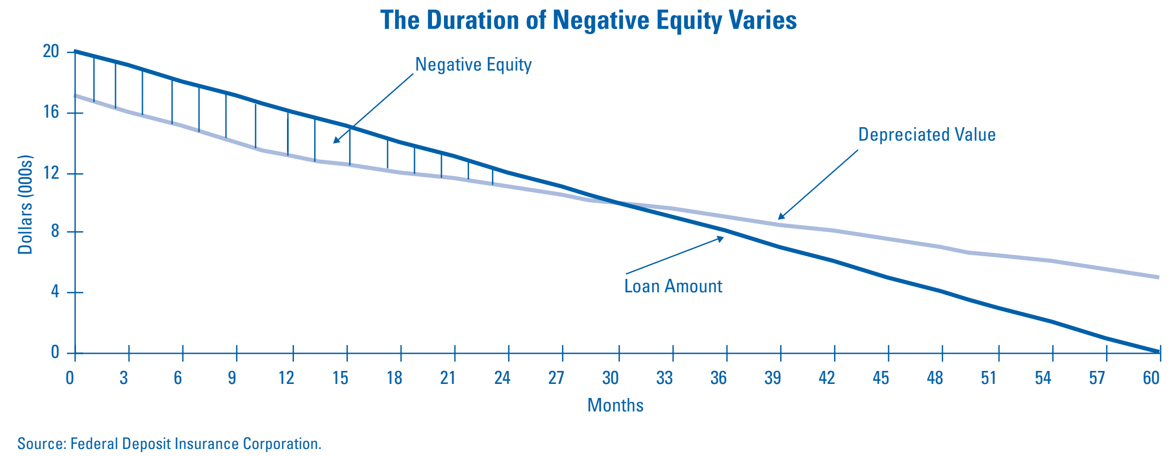
[15] Danny Hakim, "Owing More on an Auto Than It's Worth as a Trade-In," *New York Times,* March 27, 2004.

[16] Morgan Stanley, "Consumer Credit: Rates Rise and Consumers Buy Down," August 9, 2004.

Negative Equity Explained

A loan typically has negative equity (also known as being upside down) earlier in the loan cycle as the depreciation on the car exceeds the principal paydown—the total principal repaid to the lender—on the car loan (see Chart 3). Negative equity declines more slowly with lower monthly car payments and more quickly with higher payments. As the owner makes payments and the depreciation rate slows, the level of negative equity declines until the owner is right-side up, or when the owner owes less on the loan than the car is worth, which is approximately 30 months into the loan in the Chart 3 scenario.

Chart 3



Competition within the industry has led many dealers to roll negative equity into a purchaser's new loan. A scenario in which negative equity is consolidated into a new car loan is described in the table below:

Table

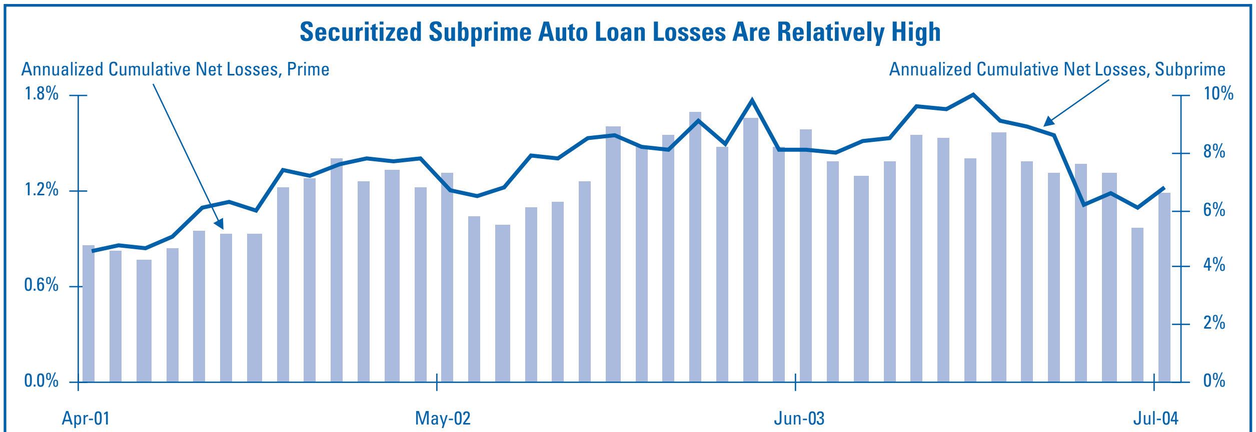
Scenario Resulting in Negative Equity

- Dealership offers new car for $25,000.
- Buyer negotiates price to $22,000.
- Buyer and seller agree on $10,000 value of trade-in car and recognize $12,500 debt outstanding on existing car loan.
- Dealer adds $2,500 to $22,000 negotiated price of new car, resulting in new purchase price of $24,500.
- Dealer presents lender with loan application for a $24,500 car.
- Lender agrees to finance 95 percent of the $24,500 transaction price ($23,275) on a car with a $25,000 MSRP.
- Customer borrows $23,275 for a car that had a negotiated purchase price of $22,000.
- Loan-to-market market value ratio approximates 106 percent (loan amount of $23,275 as compared with original negotiated sales price of $22,000).

value ratios and longer repayment terms are key factors that have contributed to the increased frequency of negative equity. Some car owners with high loan-to-value ratios and extended repayment plans may never reach positive equity, as they are enticed back into the showroom while owing more on their current vehicles than the cars are worth.

The amount of negative equity on outstanding car loans may continue to increase in 2004. While information on the maturity of car loans held by

Chart 4



Source: Fitch Ratings Ltd.

FDIC-insured institutions is not readily available, car loan maturities have increased among captive auto finance companies. Reports indicate that approximately 21 percent of Ford Motor Credit's new car loans in 2003 span 72 months—compared with 7 percent in 2002—even though Ford projects that consumers will sell their cars after 40 months. The percentage of 72-month loans also substantially increased last year at GMAC (29 percent) and Chrysler (35 percent).[17] Incentive programs, such as loans recently offered by General Motors and Ford with 72-month terms and 0 percent financing, are likely to continue this trend.

Credit Quality on Securitized Auto Loans Improved, but Subprime Remains Weak

Improved economic conditions and wholesale vehicle prices have contributed to lower delinquencies and charge-offs on auto loans in the past year.[18] According to ***Fitch Ratings***, both delinquencies and charge-off rates on securitized prime auto loans improved during 2004 after some weakness during 2003 (see Chart 4). This improvement in loss rates was also partly due to some recovery in used car values that helped stabilize losses on repossessed cars. For subprime auto loans, loss rates improved through August 2004 on a year-over-year basis, but levels and month-to-month volatility remained high (see Chart 4).[19] In spite of the improvement in 2004, risks to the subprime sector remain, including rising interest rates, financially weakened consumers, and lower collateral values.

Looking Forward: Factors That Will Influence Auto Credit Loan Quality

A fundamental gauge of auto loan underwriting is credit scores. However, detailed trends in credit score history for car loans are proprietary and not readily available. A May 2004 ***Consumer Bankers Association*** (CBA) study with survey results from respondents such as finance companies and insured institutions showed a slight improvement in credit scores among auto lenders in the past two years.[20] The study reported that 52 percent of auto loans were assigned scores of 720 or above in 2003, compared with 50 percent in 2002. Moreover, according to the study, 24 percent of auto loans had scores below 680 in 2003, down from 29 percent the previous year. However, according to an August 2004 report by ***CreditSights, Inc.***, an independent research company, the average credit score for all consumer loans has drifted up during the past ten years or so, from the mid-600s to 700 today, suggesting a general inflation of credit scores.[21]

[17] Deutsche Bank Securities, Inc., "Ford Motor Company," March 2004.

[18] Although auto loans are not segregated on Call Reports filed by insured institutions, credit quality information on securitized auto loans is available from various rating agencies.

[19] Fitch Ratings Ltd., "Third Quarter 2004 Term ABS Recap and Outlook: Through the Looking Glass," October 8, 2004.

[20] Consumer Bankers Association, 2004 Automobile Finance Study, May 2004. This is a national study of indirect auto financing, leasing, and direct floor-plan financing. Surveys were completed in January and February 2004 and based on activity during 2003.

[21] CreditSights, Inc., "Consumer Credit Scoring: Is FICO Fixed?" August 24, 2004, http://www.creditsights.com.

While overall credit scores on auto loans among lenders may have modestly improved, reports suggest that other aspects of auto loan underwriting may have eased in the past several years. According to the May 2004 CBA study, the percentage of auto lenders that allowed dealers to approve loans without the lenders' initial approval doubled in 2003, rising from 25 percent in 2002 to 51 percent last year. The percentage of lenders that accepted indirect auto loan applications via the Internet also substantially increased in 2003. In addition, processing times for car loan applications have declined. For example, the percentage of lenders that spent less than ten minutes per loan increased from 18 percent to 28 percent during the past year. While these results may indicate increased automation and efficiency among auto lenders, it may also indicate less scrutiny by some lenders.

Conclusion

Insured institutions that engage in auto lending, either directly or indirectly, operate in a highly competitive environment.[22] Banks face aggressive competition for pricing and terms on car loans from credit unions, other insured institutions, and captive finance companies. In the face of softening car sales, captive finance companies of large auto manufacturers often use auto lending as a loss leader to facilitate sales, thereby driving market pricing and terms on auto loans. In addition, reports indicate that competition for the various credit quality segments of auto loans is intensifying, particularly among mid-prime loans, as lenders attempt to stratify segments of the auto loan market.[23]

Credit quality on securitized prime auto loans remains relatively well-behaved at present. However, auto loan maturities are extending, auto loan collateral is increasingly upside down, and lenders continue to finance aggressively in the subprime sector. Rising interest rates, consumer fundamentals, and economic conditions, as well as institution-specific loan underwriting, will be the drivers of auto loan credit quality going forward. On the positive side, stabilization in credit quality ratios of securitized auto loans during the first three quarters of 2004 suggest that improving economic conditions could partially mitigate the effects of higher loan-to-value ratios, longer maturities, and increasing incidences of negative equity on auto loans' credit quality. However, auto loans to marginal or subprime borrowers in particular may remain more vulnerable to credit quality deterioration, particularly in a rising rate environment.

Alexander Gilchrist, Regional Economist

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[22] An *indirect loan* is a loan that is sold by a dealer or a retailer of goods to a third-party financial institution that owns the loan contract as a holder in due course and collects principal and interest payments from the borrower.

[23] Moshe Orenbuch, "Specialty Finance September Monthly," Credit Suisse First Boston, September 2, 2004. *Mid-prime loans* are defined as loans with expected cumulative losses of less than 6.0 percent.

Banks Are Still Sizing Up Opportunities in the Growing Hispanic Market

Within the past few years, Hispanics have become the largest ethnic group in the United States, and they are projected to be one of the fastest growing population segments throughout much of the 21st century. Banks are increasingly aware of these trends and have been looking to expand their presence in this vast market. However, Hispanics are not a homogeneous group, and current migration patterns clearly show that regional and socioeconomic differences within the Hispanic population will significantly influence the types of banking products and services needed by and designed for this group.

Banks' interest in the Hispanic market is being driven by the search for new sources of revenue and recognition of the substantial growth potential of this underserved market. In addition to the rapid rate of growth in the Hispanic population, factors contributing to the Hispanic market's appeal include its relative youth, a rapid rise in affluent households, and growing participation rates in financial services.

This article examines the geographical areas where Hispanics now live in the highest concentrations as well as areas where Hispanic populations are growing the fastest. It also assesses the already strong and growing purchasing power of Hispanics and categorizes their financial service needs into stages as they gain wealth and their demand for financial services evolves. Further, it uses current bank data to gain insight into potential areas of financial services growth for banks regarding this ethnic group.

The Hispanic Market Is the Future

Many industry analysts believe that more than half of all U.S. retail banking growth in financial services during the next two decades will originate from the growing Hispanic market. A projection made in 2003 by the ***TowerGroup,*** a research and advisory firm that focuses on the global financial services industry, estimates that up to 70 percent of the growth for U.S. financial services between 2003 and 2008 could come from the Hispanic market alone.[1] In 2003, Eusebio Rivera, the head of Hispanic Initiatives at ***Bank of America,*** said that "in the next couple of years, 80 percent of our growth will come from the multicultural market, and 60 percent of that will come from the Hispanic population."[2] Furthermore, U.S. banks are projected to spend over $8.5 billion marketing to and servicing the Hispanic market from 2003 to 2005.[3]

The New York-based ***Research & Advisory Group*** projects that between 2002 and 2007 the number of Hispanic households with checking accounts will increase by 57 percent, those with savings accounts will grow by 76 percent, and those using investment products will grow by 94 percent.[4] Although Hispanics represented an average of just 7 percent of all U.S. households between 1992 and 2001, they accounted for 14 percent of total growth in asset accounts and 13 percent of growth in debt accounts.[5] It is projected that between 2001 and 2007, these rates of growth will have accelerated further, with a projected 20.5 percent growth in asset accounts and 15.5 percent growth in debt accounts.[6]

Hispanic Market Includes Both High-Concentration and High-Growth Areas

Map 1 shows counties with the largest concentration of Hispanics in the United States (above the national average of 12.5 percent) based on 2000 census data. As of July 1, 2002, more than three-quarters (nearly 30 million) of Hispanics lived in seven states: California (11.9 million), Texas (7.3 million), New York (3.1 million), Florida (3.0 million), Illinois (1.7 million), Arizona (1.5 million), and New Jersey (1.2 million).[7]

[1] CMGP Hispano, "U.S. Retail Banking and the Hispanic Market Growth Engine," white paper, March 1, 2004, http://www.cmgpartners.com/hispano/HispanicBankingPaperV5.pdf.

[2] "Latinos Become Key Market for Financial-Service Firms," *Wall Street Journal,* October 23, 2003.

[3] "Banks Out to Attract Hispanics: New Immigrants Draw Attention," *Houston Chronicle,* January 16, 2003.

[4] "Big Banks Angling for More Minority Depositors," *American Banker,* January 30, 2003. Investment products include mutual funds, direct securities investments, cash-value life insurance, annuities, and retirement accounts.

[5] Federal Reserve Board, *2001 Survey of Consumer Finances,* as cited in CMGP Hispano's "U.S. Retail Banking" (see note 1).

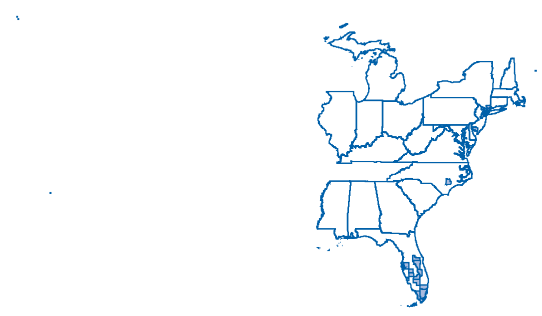
[6] Ibid.

[7] U.S. Census Bureau, "State Population Estimates by Race Alone and Hispanic or Latino Origin: July 1, 2002," table 3, September 18, 2003, http://www.census.gov/popest/archives/2000s/vintage_2002/ST-EST2002-ASRO-03.html.

Map 1

High-Concentration Hispanic Areas by County

Above the national concentration rate of 12.5 percent (385 counties)

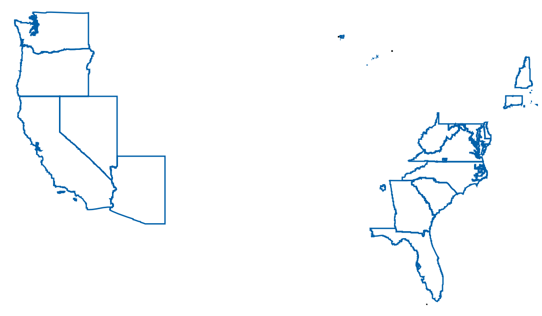


Source: U.S. Census Bureau, 2000.

Map 2

High-Growth Hispanic Areas by County

Over 400 percent increase (227 counties)



Source: U.S. Census Bureau, 1990 to 2000.

Many Hispanics are settling in places that had very little Hispanic immigration before the 1980s. In fact, every part of the United States experienced an increase in Hispanic population during the 1990s, in rural, suburban, and urban settings alike. Map 2 shows high-growth counties, defined as those that experienced Hispanic population growth of 400 percent or more between 1990 and 2000. In contrast to the concentrations shown in Map 1, much of the high growth was centered in Midwestern and Southeastern states. While Hispanic populations continue to grow in the highly concentrated areas via immigration and birthrates, a smaller but fast-growing new wave of Hispanic immigrants are seeking new destinations, particularly in suburbs and medium-size cities.[8] These areas will continue to experience rapid population growth, drawn by "the networks of families and friends now being established in these communities."[9] Additionally, an increasing number of second- or higher-generation Hispanics from high-concentration counties are also migrating to high-growth counties.

It is critical to note that there are substantial socioeconomic differences between Hispanics in the fastest growing areas of the country and those in traditional settlement areas such as the Southwest. Table 1 compares the differences between these two groups. In general, Hispanics in high-concentration counties are more likely to be bilingual or speak English, have slightly higher incomes, and have more education than their counterparts in high-growth Hispanic areas. A major reason for the difference between the two groups is that many Hispanics in high-growth areas (25 percent) tend to be recent immigrants.

Fast Pace of Hispanic Population Growth Primarily Due to Immigration

During the 1990s, the U.S. Hispanic population increased by a stunning 58 percent, from 22.4 million to 35.3 million, while the rest of the U.S. population saw only a 9 percent rate of increase.[10] At the end of the decade, Hispanics made up 12.5 percent of the U.S. population, up from 9 percent in 1990. Massive immigration during this period fueled the overall growth of the Hispanic population, accounting for almost half of the increase. Moreover, an increasingly large number of Hispanics are emigrating from Central and South American countries.[11] These "other Hispanics," as they are known, are bringing greater diversity to the U.S. Hispanic population, making it more difficult to talk about Hispanics in general terms.

[8] Audrey Singer, "The Rise of New Immigrant Gateways," The Brookings Institution, Center on Urban and Metropolitan Policy, The Living Cities Census Series, February 2004, http://www.brookings.edu/dybdocroot/urban/pubs/20040301_gateways.pdf.

[9] Steven A. Camarota and John Keeley, "The New Ellis Islands: Examining Non-Traditional Areas of Immigrant Settlement in the 1990s," Center for Immigration Studies, September 2001, http://www.cis.org/articles/2001/back1101.pdf.

[10] Data from U.S. 2000 Decennial Census.

[11] Roberto Suro, "Counting the 'Other Hispanics': How Many Columbians, Dominicans, Ecuadorians, Guatemalans and Salvadorans Are There in the United States?" Pew Hispanic Center, May 9, 2002, http://www.pewhispanic.org/site/docs/pdf/other_hispanics.pdf.

Table 1

Demographic Characteristics: High-Concentration versus High-Growth Counties

	High Concentration[1]	High Growth[2]
Population		
Total Population (as of 2000)	86,147,017	13,447,705
Hispanic Population (as of 2000)	25,891,446	712,162
Total Population Growth Rate (1990 to 2000)	17.0%	25.4%
Hispanic Population Growth Rate (1990 to 2000)	49.4%	629.5%
Share of Hispanic Population	30.1%	5.3%
Hispanic Mobility		
Moved from Different State	3.6%	18.6%
Moved from Different Country	6.9%	25.1%
Hispanic Citizenship		
Noncitizens (Number of Hispanic Origin)	7,507,927	387,627
Noncitizens as a Share of Hispanic Population	29.0%	54.4%
Hispanic Language Dominance[3]		
English Dominant	16.9%	12.9%
Bilingual (Spanish)	54.7%	37.8%
Spanish Dominant	28.4%	49.3%
Hispanic Educational Attainment[4]		
Less Than High School	50.4%	59.6%
High School Graduate	21.6%	18.6%
College Graduate	8.8%	8.9%
Household Income		
Average Household Income	$60,498	$52,486
Hispanic Average Household Income	$43,301	$43,286
Average Household Income Growth (1990 to 2000)	44.2%	56.8%
Hispanic Average Household Income Growth (1990 to 2000)	46.7%	31.0%

Notes: [1] See Map 1. [2] See Map 2. [3] Language dominance is for the age cohort 18 to 64. [4] Educational attainment is measured for those over 25 years of age.
Source: U.S. 2000 Decennial Census and authors' calculations.

The U.S. Hispanic population is expected to continue to grow rapidly over the next half-century, tripling in size between 2000 and 2050.[12] Continued immigration, high birthrates, and a young childbearing population will all contribute to this increase. In turn, this growing Hispanic market will require financial products, such as mortgages, home equity lines of credit, and car loans, to meet their needs as they start families and rear children.

Hispanic Immigration and Labor Trends Boost U.S. Economy

The pace of U.S. economic growth during the 1990s was aided greatly by immigration. *Federal Reserve Bank of Dallas* economist Pia M. Orrenius found that immigration contributed to job growth by providing workers to (1) fill an increasing share of jobs overall, (2) take jobs in labor-scarce regions, and (3) fill the types of jobs native workers often shun.[13]

Many foreign-born migrants filled labor force positions in certain worker-scarce regions of the country such as the Midwest, parts of the Southeast, and New

[12] U.S. Census Bureau, "Census Bureau Projects Tripling of Hispanic and Asian Populations in 50 years; Non-Hispanic Whites May Drop to Half of Total Population," news release, March 18, 2004, http://www.census.gov/Press-Release/www/releases/archives/population/001720.html.

[13] "U.S. Immigration and Economic Growth: Putting Policy on Hold," *Southwest Economy* 6 (November/December 2003).

Table 2

U.S. Deposit Characteristics Compared to Designated High Hispanic Concentration Areas and High Hispanic Growth Areas

	High Concentration	High Growth
Average Branch Deposits (Total Deposits/Number of Branches in 1994, $000s)	$61,580	$27,333
Average Branch Deposits (Total Deposits/Number of Branches in 2000, $000s)	$75,059	$38,560
Average Branch Deposits (Percentage Change 1994 to 2000)	22%	41%
Change in Branches (1994 to 2000)	4%	8%
Change in Deposits (1994 to 2000)	26%	53%

Notes: [1] Deposit and branch information is as of June 30, 1994, and 2000 and excludes U.S. Territories and Puerto Rico. [2] There were 277 counties in the high growth group, compared with 385 counties in the high concentration group.

Source: FDIC Summary of Deposits.

England—some of the fastest growing areas of the Hispanic population during the 1990s.[14] A significant share of employment in fast-growing counties was in manufacturing, construction, and agriculture. In contrast, Hispanics in the high-concentration counties exhibited an employment profile similar to that of the total U.S. workforce.

Finally, the effects of globalization and lower standards of living across Latin American countries, as well as U.S. economic dependence on migratory labor, suggest foreign immigration flows will continue. Although activities related to the North American Free Trade Agreement (NAFTA) and the *maquiladora* industry have benefited from economic activity along the U.S.-Mexico border, they also have resulted in some elimination of jobs south of the border, thereby motivating Mexican workers to migrate to the United States.[15]

Growing Purchasing Power Is Driving Demand for Financial Services

The ***Selig Center for Economic Growth*** at the University of Georgia has estimated that Hispanic purchasing power as measured by disposable income grew by 194 percent between 1990 and 2003, from $222 billion to $653 billion.[16] The latter sum is actually larger than the estimated nominal GDP of Mexico in 2003.[17] The Selig Center also projects that U.S. Hispanic purchasing power, stimulated by population and income growth, will approach $1 trillion by 2009.[18] This aggregate income will be spent, saved, and invested, all of which will spur demand for checking accounts, consumer credit, mortgages, and investment services.

Hispanic Financial Services Marketplace Is Fertile Ground for Banks

Banking Services Are Currently Underused…

The rapid growth of the underbanked Hispanic market suggests a new growth opportunity for many institutions. Although the volume of deposits per bank branch in high-growth Hispanic areas remains substantially below that of the nation, the rate of deposit growth in these areas is twice as fast as that of the nation, which suggests the gap is rapidly closing.

…But Projected Growth Is Strong

Banks and thrifts in many of the fastest growing Hispanic counties have the advantage of proximity to a potential source of new customers. As shown in Table 2, high-growth Hispanic areas experienced substantially faster growth in both deposits and branch formation than did either highly concentrated Hispanic areas or the nation as a whole. Moreover, a continued rapid increase in Hispanic populations in these areas suggests that strong bank deposit growth will continue.

[14] Ibid.

[15] A *maquiladora* is a factory located in a Mexican border town that imports materials and equipment on a duty- and tariff-free basis for assembly or manufacturing.

[16] Jeffrey M. Humphreys, "The Multicultural Economy 2003: America's Minority Buying Power," *Georgia Business and Economic Conditions* 63, no. 2 (Second Quarter 2003), Selig Center for Economic Growth, Terry College of Business, University of Georgia, http://www.selig.uga.edu/forecast/GBEC/GBEC032Q.pdf.

[17] Energy Information Administration, "Mexico," *Country Analysis Briefs,* March 2004, http://www.eia.doe.gov/emeu/cabs/mexico.html.

[18] Jeffrey M. Humphreys, "The Multicultural Economy 2004: America's Minority Buying Power," *Georgia Business and Economic Conditions* 64, no. 3 (Third Quarter 2004), Selig Center for Economic Growth, Terry College of Business, University of Georgia, http://www.selig.uga.edu/forecast/GBEC/GBEC043Q.pdf.

Gains in Hispanic Labor Force Reflected in Branch Growth

The U.S. Department of Labor's ***Bureau of Labor Statistics*** projects that the Hispanic labor force will increase by 33 percent between 2002 and 2012, more than three times faster than growth in the non-Hispanic labor force over the same period.[19] Demand for Hispanic workers is credited with helping to revitalize U.S. labor markets since the 2001 recession, with immigrants playing an important role.[20] Hispanic employment gains are a reflection of the Hispanic labor force growing much more rapidly than other segments of the labor force and moving to areas where there is a greater demand for labor. This geographic movement is also reflected in the increasing number of bank branches being opened in the 277 high-growth counties where the Hispanic population increased by more than 400 percent in the 1990s. The number of bank branches grew by 8 percent in the high-growth counties versus 5 percent overall, and total deposits in those branches grew by 53 percent versus 27 percent for the nation as a whole (see Table 2).

Understanding Unique Needs of the Hispanic Community Is Key to Successful Marketing of Financial Services

Marketing approaches targeting the Hispanic community are not yet mainstream. Rather, they are tailored to where the Hispanic population currently resides, whether in high-growth or high-concentration counties, because acculturation levels among Hispanics in these two groups are very different. Generally, Hispanics in high-growth counties have lower levels of education, slightly lower incomes, and less proficiency in speaking English. In addition, significant shares of Hispanics in high-growth counties are foreign immigrants and consequently have lower citizenship rates.

Thus, high-growth Hispanic counties will have a greater need for financial literacy programs, cash remittance services, and bilingual tellers and loan officers. Because this wave of Hispanic immigration is relatively new to these areas of the country, banks there face the challenge of integrating this growing Hispanic population into the mainstream of the financial services industry. Nevertheless, strong immigration flows will continue in high-concentration counties as well, providing opportunities for banks there. Overall, the growth in Hispanic population and income will be a major demographic force for the next half-century.

Multicultural Events Used in Marketing Programs

According to the 2003 ***American Bankers Association*** Bank Marketing Planning Survey Report, 21 percent of small banks targeted ethnic communities in multicultural marketing events as a means of meeting prospective ethnic customers. The survey reported that 62 percent of Southwestern banks specifically targeted ethnic communities in 2003, most likely aimed at their large Hispanic populations. While only 20 percent of banks headquartered in the Southeast directly marketed to ethnic communities in 2003, an additional 27 percent say they plan to target ethnic communities. This increased interest suggests that bankers in the Southeast are becoming more aware of the high rate of Hispanic population growth in their area and the growing Hispanic market for new bank products and services. How banks go about capturing this market will depend in large part on the financial life cycle (explained below) of the target group.

Understanding Financial Life Cycles Is Vital

Most banks are still in the early stages of developing their strategies for the Hispanic market. They may benefit from determining the financial life-cycle stage of their target households (see Chart 1).

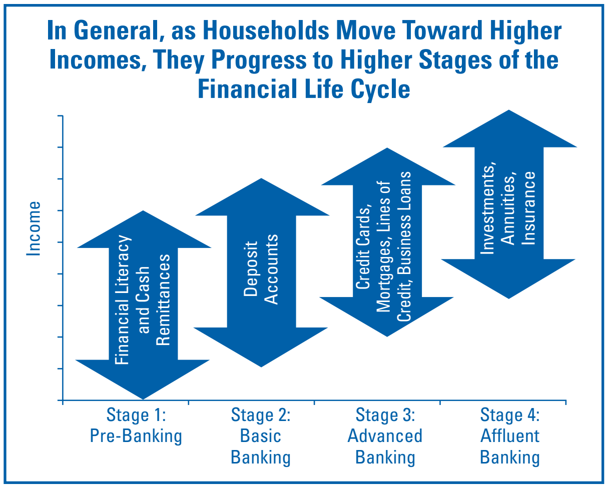
The financial life cycle of Hispanics can be divided into four stages: (1) pre-banking services, (2) basic banking services, (3) advanced banking services, and (4) affluent banking services. As Hispanic households earn higher levels of income and become more acculturated into U.S. society, their demand for banking products and services will evolve from pre-banking services to more affluent banking services. A strong correlation exists between financial services participation by Hispanics and their level of acculturation—both "the individual acculturation trends of recent immigrants and the relative weight of this group to overall Hispanic population growth."[21] As Hispanic immigrants spend more time in the United States, they increasingly avail themselves of different kinds

[19] U.S. Department of Labor, "Labor Force," *Occupational Outlook Quarterly,* Winter 2003-04, http://www.bls.gov/opub/ooq/2003/winter/art05.pdf.

[20] Rakesh Kochhar, "Latino Labor Report, First Quarter, 2004: Wage Growth Lags Gains in Employment," Pew Hispanic Center, June 2004, http://www.pewhispanic.org/site/docs/pdf/Labor%20Report%202004_1%20Final.pdf.

[21] Strategy Research Corporation, "2002 U.S. Hispanic Market Report," 2002, as cited in CMGP Hispano's "U.S. Retail Banking" (see note 1).

Chart 1



of financial products. As mentioned, most high-growth Hispanic counties during the 1990s were in the Midwest and Southeast, and Hispanics in these areas are more likely to be in one of the first two stages, pre-banking or basic banking services.

Stage 1, Pre-Banking Services

First-generation (foreign-born) Hispanics are typically at the pre-banking services level, or Stage 1, often because they have had very few dealings with, or little confidence in, banks in their native countries. As a result, financial education is a very important need for this group, as most immigrants know little about financial planning and other financial services. Banks and regulatory agencies are already seeing the value in conducting financial literacy workshops, often in cooperation with community groups, to improve financial management skills and increase trust in mainstream financial institutions (see the inset box regarding the FDIC *Money Smart* program).

Stage 2, Entry-Level Basic Banking Services

Entry-level personal basic banking services (Stage 2) are aimed at Hispanics seeking products to establish a banking relationship and credit needs. A survey by the ***Pew Hispanic Center*** and the ***Kaiser Family Foundation*** estimates that only 65 percent of Hispanics have

FDIC Money Smart Program

In addition to its banking supervisory role, the Federal Deposit Insurance Corporation (FDIC) is involved in financial education to help fight predatory lending, encourage financial institutions to identify untapped markets, and assist consumers in shaping their financial future. The FDIC contributes to these goals through its *Money Smart* program, which is a set of ten training modules for instructor and individual use covering basic financial topics. Topics include a description of deposit and credit services offered by financial institutions, choosing and maintaining a checking account, the mechanics of budgeting, the importance of saving, and how to obtain and use credit effectively.

Money Smart was designed specifically for the 8 million to 12 million families currently outside of the economic mainstream, as well as those who may be familiar with some of the financial basics, but would like to enhance their financial knowledge in certain areas to operate more effectively within the banking system. It starts with the basics but increases in complexity. At present, the *Money Smart* program comes in a paper format, on CD-ROM, or in a Web-based format. The instructor version contains everything necessary to begin teaching the program right away and includes take-home booklets and other resources for participants. It can be taught in its entirety, or specific modules can be used to fill in the gaps in other financial education programs. The computer-based instruction (available on CD-ROM and through the FDIC Web site) can be used to complement classroom instruction or for independent self-paced study by consumers. The material may be photocopied and distributed without authorization from the FDIC and is available in English, Spanish, Chinese, Korean, and Vietnamese.

Through the *Money Smart* program, the FDIC is working toward some ambitious goals, such as enlisting 1,000 alliance members, including banks, corporations, government agencies, and civic, fraternal, and religious organizations; delivering 100,000 copies of *Money Smart* curricula; and reaching 1,000,000 people in all 50 states by December 31, 2007. *Money Smart* is being taught by a host of diverse organizations in a variety of settings, and to date, the program has over 900 alliance members. The FDIC has distributed more than 160,550 copies of *Money Smart* and had over 294,400 people attend at least one financial education class using the *Money Smart* curriculum, with more than 39,180 establishing new banking relationships. To learn more about the FDIC's *Money Smart* program, contact an FDIC Community Affairs Officer from one of our eight regional or area offices or visit http://www.fdic.gov/consumers/consumer/moneysmart/index.html.

bank accounts, compared with 95 percent of non-Hispanic whites.[22] The disparity is even greater in areas that experienced significant Hispanic immigration in the 1990s. Candidates at Stage 2 are likely to be first-generation Hispanics who have lived in the United States for a time and now need basic checking and savings accounts in addition to remittance services.

Stage 3, Advanced Banking Services

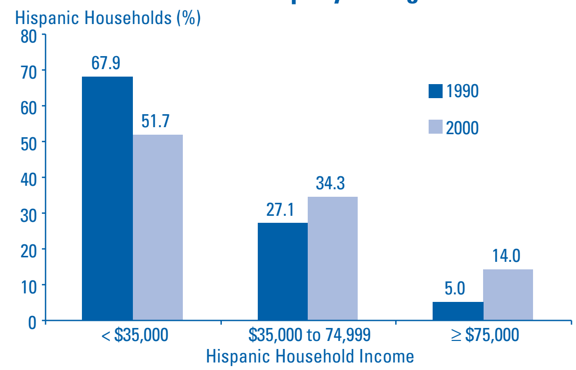
Advanced banking services (Stage 3) are aimed primarily at second- and third-generation Hispanics looking beyond basic banking services and focusing more on mortgage, personal, and business lending products. Since the 1970s, almost half of the total growth in the Hispanic population growth has been driven by immigration. However, this trend is reversing. The Pew Hispanic Center projects that over the next two decades, second- and third-generation Hispanics will make up 75 percent of total growth in the Hispanic population, with new immigrants representing the remaining 25 percent.[23] Consequently, the Stage 3 population group is likely to grow into a large and profitable market segment ripe for greater banking development.

Stage 4, Affluent Banking Services

As second- or higher-generation Hispanics become wealthier, better educated, and more acculturated, their financial services participation levels rise, and they are apt to avail themselves of the higher margin banking products and services that make up Stage 4, or affluent banking services. According to census data, almost two-thirds of Hispanic households had incomes of less than $35,000 in 1990 (see Chart 2). However, by 2000, only slightly more than half of Hispanic households were earning less than $35,000. Middle-income Hispanic households (those earning between $35,000 and $74,999) rose by more than a quarter during this ten-year period, and affluent Hispanic households (those earning $75,000 and above) nearly tripled. A study by the ***Tomas Rivera Policy Institute*** shows that "Latino middle class households—defined as those with annual incomes over $40,000—increased from just under 1.5 million in 1979 to almost 2.7 million by 1998, or by about 80 percent in twenty years."[24]

Chart 2

The Share of Middle-Income and Affluent Hispanic Households Grew Rapidly during the 1990s



Sources: U.S. Census Bureau, 1990 and 2000.

As their purchasing power continues to increase, Hispanics will have a significant need for credit cards, residential mortgages, consumer loans, and other products. The difference in homeownership rates by ethnicity demonstrates the potential demand for homeownership in this largely untapped market. As of June 30, 2004, the national average for homeownership was 69.3 percent, significantly higher than the 47.4 percent rate for Hispanics.[25] As Hispanics become more acculturated and their incomes rise, they should become a major source of demand for mortgage products.

Remittances Are a Hot Product for Immigrants

Because many Hispanics in the pre-banking group are newly arrived in the United States, they are likely to make greater use of remittances, a rapidly growing and lucrative market estimated at more than $30 billion in 2004.[26] An article in the Winter 2004 issue of the FDIC's ***Supervisory Insights***, "Linking International Remittance Flows to Financial Services: Tapping the Latino Immigrant Market," by Michael Frias, explores how recent demographic shifts will continue to influence banks' strategies for tapping new markets and

[22] Mollyann Brodie et al., "2002 National Survey of Latinos," Pew Hispanic Center/Kaiser Family Foundation, December 2002, http://www.pewhispanic.org/site/docs/pdf/LatinoSurveyReportFinal.pdf.
[23] Roberto Suro and Jeffrey S. Passel, "The Rise of the Second Generation: Changing Patterns in Hispanic Population Growth," Pew Hispanic Center, October 2003, http://www.pewhispanic.org/site/docs/pdf/PHC%20Projections%20final.pdf.
[24] "The Latino Middle Class: Myth, Reality and Potential," Tomas Rivera Policy Institute, February 2001.
[25] U.S. Census Bureau via Haver Analytics.
[26] Manuel Orozco, "Remittances to Latin America and the Caribbean: Issues and Perspectives on Development," Organization of American States (report commissioned by the Summits of the Americas Secretariat), July 14, 2004, http://www.summit-americas.org/Panels/Panel_on_Remittances/Remittances.pdf.

discusses the implications of the swift growth and significant size of the Latino market for the U.S. banking Industry. Both large and small banks are capitalizing on remittance flows as a means of bringing "unbanked" immigrants into the banking system.

Conclusion

Increasing numbers, rising incomes, and a comparatively young population suggest that Hispanics will become a major consumer of financial services in the years ahead. Greater consumer participation by Hispanics in mainstream financial markets can improve their ability to build assets, create wealth, and promote economic stability and vitality in their communities. By providing needed financial services to this growing market, banks will find new and welcome sources of revenue. But this market is still in its infancy. As it continues to mature, large banks and community banks alike will find new opportunities to meet the demands of the Hispanic marketplace by customizing their products to its unique needs.

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