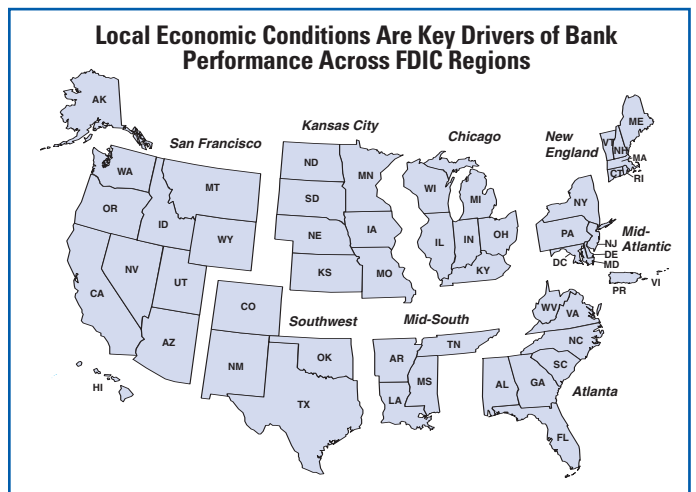


Region by Region: Looking Ahead at Banking Conditions in 2007

The U.S. economy is now in its sixth year of expansion. Pronounced weakness in the housing sector is being largely offset by continued strength in the corporate sector, commercial construction activity, and exports. Meanwhile, FDIC-insured institutions continue to ride a string of six consecutive years of record earnings. Bank capital levels remain at historic highs, while loan performance has slipped only slightly from record levels. Only one FDIC-insured financial institution has failed over the last two and a half years.

Still, some negative trends have emerged for banks. They include a narrowing of net interest margins, particularly among larger institutions; increasing concentrations of traditionally riskier commercial real estate loans; and emerging signs of credit distress in subprime mortgage portfolios. Ultimately, it is local economic conditions that are the most important determinants of credit quality and earnings strength at the majority of banks and thrifts. In this issue of the **FDIC Outlook**, our regional analysts identify trends that are expected to affect banking in their areas during the remainder of 2007.



Atlanta Region: The residential real estate sector has contributed greatly to the recent economic expansion in the Region, particularly in metropolitan areas. However, continued weakening in the housing sector could moderate demand for real estate construction loans and slow revenue growth from lending activities. *See page 3.*

Chicago Region: The Region's automobile manufacturing industry continues to face an uphill climb, pressuring employment growth, housing markets, and the overall performance of FDIC-insured institutions in the Region. Analysts consider the potential for strength in other sectors, most notably the services sector, to mitigate the ongoing problems in manufacturing. *See page 8.*

Dallas Region: Unlike other areas of the country, the energy and housing sectors have been key drivers of recent economic growth in the *Southwest* (*See page 12*). Although the overall pace of economic growth across the *Mid-South* has been favorable, much of this growth has occurred in urban areas. Key differences in economic activity exist between rural and urban counties and have implications for the local banking industry. *See page 16.*

Kansas City Region: The unique rural and agricultural nature of this Region heightens its vulnerability to ongoing rural depopulation trends, dependence on agricultural subsidies, and continuing drought. *See page 19.*

New York Region: Weakness in the housing sector is of particular importance due to the relatively large share of residential mortgage lenders in the *Mid-Atlantic* (*See page 23*) and *New England* (*See page 27*) areas. Analysts in these areas assess the potential for strength in other economic sectors to mitigate the negative effects of a housing sector downturn.

San Francisco Region: The construction sector has driven much of the Region's recent economic expansion and has contributed to high and increasing concentrations of commercial real estate and construction loans. Should the housing sector continue to weaken, the effects of a slowing in the construction industry could ripple through local economies. *See page 32.*

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Residential Housing Sector Key to Atlanta Region Future

Economic performance in the **Atlanta** Region is driven primarily by manufacturing, tourism, and real estate (see Table 1). The structure of the manufacturing sector continues to change. Employment in older industries, such as textiles, apparel, and furniture manufacturing, has continued to erode because of increased use of automation and competition from overseas. Between 2000 and 2005, these industries shed more than 200,000 jobs across the Region. In contrast, employment in other types of manufacturing has grown substantially in recent years. Chief among them is auto-related manufacturing. Although older production facilities continue to shut down, the Region's favorable business climate has attracted foreign manufacturers, particularly to areas such as **Alabama** and, most recently, **La Grange, Georgia**. The Region has benefited from growth in other types of manufacturing, such as food processing (particularly poultry). As the structural shift in the manufacturing sector continues into 2007, the Region's economy is poised to benefit from these newer industries.

In addition, tourism—benefiting from an expanding selection of entertainment attractions, long coastline, and favorable climate—is a critical component of local economies in several areas of the Atlanta Region. Currently, this sector of the economy is performing well, as hotel occupancy rates in major markets now rival or surpass those before the 2001 recession. The run-up in transportation costs during the first half of 2006 appeared to exert only a limited impact on tourism.

Table 1

Key Sectors of the Atlanta Region Economy Will Shape Economic Performance in 2007	
Sector	Share of Total Employment
Manufacturing	9.9%
Tourism-Related	11.2%
Homebuilding and Residential Real Estate-Related	9.9%

Source: Quarterly Census of Employment and Wages (Bureau of Labor Statistics), 2005 data.



The residential real estate sector also has been a key contributor to the Atlanta Region's recent expansion and is perhaps the most important component of many metropolitan economies. Of the 43 metropolitan areas nationwide, where at least 10 percent of total employment is in housing-related sectors, 21 are in the Atlanta Region. In addition, the Region has outpaced the nation in construction employment growth and housing starts in recent years. Between 2000 and 2005, for example, construction employment in the Region increased at an average annual rate of 2.7 percent, compared with 1.4 percent nationally. Similarly, regional starts in 2005 were 58 percent higher than in 2000, compared with a 40 percent nationwide increase. However, many local housing markets are slowing, and this could jeopardize the Region's economic performance into 2007. This article assesses the implications of a continued slowdown in the housing sector on the regional economy and FDIC-insured institutions.

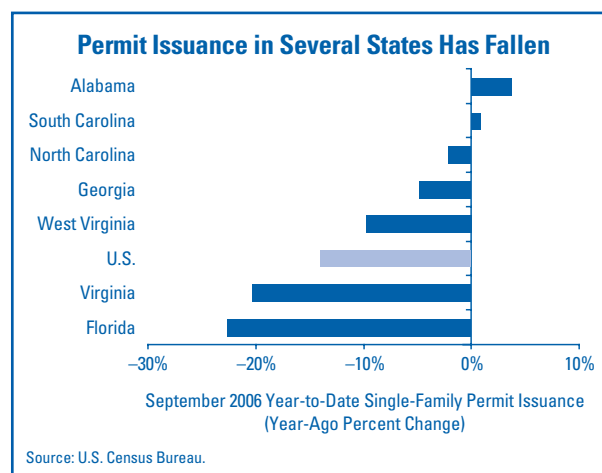
Weakness in the Residential Real Estate Sector Weighs on the Region's Economic Outlook

Weakness is emerging among several key residential real estate supply and demand indicators in Atlanta Region housing markets. Construction activity is slowing as the pace of housing starts regionally and nationally fell more than 15 percent between January and September 2006, according to estimates from **Moody's Economy.com** (www.economy.com/default.asp). Planned construction activity, as measured by permit issuance, suggests continued declines in housing starts. During the first nine months of 2006, permit issuance dropped in several states, including **Florida, Virginia, West Virginia, Georgia, and North Carolina** (see Chart 1).

Year-ago growth in construction sector employment in the Atlanta Region, at 5.3 percent, was double the national average in third quarter 2006. However, continued declines in homebuilding could constrain growth in this critical sector with potentially broader implications for the regional economy as demand for

Region by Region: Banking Conditions in 2007

Chart 1



other real estate-related employment—such as realtors, building material suppliers, and specialty contractors—may moderate. Any slowing in residential building activity will be difficult to replace because this sector represents almost two-thirds of all construction activity in the Region, compared with 55 percent nationally. Some of the decline in demand for construction workers could be offset, in part, by growth occurring in nonresidential construction activity for which the value of put-in-place construction in second quarter 2006 was up more than 10 percent from one year earlier.

The increase in residential building during the past several years has driven demand for construction and development (C&D) loans at FDIC-insured institutions based in the Atlanta Region. Among community institutions, in particular, these loans tend to be for the building of residential units.¹ This component of the commercial real estate (CRE) loan portfolio has been the most rapidly growing loan category reported by the Region's community banks and thrifts, with average annual accretion of roughly 41 percent during the past five years.² This compares with a 31.2 percent annual growth rate nationwide. The rapid pace of C&D loan growth has led to record exposures reported by FDIC-insured institutions in the Atlanta Region; the median C&D-to-Tier 1 capital ratio was 97 percent as of June 30, 2006, compared with 35 percent nationally. In addition, five of the Region's seven states ranked among the top ten nationally for C&D exposure: Georgia

¹ Community institutions are insured banks and thrifts holding assets less than \$1 billion.

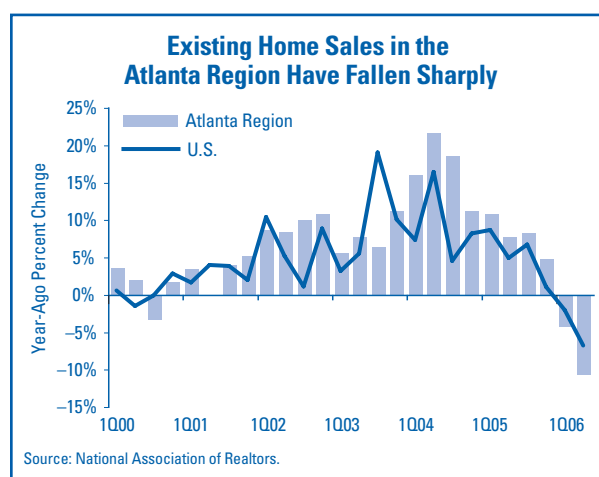
² CRE loans consist of construction and development, multifamily, and nonresidential loans. Data from bank call reports are as of June 30. Growth rates are merger adjusted.

(second), North Carolina (sixth), Florida (seventh), South Carolina (ninth), and Virginia (tenth).

Moderating Demand for Residential Real Estate Is Reflected in Declining Home Sales

Moderating activity in several Atlanta Region housing markets is evidenced by the recent sharp downturn in sales of existing homes (see Chart 2). However, these declines have not been uniform across the Region. Sales in Florida, Virginia, and West Virginia fell more rapidly than the national average during the year ending second quarter 2006; at the same time, however, sales continued to climb in North Carolina, South Carolina, and Georgia. In addition, as home sales have weakened in some markets, inventories of unsold homes have risen dramatically—even in some markets where sales remain above year-ago levels. In July 2006, year-ago increases in inventory were greatest in Orlando, Northern Virginia markets, and the West Virginia Eastern Panhandle. The property insurance market could exacerbate the slowdown in residential real estate sales in many of the Region's coastal markets as higher premiums could constrain affordability. Citing heightened reinsurance costs, insurance companies have raised premiums for homeowners and commercial businesses. In Florida, property insurance premiums for most homeowners have more than doubled.³

Chart 2



³ John Hielscher and Stephen Frater, "'Sticker Shock': Florida Homeowners Face Soaring Insurance Costs, with No Sign of Relief in the Forecast," *Sarasota Herald-Tribune*, June 8, 2006.

Weakness in sales activity likely extends beyond existing homes to new construction. Although not available at the state level, data indicate that new home sales across the entire South Census Region have fallen while inventories continue to rise.⁴ Anecdotal evidence suggests homebuilders in the Atlanta Region are making increased use of advertised incentives, such as free upgrades worth thousands of dollars, and other concessions to sell new homes.

Price Appreciation Cools

As home sales have declined, rates of price appreciation have moderated. By midyear 2006, year-ago appreciation rates had decelerated in all states in the Atlanta Region, except North Carolina (see Chart 3). According to the Office of Federal Housing Enterprise Oversight, 40 percent of the Region's metropolitan markets reported that the rate of appreciation slowed considerably more than the national average during the first six months of 2006. However, several metropolitan markets, primarily in states where home sales remained resilient, reported increasing rates of price appreciation during this period.

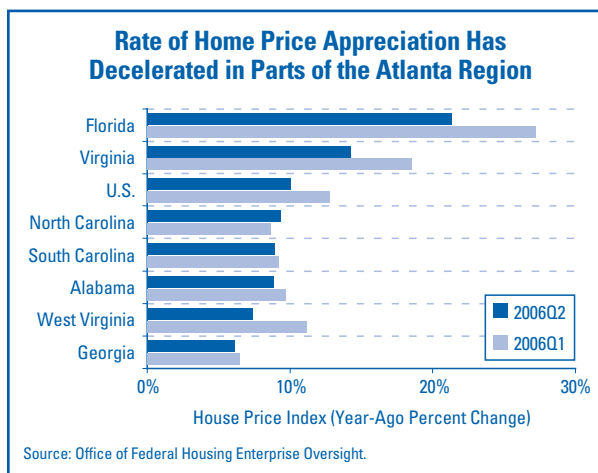
Although the rate of price appreciation across the Region's housing markets remained positive through midyear 2006, the potential for price declines exists in

some markets over the next several quarters. According to recent projections from Moody's Economy.com, which considers such things as affordability, speculation, and overbuilding, price declines greater than 10 percent could occur in the Cape Coral, Florida; Sarasota, Florida; Naples, Florida; and Washington, D.C., metropolitan areas.⁵ Many other Florida markets could see a less-pronounced drop in home prices. The bearish outlook for some Atlanta Region metropolitan markets also is reflected by *The PMI Group's* "Risk Index," which measures the probability that prices will decline in a particular market within two years. This index suggests that markets such as Fort Lauderdale, Virginia Beach, Tampa, and Orlando could experience a greater than 30 percent chance of home price declines in the near term.⁶

Affordability Continues to Fall in Certain Areas of the Region

Rapid rates of price appreciation in recent years, rising property taxes and mortgage interest rates, and sharp increases in property insurance premiums, particularly in coastal markets, have sharply constrained affordability in several areas of the Atlanta Region. The effects of declining affordability may be particularly evident in areas where households spend an inordinate share of income on housing. Data from the *U.S. Census Bureau's American Community Survey (2005)* show that an above-average share of homeowners in some areas of the Atlanta Region, most notably South Florida, spend more than 30 percent of income on housing costs—a level defined as "excessive."⁷ Overall, Florida ranked fourth nationally for the share of homeowners with excessive housing costs. Although price appreciation has moderated somewhat in recent quarters, and the prospect of price declines may loom in some areas, affordability likely will continue to weigh on the demand for housing in several Atlanta Region markets.

Chart 3



⁴ The South Census Region includes Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

⁵ James R. Hagerty and Anjali Athavaley, "The Shifting Consensus of Buying a House," *Wall Street Journal*, October 5, 2006.

⁶ *Economic Real Estate Trends*, PMI Mortgage Insurance Company, Fall 2006. The index incorporates home price data from the Office of Federal Housing Enterprise Oversight, employment data from the Bureau of Labor Statistics, and an affordability index calculated by PMI.

⁷ However, the 2005 data do not incorporate the property insurance premium hikes that occurred following the 2005 hurricane season. As a result, the share of homeowners may be even greater now.

Region by Region: Banking Conditions in 2007

Negative trends in affordability may have prompted the increased use of innovative mortgages.⁸ In recent years, originations of these mortgage products has tripled, growing from less than 10 percent in 2003 to about 30 percent in 2005. According to a **Government Accountability Office** report, consumer demand for these products increased because low initial monthly payments enabled borrowers to purchase homes they might not have been able to afford with a conventional fixed-rate mortgage. The effects of greater use of these innovative mortgages on FDIC-insured institution credit quality are uncertain. However, the expiration of low initial teaser rates and subsequent interest rate resets may stress the future repayment ability of some borrowers. Although many banks have mitigated this potential credit risk by selling a substantial amount of these loans in the secondary market, some exposure may remain in the investment portfolio through the purchase of mortgage-backed securities that hold these innovative mortgages as collateral. In the Atlanta Region, these products were particularly popular in Florida and Virginia, where rates of home price appreciation have exceeded the national average.⁹

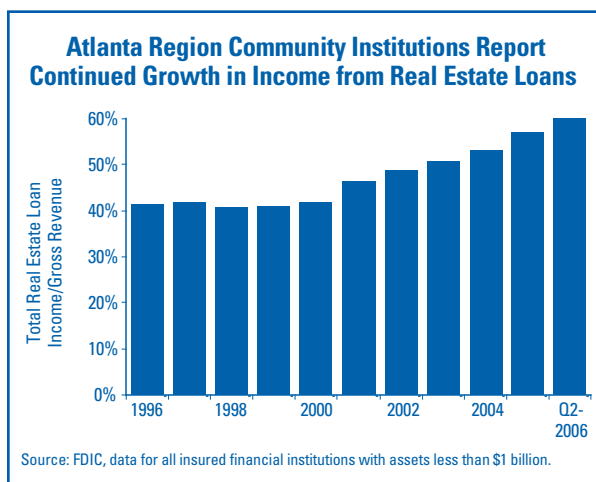
Continued Demand for Real Estate Loans Supports Bank Revenue Growth

In recent years, earnings growth among Atlanta Region community FDIC-insured institutions has been driven primarily by CRE lending. Real estate markets in the Southeast have been bolstered by continued in-migration into the Region and solid employment growth trends. This, in turn, has increased the potential for banks to gain revenue from real estate-related activities. As of second quarter 2006, total income from all real estate lending accounted for 60 percent of gross revenue at the Region's community institutions, compared with 49.3 percent nationally (see Chart 4). Given the importance of this income to the revenue stream, any slowdown in the real estate sector could adversely affect earnings among those community banks in the Atlanta Region with sizable CRE portfolios. Coupled with a flat to slightly inverted yield curve, banks may find it difficult to identify other investments that would generate a comparable yield.

⁸ Innovative mortgages are interest-only and pay option adjustable-rate mortgage (ARM) nonprime mortgage loans.

⁹ Government Accountability Office, "Alternative Mortgage Products," September 2006.

Chart 4



Higher Real Estate-Related Loan Demand Drives Profitability in the Atlanta Region

Atlanta Region community FDIC-insured institutions continue to report solid performance. Despite several interest rate hikes, record earnings were reported in second quarter 2006. Driven higher by increasing demand for real estate-related loans, growth in net interest income has bolstered FDIC-insured institution profitability across the Region. In addition to top-line revenue growth from lending activities, improved efficiencies and a lower provision expense offset declines in noninterest income. However, the slowdown in the housing market could lead to a moderate demand for real estate construction loans, potentially hurting top-line revenue growth in 2007.

For the year ending second quarter 2006, the average return-on-assets (ROA) ratio at community institutions rose for the fifth consecutive year. However, profitability growth has begun to slow as the percentage of institutions reporting an increase in ROA year-over-year declined appreciably during the past 12 months. In addition, average net interest margins have trended higher as Atlanta Region community institutions reported an increase in asset yields that outpaced the growth in funding costs.

Unlike large banks that are reporting margin compression, community institutions typically rely more heavily on core deposits to fund loan growth.¹⁰ More recently, robust loan demand coupled with sluggish core deposit

¹⁰ Large banks hold assets greater than \$10 billion.

growth has contributed to an increased exposure to noncore sources of funding. These noncore liabilities tend to be more volatile and highly sensitive to changes in interest rates. As the funding mix has shifted away from core deposits, noncore liabilities reached approximately 30 percent of overall funding sources, with a heavy emphasis on large time deposits. Going forward, a flat yield curve and increased volume of volatile liabilities could pressure margins at some of the Region's community institutions.

Given its relative importance, the residential real estate sector likely will continue to shape the Atlanta Region's economic performance into 2007. The impact of this sector on FDIC-insured institutions is reflected by growing exposures and the close link between earnings and prospects for continued growth in the real estate portfolio.

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Future of Chicago Region Tied to Manufacturing

The manufacturing sector has long been the engine of growth in the **Chicago** Region economy. This sector is particularly vital to the health of communities in **Indiana, Michigan, and Ohio**, where it represents 16 percent of all nonfarm employees, compared with 10 percent nationwide. During the past three years, manufacturing jobs in the Chicago Region have declined by 3 percent to 3.5 million. This decline reflects both the long-term competitive weakening of U.S. firms in industries such as steel and autos and the lingering effects of the 2001 recession. Increasingly, job losses in this critical sector also can be attributed to the effects of globalization, whereby U.S. manufacturers have extended supply chains beyond domestic borders and have come to rely less on domestically sourced inputs.

The Chicago Region is also home to a disproportionate share of employment in the auto manufacturing subsector. As is the case with manufacturing generally, the Region's auto industry has been under considerable stress for the past three years, during which the transportation sector as a whole has shed almost 60,000 jobs or 9 percent of its previous total. But despite these setbacks, pockets of strength in auto manufacturing remain. Foreign auto companies continue to perform well, and their plans to expand domestic operations could bolster the regional economy. At the same time, an expanding services sector is helping to mitigate the effects of weakness in auto manufacturing. In 2006, growth in the services sector helped boost employment in all of the Region's states except Michigan.

Decline of Auto Giants Highlights Regional Manufacturing Woes

U.S. automakers continue to lose ground to Asian competitors. Combined U.S. market share for **General Motors Corporation, Ford Motor Company, and DaimlerChrysler AG** fell to an unprecedented low of 53 percent in 2006, down from 61 percent in 2003. In response to falling revenue and operating losses that have accompanied declining market share, the largest U.S. automakers have announced major restructurings that will scale back production, overhead expenses, and the number of suppliers. In addition, higher gasoline prices in 2005 and 2006 have constrained consumer demand for U.S.-based automaker vehicle fleets, partic-

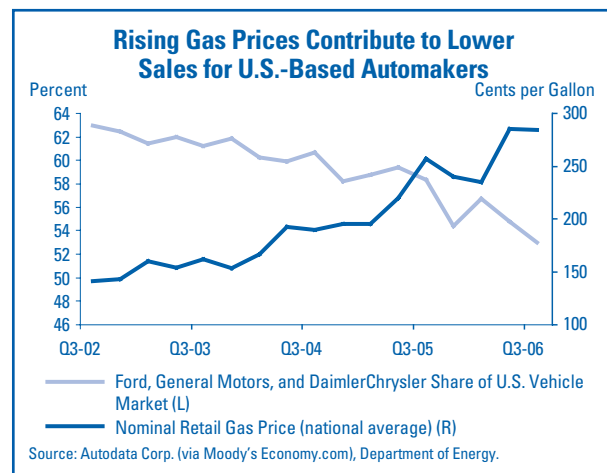
ularly less fuel-efficient trucks and sport utility vehicles (see Chart 1).



The declining market share of U.S.-based automakers also has hurt supplier profitability. Several major parts suppliers, including the largest, **Delphi Corporation** (Troy, Michigan), have filed for bankruptcy protection since 2005. Other major Chicago Region-based suppliers have recently announced job cuts.¹

Against this backdrop, the performance of foreign-based auto makers is positive news for the auto industry. **Toyota Motor Corporation** and **Honda Motor Co., Ltd.** reported record year-to-date U.S. unit sales as of September 2006. Both automakers have assembly and parts plants as well as a network of suppliers in the Region and plan to expand domestic production. Honda also announced plans to build an assembly plant in **Decatur County, Indiana**. Honda's **Anna, Ohio**, engine plant will supply the Decatur plant, which will strengthen the west-central Ohio manufacturing sector. In addition, Toyota announced a new Camry production line at the **Lafayette, Indiana, Subaru** facility.

Chart 1



¹ American Axle & Manufacturing Holdings, Inc. (Detroit, Michigan), BorgWarner, Inc. (Auburn Hills, Michigan), Collins & Aikman (Southfield, Michigan), Johnson Controls, Inc. (Milwaukee, Wisconsin), and Visteon Corporation (Van Buren Township, Michigan) announced job cuts in North American operations in 2006.

Auto Sector Declines Affect Employment and Housing Markets

Analysts estimate that the U.S. automotive manufacturing sector generates more than 5 million jobs (directly and indirectly) annually that contribute approximately \$180 billion in disposable income to the U.S. economy.² Three Chicago Region states—Indiana, Michigan, and Ohio—are home to 40 percent of the nation's motor vehicle assembly and parts manufacturing jobs.³ However, recent weakness in this sector continues to weigh on regional employment growth and housing markets. During the past two years, these three states also have ranked at the bottom regionally in terms of average employment growth in nonmanufacturing sectors such as professional and business, leisure and hospitality, and education and health services. Not surprisingly, these states also ranked lowest in overall job growth for the Region during 2006.

Housing markets in auto-dependent states also appear to be weakening to a greater degree than markets in other areas of the country. Since early 2006, housing markets in many parts of the nation have been characterized by slowing rates of price appreciation and increasing inventories of unsold homes. Although these trends also are evident across much of the Chicago Region, the reversal in regional housing market activity may not have been as pronounced here, if only because previous rates of appreciation and volumes of new construction were not as dramatic in the Region as they were elsewhere in the country.

Still, considerable slowing is evident in housing markets in areas where concentrations in auto sector employment are particularly high. Existing home sales in Michigan fell 17 percent in the year ending third quarter 2006, the most rapid decline in the Region and greater than the national average decline of 13 percent. Twenty-four metropolitan statistical areas (MSAs) in the nation recorded outright price declines on existing home sales in third quarter 2006; 18 of these metro areas are in Indiana, Michigan, and Ohio. In addition,

² *Contributions of the U.S. Motor Vehicle Industry to the Economies of the United States, California, New York, and New Jersey in 2003*, prepared by the University of Michigan Institute of Labor and Industrial Relations and the Center for Automotive Research for the Alliance of Automobile Manufacturers, Inc., May 2004. Disposable income is the value of compensation (salary and benefits) less transfer payments and taxes.

³ Indiana, Michigan, and Ohio rank highest in the Region in terms of their concentration in auto sector employment.

Table 1

The Housing Markets Showing Year-over-Year Negative Price Trends Are Concentrated in the Midwest

MSA	Year-over-Year Percent Change in Home Prices, Third Quarter 2006*
Anderson, Indiana	-6.05
Muncie, Indiana	-6.02
Sandusky, Ohio	-3.13
Ann Arbor, Michigan	-3.00
Springfield, Ohio	-2.09
Holland, Michigan	-2.03
Greeley, Colorado	-1.99
Kokomo, Indiana	-1.98
Detroit, Michigan	-1.98
Brownsville, Texas	-1.68
Warren, Michigan	-1.47
Muskegon, Michigan	-1.08
Owensboro, Kentucky	-1.03

* A total of 24 MSAs had a falling index; this table lists those with declines greater than 1 percent.
Source: OFHEO Housing Price Index.

the vast majority of MSAs that have experienced the greatest rates of price depreciation are located in the Chicago Region (see Table 1).⁴

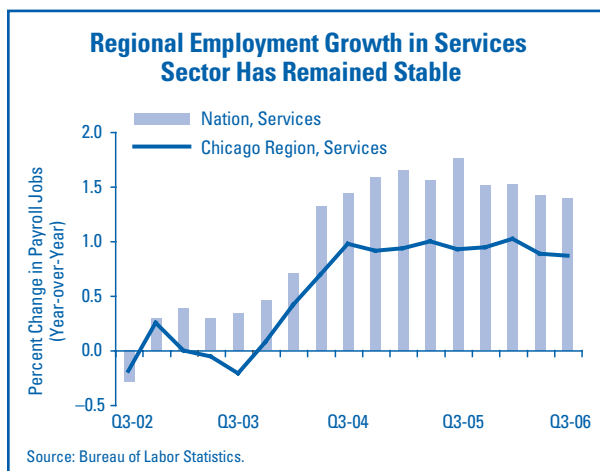
Services Sector Is a Relative Bright Spot

Growth in the services sector has managed to offset much of the weakness in auto manufacturing in recent quarters. The services sector has been an important source of job growth for both the nation and the Chicago Region since 2003. These gains helped lower unemployment in all states in the Region except Michigan during the year ending third quarter 2006. Services-sector job growth in the Region has been relatively stable since year-end 2003, albeit at rates below the national average (see Chart 2).

Employment in professional and business services expanded more rapidly than in any other sector in the Region in 2006, followed by growth in the education and health services, and leisure and hospitality services

⁴ Based on Office of Federal Housing Enterprise Oversight (OFHEO) Home Price Index data. Michigan, the state with the highest auto employment concentration, was the only state in the nation whose index fell year-over-year in third quarter 2006.

Chart 2



sectors. Professional and business services jobs tend to be relatively high-paying, particularly in **Illinois**, Michigan, and **Wisconsin**, where recent growth has been the strongest. In Illinois, average annual earnings in the professional and business services sector are almost 20 percent greater than the average across all sectors.⁵ Increasing employment in this sector also has bolstered office real estate fundamentals in the Chicago area, where demand for office space has grown substantially in recent months. Year-to-date net absorption (net change in occupied space) for Chicago in third quarter 2006 was more than twice the volume of a year ago.⁶

Margin Compression Dampens Profitability

Despite ongoing economic challenges, FDIC-insured institutions in the Region continue to perform fairly well. While profitability has dropped somewhat from previous levels, the Region's banks reported a median return on assets of 0.92 percent (annualized) for the first three quarters of 2006.

One of the biggest challenges to profitability is net interest margin (NIM) compression. Chicago Region banks reported a 9-basis-point decline in the median NIM for the first three quarters of 2006 (annualized) compared with the same period a year ago. Narrowing NIMs are due in part to the unfavorable environment facing the large number of mortgage specialists in the

Region; only states in the Mid-Atlantic and New England are home to a greater share of mortgage lenders. Heavy reliance on mortgage lending tends to heighten the sensitivity of FDIC-insured institutions to both changes in the shape of the yield curve and slowing in regional housing markets. Because mortgage lenders tend to borrow using short-term funding sources and invest in intermediate- to longer-term assets, these institutions typically rely more on *spread* income (the difference between short- and long-term interest rates) than other types of banks. The result is often a greater vulnerability to declining interest margins in a flat yield curve environment.

A rising cost of funds is also contributing to NIM compression at FDIC-insured institutions in the Region. At 2.73 percent (annualized) for the first three quarters of 2006, the Region's median cost of funds was second highest among the FDIC Regions. This relatively high cost of funds results, in part, from the combination of rising short-term interest rates, increasing reliance on higher-cost noncore funding, and relatively slow growth in lower-cost core deposits. Meanwhile, asset yields have not kept pace with a rising cost of funds despite the presence of two factors that served to boost interest income: an increase in the median loans-to-assets ratio for the Region to a record high 70.4 percent in the third quarter, and an 11.1 percent rate of growth in higher-yielding commercial real estate loans.⁷

Auto Sector Weakness Reflected in Weakening Credit Quality

The Region's economic challenges are also reflected in specific credit quality indicators. Mortgage foreclosures and personal bankruptcy rates in Indiana, Ohio, and Michigan currently exceed those of most other states. Personal bankruptcy rates in each of these three states were among the eight highest in the nation for third quarter 2006.⁸ These three states also ranked as the top three nationwide for mortgage foreclosures in third quarter 2006.⁹

⁷ Growth rate based on aggregate merger-adjusted data between September 30, 2005, and September 30, 2006.

⁸ Nonbusiness bankruptcies per 1,000 people (quarterly annualized). Administrative Office of the U.S. Courts and Bureau of the Census.

⁹ Indiana, Ohio, and Michigan were ranked first, second, and third, respectively, in state rankings of mortgage foreclosures for third quarter 2006. Quarterly mortgage foreclosures started as a percentage of the number of loans. Mortgage Bankers Association.

⁵ State sector and average annual earnings based on data from *Precis Metro, Chicago*, published by Moody's Economy.com, Inc., updated October 2006.

⁶ *PPR Fundamentals 3Q 2006: Chicago Office*, published by Property & Portfolio Research, Inc.

FDIC-insured institutions in auto-dependent states also are reporting rising rates of delinquent loans (see Table 2). Delinquencies reported by banks in Ohio and Michigan are near the ten-year highs reached in the 2001 recession. Delinquency rates have risen for a number of loan categories, with some of the greatest deterioration occurring in residential mortgage and commercial real estate loan portfolios.¹⁰ Similarly, banks based in the **Detroit** and **Cleveland** metro areas, some of the hardest hit by auto sector setbacks, have seen delinquent loans rise to higher levels than those of banks in most MSAs nationwide.

Conclusion

The challenges facing U.S.-based automakers and their suppliers will continue to be felt across much of the Chicago Region during 2007. U.S. automakers and parts suppliers still face structural overcapacity, and

workforce reductions will probably continue to be part of their strategic plans. Banks operating primarily in auto-dependent areas may experience slow loan growth and subpar loan performance as the auto-sector restructuring proceeds. Notwithstanding these difficulties, the regional economy and banking industry should continue to benefit from expansion in the services sector, which until now has helped keep unemployment rates well below recession levels and has supported growth in household incomes and spending. Though auto-dependent housing markets may struggle, the overall outlook for the Region is less pessimistic. Among the bright spots is a banking industry that remains profitable, well capitalized, and willing to lend to creditworthy borrowers.

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Table 2

Asset Quality Indicators Reflect Somewhat Higher Risk for FDIC-Insured Banks Based in Areas Impacted by the Struggling Auto Sector									
Area	Delinquency Rates								
	Total Loans			Residential Mortgage Loans			CRE Loans		
	Rank	Sep-06	Sep-05	Rank	Sep-06	Sep-05	Rank	Sep-06	Sep-05
Michigan	2	2.3	1.9	1	2.5	1.9	2	1.9	1.2
Ohio	4	2.0	1.7	5	2.1	1.8	7	1.1	0.8
U.S.		1.4	1.4		1.3	1.3		0.6	0.5
Detroit-Warren-Livonia	3	3.1	1.5	4	3.2	1.6	16	2.0	0.9
Cleveland-Elyria-Mentor	16	2.3	1.5	41	1.9	1.3	8	2.5	1.0
All Metros		1.1	1.1		0.9	0.9		0.5	0.4

Note: Metro ranking includes 215 metros in which five or more banks are headquartered. All ratios are median percent. CRE = commercial real estate. Source: FDIC.

¹⁰ Commercial real estate loans consist of construction and development, multifamily, and nonresidential real estate loans.

Energy and Housing Likely to Be Net Positives for the Dallas Southwest in 2007



FDIC-insured institutions based in the **Dallas Southwest** continue to report solid performance, with continued strong profitability and loan growth and favorable credit quality. The Southwest's banks and thrifts also reported historically low mortgage past-due and charge-off rates for third quarter 2006. In addition, **Texas** and **Colorado** continue to rank among the nation's top five states for branch growth.¹ Strong performance by the area's insured institutions has been due in large part to the relatively healthy local economy, particularly the energy and housing sectors.

Energy and housing have been key drivers of economic growth in the Dallas Southwest. Growth in these sectors accounts for much of the 2.4 percent job growth in 2006—a rate of growth that easily outpaced the national average of 1.4 percent. Unlike many parts of the country where higher energy prices have constrained consumer spending, the surge in energy prices provided a net boost to the Dallas Southwest economy in 2006 because of the relatively high share of employment in energy production and exploration. Housing markets also have shown strength relative to the nation; most Dallas Southwest metro areas have not experienced the home price weaknesses seen elsewhere in the country. Because of the strong underlying fundamentals, the energy and housing sectors are likely to remain positives for the Dallas Southwest in 2007.

Energy Sector Drives the Dallas Southwest Economy

The energy sector plays a leading role in the regional economy. Although the Dallas Southwest represents only 11 percent of the nation's nonfarm employment and gross domestic product, it accounts for 29 percent of U.S. crude oil production, 48 percent of U.S. natural gas production, and 25 percent of total U.S. petroleum industry employment.² As energy prices have risen in recent years, this sector has become an increasingly important driver of economic growth. In 1999, oil and gas extraction accounted for approximately 3

percent of the Southwest's economic activity (measured as a share of gross state product), compared with approximately 6 percent in 2004 (the most recent data available).³ The area's share has undoubtedly risen since then, given the spike in oil prices in the past two years.

Rising energy prices typically have a negative influence on U.S. economic activity. However, in energy-producing states, higher prices promote economic activity by boosting industry profits and hiring. The current strength in oil and natural gas prices has resulted in an annual employment growth rate of more than 7.5 percent in the Dallas Southwest area's natural resources and mining sector in 2006.⁴ Thus, the regional economy benefits disproportionately compared with the rest of the country when energy prices are high.

Some analysts think oil prices could remain high through the end of 2007 despite recent declines. The **Energy Information Administration** (EIA) is projecting oil prices (West Texas Intermediate) will linger in the \$60 to \$70 per barrel range in 2007 (see Chart 1). Also, global excess production capacity remains extremely tight by historical standards, which will likely place upward pressure on prices. According to EIA estimates, surplus world crude oil production capacity is projected to increase slightly in 2007 but will remain near 30-year lows. In addition, the **Organization of Petroleum Exporting Countries** (OPEC) announced in October that it was cutting daily oil production by 1.2 million barrels per day to prevent prices from falling too far below \$60 a barrel.⁵ The announced production cuts are the first by OPEC since December 2004. Further, global economic growth is likely to remain healthy in 2007 and 2008, boosting demand for oil and supporting higher prices in the near term.

¹ Summary of deposit information is collected each June 30.

² U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, and the Independent Petroleum Association of America. Data are for 2003.

³ Calculated using U.S. Bureau of Economic Analysis gross domestic product data.

⁴ U.S. Bureau of Labor Statistics.

⁵ Stephen Mufson, "OPEC Says It Will Cut 1.2 Million Barrels a Day," *Washington Post*, October 20, 2006, page D3.

Chart 1

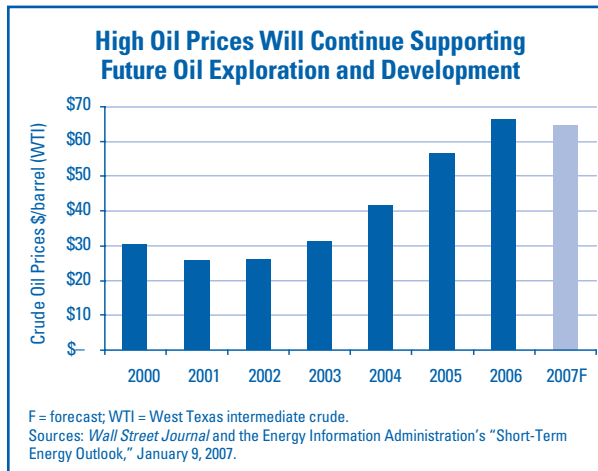
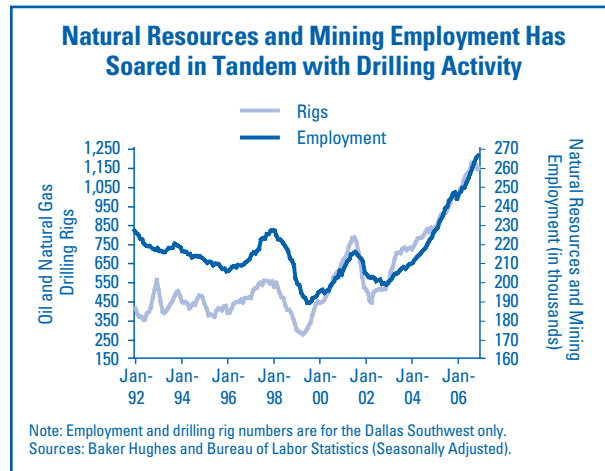


Chart 2



Employment and Personal Income Growth

The Dallas Southwest surpassed the nation in employment growth in 2006, and is on pace to surpass the nation in personal income growth as well (see Table 1). Higher energy prices have generated increased capital expenditures in energy exploration and production, creating additional jobs in the area's mining sectors (see Chart 2). In addition, demand for oil and natural gas field equipment and oil field services is increasing. According to *Bakers Hughes*, active oil and gas rotary rigs increased 20 percent in 2006. Moreover, strong international energy activity is creating demand for oil field equipment and services. The marketing and

distribution of energy-based products stimulates additional demand in support activities such as financial and legal services, which spurs employment and income growth in the Southwest. State government coffers also are greatly enhanced by the growth in severance tax revenues.

Housing Sector Remains Strong in Most of the Dallas Southwest

While the housing market is slowing for the nation, it continues to be a source of growth for the Dallas Southwest area. Nationwide, year-over-year median home price growth peaked in third quarter 2005 at 14.2 percent, but home prices declined 2.7 percent on a year-ago basis in fourth quarter 2006.⁶ This recent downturn has so far bypassed key markets in the Dallas Southwest, only the **Denver-Aurora** metro area experienced declining home prices on a year-ago basis in third quarter 2006. Existing home sales also have outpaced those of the nation. For instance, Texas saw existing home sales in the third quarter climb 8.6 percent higher than year-ago levels. In contrast, nationwide sales were down more than 12 percent on a year-ago basis, allowing the area to capture a larger share of the nation's totals (see Chart 3). Texas accounted for 74 percent of the area's homebuilding activity in 2006, and 66 percent of its existing home sales through the first three quarters of 2006, making the state a key driver of regional housing trends.⁷

Table 1

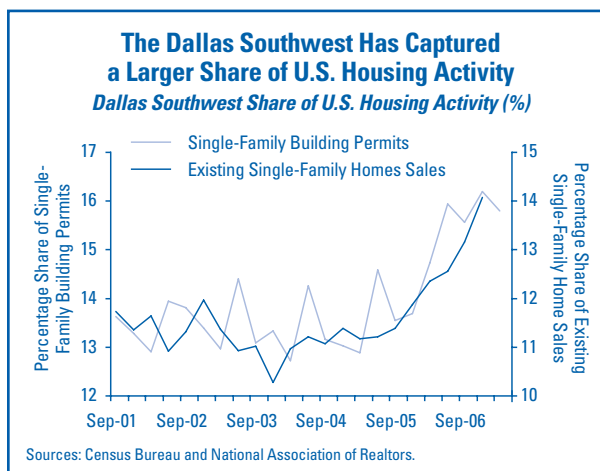
The Dallas Southwest Expansion Remains Strong		
Area	Nonfarm Employment Annual Growth Rate*	Personal Income Annual Growth Rate**
Colorado	2.1	5.8
New Mexico	2.7	7.5
Oklahoma	1.9	8.7
Texas	2.5	8.3
Dallas Southwest Region	2.4	7.9
United States excluding the Dallas Southwest Region	1.3	6.4

* Preliminary average annual employment growth rate for 2006.
** First three quarters of 2006 compared with same period a year ago.
Sources: Bureau of Labor Statistics and Bureau of Economic Analysis.

⁶ National Association of Realtors.

⁷ U.S. Census Bureau and the National Association of Realtors.

Chart 3



Most local markets in the Dallas Southwest have not experienced the sudden deceleration in home prices seen elsewhere in recent months. In fact, half the 40 metropolitan areas experienced home price increases that outpaced the year-ago rate, compared with less than one-fourth of metropolitan areas elsewhere in the country.⁸ Further, despite ongoing home price gains in many of the metro areas, local housing markets remain relatively affordable, primarily because home price gains have not outpaced median family incomes to the extent seen in many coastal markets.

Colorado metro areas are an exception to the area's strong housing performance. Despite continued employment growth and relatively low mortgage rates, Colorado existing single-family home sales fell for the second consecutive quarter on a year-ago basis in third quarter 2006. The rapid deterioration in affordable housing is the primary reason for weakness in the state's home sales. According to the *National Association of Home Builders/Wells Fargo* Housing Opportunity Index (HOI), affordability has declined in all seven Colorado metro areas.

Meanwhile, annual home price growth in Colorado decelerated from a peak of 6.2 percent in fourth quarter 2005 to 3.7 percent in third quarter 2006.⁹ A *Moody's Economy.com* housing study projects home price declines ranging from 1.3 percent to 10.7 percent for all seven Colorado metropolitan areas within the next two years.¹⁰ In addition, Colorado posted the highest

foreclosure rate in the nation as a percent of total households (3 percent) in 2006. Overall, Colorado foreclosures totaled almost 55,000 last year for an increase of 85 percent from 2005, and a percentage increase double that of the nation.¹¹ The combination of weakening home sales, rising inventories of unsold homes, and high levels of foreclosures is likely contributing to weak home price trends and may present challenges in the near term.

Nonetheless, a number of factors signal continued stability in most of the Southwest's metropolitan area housing markets. According to recent FDIC analyses of the nation's housing cycles, housing busts in the United States have been rare and are usually triggered by substantial local economic distress, such as the large-scale job losses associated with a local recession. Generally, the nation's housing booms have been followed by a period of home price stagnation as incomes slowly catch up to housing prices.¹² Given these criteria, a severe downturn in the Dallas Southwest appears unlikely. In fact, several factors point to stability in the area's housing markets in 2007.

For example, the absence of severe overbuilding in many markets should help support home prices. Until second quarter 2006, the number of new homes had more than kept pace with the strong demand for housing. Since then, homebuilders have limited new construction, keeping inventories in check. Also, a considerably smaller percentage of mortgages was used to buy second/investor homes in 11 of the 14 major markets in the Southwest compared to the country as a whole.¹³ Local housing markets with lower levels of investor ownership often exhibit less volatility, as investors may be more likely to sell a home in a declining market. In addition, *Blue Chip Financial Forecasts* projects that interest rates on conventional home mortgages will remain between 6 and 7 percent through the end of 2007, which, if realized, should support continued home sales and price gains.¹⁴

⁸ Office of Federal Housing Enterprise Oversight (OFHEO) for the year ending third quarter 2006.

⁹ *Ibid.*

¹⁰ Moody's Economy.com, "Housing at the Tipping Point: The Outlook for the U.S. Residential Real Estate Market," October 2006.

¹¹ RealtyTrac press release, "More than 1.2 million foreclosures reported in 2006," January 25, 2007.

¹² See *FYI: An Update on Emerging Issues in Banking*, "U.S. Home Prices: Does Bust Always Follow Boom?" February 10, 2005, and *FYI Revisited: "U.S. Home Prices: Does Bust Always Follow Boom?"* May 2, 2006.

¹³ National Association of Realtors, July 2006.

¹⁴ Blue Chip Financial Forecasts, January 1, 2007.

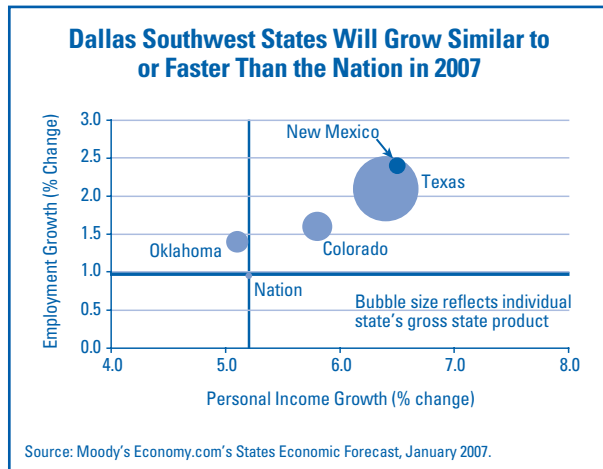
Outlook for 2007 Remains Good, Despite Some Challenges

Employment and income growth in the Dallas Southwest are expected to largely outperform the nation again in 2007 (see Chart 4). Mining, construction, financial activities, professional and business services, and educational and health services are among the sectors likely to see strong job and income growth next year. Finally, the area’s robust population growth should support continued strong demand for housing. Consensus state forecasts project population growth in Colorado, **New Mexico**, and Texas will outpace the nation in 2007—1.6 or 1.7 percent annually for the three states compared with 0.9 percent for the nation.¹⁵

While the Dallas Southwest is expected to remain one of the nation’s economic leaders in 2007, there are a few clouds on the horizon. In the wake of the 2005 hurricane season, the accessibility and affordability of property and casualty insurance remain in flux for the Gulf Coast region. Because housing in the Texas Gulf Coast area is at risk from wind and hailstorms, many homeowners have seen their premiums and deductibles rise in conjunction with reduced policy coverage. The lack of affordable casualty insurance could slow development in Texas coastal areas. Moreover, rising insurance premiums could strain borrower finances, thereby pressuring repayment capacity and negatively affecting insured institution credit quality.

In addition, there are considerable risks facing the area’s agricultural sector in 2007. Declining farm income, escalating fuel prices, lingering drought across much of the Southwest, and the uncertainty surrounding the nature and level of future farm subsidy payments will present challenges to farmers and agricultural lenders.

Chart 4

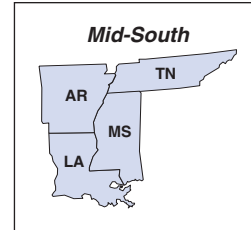


The United States Department of Agriculture (USDA) is forecasting net U.S. farm income to decline 22 percent in 2006. Also, expenses paid by agricultural producers have increased substantially since 2003, with the cost of diesel fuel increasing by 45 percent. USDA is forecasting producer interest costs to rise 11.9 percent in 2006. Although conditions at the Southwest’s agricultural banks are strong, agricultural borrowers may begin to exhibit greater financial stress from a combination of higher expenses, lower income, and continuing drought conditions, primarily in parts of Texas and **Oklahoma**. Further, any significant cuts to the amount of government payments in the 2007 farm bill could hurt the cash flow positions of agricultural producers and collateral values of farmland in areas with high subsidies.

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¹⁵ Western Blue Chip Economic Forecast, January 2007, and U.S. Census Bureau.

Expansion of Mid-South Economy Masks Rural-Urban Divide



The pace of economic growth across the **Mid-South** has been favorable during recent years as more than 200,000 net new jobs have been added to the regional economy since 2001.¹ However, much of this growth occurred in the urban areas, while rural areas have experienced considerably weaker economic conditions (see Table 1). Much of this divergence can be explained by employment conditions and trends in key industry sectors in these areas. Unemployment rates in rural areas continue to exceed those in urban areas, and rural household incomes remain below those in metro areas. To gain insight into the expanding urban/rural divide, this article examines key differences in economic activity between the Mid-South's rural and urban counties and assesses the implications for the local banking industry.

Breaking down the Mid-South, 94 counties are considered urban, with a median population of 57,000.² The majority (62 percent) of the total population lives in these urban counties, primarily in core urban counties.³

Another 212 counties are considered rural, with a median population of 21,200.⁴ The remaining 38 percent of the total population lives in these rural counties, primarily in small urban clusters or micropolitan areas.⁵

Weak economic conditions in rural Mid-South counties can be attributed to greater reliance on the farming and manufacturing sectors, two industries that have shed jobs in recent years in part because of increasing global competition. Sixty percent of the rural counties depend heavily on one of these sectors, according to the U.S. Department of Agriculture Economic Research Service.⁶ The median employment growth rate in farming- or manufacturing-dependent rural counties in the Mid-South during the past five years was negative 5.7 percent, compared with negative 2.4 percent for all other rural counties and 4.8 percent for all urban counties of the Mid-South.

In contrast, Mid-South urban county economies are more diversified, rely less on manufacturing and farming, and have benefited from strong demand for service-related jobs. Companies have migrated to metropolitan counties of the Mid-South that offer a relatively high degree of industrial diversification and access to quality education and health care.

The education and health services sector has been a key driver of the economies of the Mid-South's urban counties, while the professional and business services, leisure and hospitality, and government sectors also helped to create more than 250,000 net new jobs since 2001 (see Table 2). Unlike other areas of the nation, housing markets in the Mid-South have remained relatively stable, as evidenced by the solid, but relatively modest, number of construction jobs added during the

Table 1

Metropolitan Areas of the Mid-South Are Growing Steadily, While Rural Areas Continue to Shed Jobs		
Area	Urban Counties	Rural Counties
Number of Counties	94	212
Total Population, 2006	9,169,160	5,582,225
5-Year Median Population Growth, %	4.9	0.4
Median Household Income, 2006	\$38,934	\$30,296
5-Year Median Employment Growth, %	4.8	-3.5
5-Year Total Jobs Added/Lost	256,947	-52,006

Source: Bureau of Labor Statistics, median figures, as of year-end 2006. Data for New Orleans and Gulfport-Biloxi MSAs excluded because of effects of Hurricane Katrina.

¹ Excludes New Orleans (Louisiana) and Gulfport-Biloxi (Mississippi) metropolitan areas because of the effects of Hurricane Katrina.
² Urban counties have a population of 50,000 or greater or are considered an adjacent county with a high degree of social and economic integration with the core county, as defined by the Office of Management and Budget (OMB). www.whitehouse.gov/omb/bulletins/fy2006/b06-01_rev_2.pdf.
³ Such as Shelby County, Tennessee (Memphis), Davidson County, Tennessee (Nashville), and East Baton Rouge Parish, Louisiana (Baton Rouge).

⁴ Rural counties are defined as counties not included in metropolitan statistical areas as defined by the OMB. www.whitehouse.gov/omb/bulletins/fy2006/b06-01_rev_2.pdf.
⁵ Such as Tangipahoa Parish, Louisiana (Hammond), St. Landry Parish, Louisiana (Opelousas-Eunice), and Sevier County, Tennessee (Sevierville).
⁶ For more information, access the U.S. Department of Agriculture Economic Research Services 2004 County Typology Codes at www.ers.usda.gov/Briefing/Rurality/Typology/.

Table 2

The Vast Majority of New Jobs Have Been Created in the Education and Health Services Industries		
Job Sector	Net Jobs Added (2001–2006)	
	Urban	Rural
Education and Health Services	88,354	15,685
Professional and Business Services	43,939	16,819
Leisure and Hospitality	47,515	5,069
Government	40,793	1,568
Trade, Transportation, and Utilities	44,121	–8,269
Finance, Insurance, and Real Estate	15,589	–947
Other Services	11,853	–4,862
Construction	19,225	–7,051
Natural Resources and Mining	–315	–3,192
Information	–4,139	–3,609
Manufacturing	–54,809	–63,217

Source: Bureau of Labor Statistics, Moody's Economy.com. Mid-South data exclude New Orleans and Gulfport-Biloxi MSAs because of effects of Hurricane Katrina.

past five years. The Mid-South construction sector contributed 8 percent of total new jobs, compared with 18 percent nationally.

What may the future hold for the Mid-South's rural and urban areas? The vast majority of the jobs created during the past five years have come from the education and health services sector. This trend is likely to continue as the Bureau of Labor Statistics projects this industry to grow faster and add more jobs than any other economic sector in the nation through 2014.⁷ The professional and business services and leisure and hospitality sectors also are forecasted to generate jobs in the near term. However, as has been the case in the recent past, most of these job gains are expected to occur in the Mid-South urban areas, and rural economies likely will continue to struggle.

A few positives do exist for the economies of Mid-South rural counties. Should the use of biofuels, such as ethanol, become more widespread, the production of energy alternatives has the potential to stimulate economies in some farming-dependent communities. The Mid-South is already a leading producer of soybeans, sugarcane, and poultry, three materials that can be used to produce biofuels. In recent months,

⁷ *Tomorrow's Jobs*, Bureau of Labor Statistics Occupational Outlook Handbook 2006–07 Edition. Available at <http://www.bls.gov/oco/pdf/oco2003.pdf>.

several biofuel plants have opened and more may commence operation.⁸ Although these biofuel plants typically do not employ large numbers of workers, these are capital intensive facilities that are expected to generate construction jobs and may help spur demand for service-related jobs.

Energy production also may benefit rural areas of the Mid-South. The use of new technologies has improved oil and natural gas extraction and helped in the identification of new sites, including the Fayetteville Shale Play in rural central Arkansas and a major oil reserve off the Louisiana coast that could boost the nation's oil reserves by as much as 50 percent.⁹ Extraction activity in these new energy fields is expected to generate relatively higher-paying jobs and diversify the local employment base.

Rural Banks Are Performing Surprisingly Well

Despite weaker economic conditions across many of the Mid-South's rural counties, community banking performance is on par with that in urban counties. The urban-based institutions generally report higher net interest margins (NIMs) and service fee income levels than their rural-based counterparts. However, as of third quarter 2006, rural institutions earned a median pretax return on assets (ROA) of 1.49 percent, 7 basis points higher than banks in urban areas.

Mid-South rural-based institutions make up for the shortfall in NIMs and service fee income by holding down overhead expenses. During the five years ending third quarter 2006, the median noninterest expense ratio reported by rural institutions was 2.99 percent, well below the 3.29 ratio posted by Mid-South urban-based institutions.

Generally weaker economic conditions have constrained branching and de novo activity in Mid-South rural areas in recent years. Metropolitan areas added a net total 402 bank branches (13.3 percent) during the past five years, while only 56 (2.3 percent) were added in rural areas.¹⁰ In addition, 24 banks

⁸ Elton Robinson, "Are Mid-South Farmers Ready to Become Fuel Producers?" *Prism Insight*, June 15, 2006.

⁹ Mark Morrison, Stanley Reed, and Chris Palmer, "Plenty of Oil, Just Drill Deeper," *BusinessWeek*, September 18, 2006.

¹⁰ Based on FDIC/OTS Summary of Deposits database as of June 30, 2006.

Pace of Rebuilding Expected to Differ in New Orleans and Gulfport-Biloxi; Banks in Both Areas Remain Resilient

Hurricane Katrina severely affected the metropolitan areas of **New Orleans** and **Gulfport-Biloxi**. To date, job recovery in both areas has been weak, a reflection of the magnitude of the devastation of homes and businesses.*

Going forward, the nature and pace of the recovery in the New Orleans and Gulfport-Biloxi areas are expected to differ considerably. Prospects for growth in Gulfport-Biloxi appear bright because of fewer rebuilding issues and the fact that **Mississippi** is allowing the gaming industry, a key economic driver, to build casinos on land, allowing for larger and more luxurious facilities. However, in New Orleans, hurdles relating to levee protection, coastal restoration, and the need to elevate homes must be overcome. Although rebuilding will promote job growth, severe housing shortages in both areas will constrain the number of available workers in the near term.

Overall, insured institution performance in the affected areas has been favorable. Banks and thrifts have reported strong deposit growth from public and private aid and insurance proceeds. Nearly all affected institutions are once again profitable, and many are reporting improved profitability, in large part a result of increasing NIMs. The median pretax ROA for all insured institutions based in the New Orleans and Gulfport-Biloxi metropolitan statistical areas (MSAs) climbed to 1.58 percent in third quarter 2006, the highest level for this group of institutions since 1997. Similarly, the median NIM now stands at 4.30 percent, the highest level since 2000. In the near term, NIMs and profitability are expected to remain elevated because of the disbursement of billions of dollars in community development grants to owners of damaged homes.

After weakening dramatically in the two quarters after Hurricanes Katrina and Rita, asset quality is now on par with, and in many cases improved from, pre-storm levels. In fact, the median past-due ratio for all insured institutions based in the New Orleans and Gulfport-Biloxi MSAs declined to an all-time low of 1.17 percent in third quarter 2006. Generally, real estate lenders in the affected areas required hazard and flood insurance, which has helped minimize losses in bank real estate loan portfolios.

* Between October 2005 and November 2006, New Orleans recovered approximately 50,000 jobs (23 percent) lost as a result of Katrina. Since year-end 2005, the Gulfport-Biloxi area has recovered approximately 10,000 jobs (40 percent).

opened in metropolitan counties, and only 12 opened in rural counties during this time. Furthermore, the FDIC Summary of Deposits database shows rural areas are generally characterized by greater concentrations of deposits in fewer institutions, suggesting that Mid-South rural-based community institutions face relatively less competition from other insured financial institutions than do banks in urban areas.

Community banks in rural counties face the prospect of much slower growth than their urban counterparts in terms of deposits and loans. During the past five years, total deposits held in bank branches in Mid-South urban counties increased 44 percent, compared with 20 percent growth for banks based in rural counties. Reflecting fewer lending opportunities, community banks based in rural counties report weaker loan growth rates and lower loan-to-asset ratios than metro-based institutions. Although urban-based banks report more favorable credit quality, rural-based community banks generally mitigate higher past-due and charge-off ratios with higher levels of equity capital.

Overall, continued slow growth by insured institutions based in Mid-South rural counties does not by any means suggest the demise of the small, rural community bank. However, should population continue to move from rural to urban areas, as has been the case for decades, rural-based banks likely will continue to face strikingly different prospects than their urban counterparts. Weaker deposit growth makes funding increasingly difficult, while weaker demand for loans may constrain earnings for rural banks. However, consolidation opportunities may exist among rural banks, perhaps providing some scale efficiencies in this slower-loan-growth environment.¹¹

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¹¹ For more information on rural depopulation trends, see the FDIC's *Future of Banking* studies at www.fdic.gov/bank/analytical/future.

Agricultural and Rural Issues Will Determine Future of Kansas City Region

Rural and agricultural issues continue to drive the Kansas City Region's economic and banking risk profile. The Kansas City Region is the most rural and agriculturally dependent of the six FDIC Regions, with a share of rural population that is more than twice the national average.¹ These rural areas tend to rely heavily on agriculture. The Region's FDIC-insured institutions reflect these rural characteristics. Foremost, the Region's institutions tend to be much smaller than elsewhere in the country.² The Kansas City Region is home to only 4 of the nation's 122 institutions holding assets greater than \$10 billion. Also, more than half the banks in the Region are farm banks, predominately located in rural communities.³

Overall, the agricultural sector is performing well; U.S. farmers started 2006 on the heels of record-high net farm income. Although income levels declined in 2006, they are still expected to reach the 10-year average in 2006.⁴ Despite this favorable performance, rural and agricultural issues—specifically ongoing rural depopulation trends, uncertainty surrounding the next farm bill, and continuing hydrological drought conditions—are expected to influence the regional economy and insured financial institutions in the near and long term.

Depopulation Challenges Banks to Operate with Smaller Customer Bases

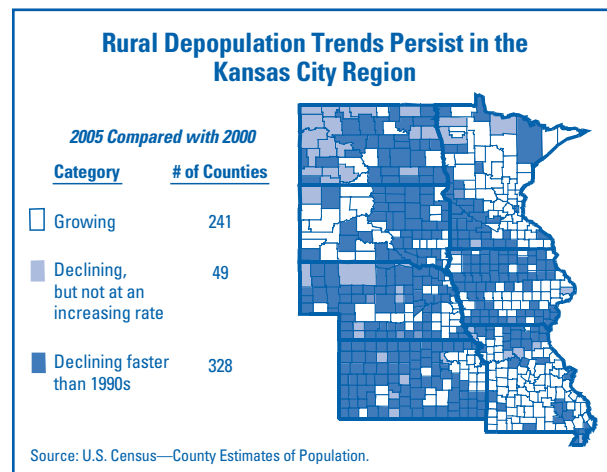
Residents have been slowly migrating from the Region's rural counties for decades, largely because technological advances in agriculture have reduced the need for farm

laborers.⁵ In many areas of the Region, the pace of rural depopulation accelerated in the 1990s, raising concerns about the viability of many sparsely populated counties. This trend has continued into the 2000s, as 328 of the Region's rural counties lost population from 2000 to 2005 at a greater rate than during the 1990s (see Map 1).

To date, FDIC-insured financial institutions in depopulating rural counties have performed well—similar to institutions in rural counties with growing populations. The primary differences in performance between these groups have been in loan and deposit growth, which has been considerably lower for institutions in depopulating counties.⁶ Because depopulation equates to a



Map 1



¹ Almost 35 percent (34.7 percent) of the Region's population lived in rural areas in 2005, compared with less than 16 percent elsewhere in the country. U.S. Census, "2005 Estimates of County Population," <http://www.census.gov/popest/counties/>.

² More than 86 percent of the Region's institutions hold less than \$250 million in assets, while outside the Region two-thirds of banks and thrifts are this small.

³ Farm banks are defined by the FDIC as insured financial institutions with at least 25 percent of loan portfolios invested in loans to agricultural operations or secured by agricultural real estate.

⁴ U.S. Department of Agriculture, Economic Research Service, "2006 Forecast," <http://www.ers.usda.gov/Briefing/FarmIncome/nationalestimates.htm>.

⁵ For a detailed analysis of the causes and implications of rural depopulation in the Great Plains, see Jeffrey Walser and John Anderlik, "Rural Depopulation: What Does It Mean for the Future Economic Health of Rural Areas and Community Banks That Support Them?" *FDIC Banking Review* 16, no. 3 (2004): pages 57-95.

⁶ *Ibid.* An FDIC analysis showed that commercial banks headquartered in metropolitan statistical areas had ten-year annualized asset, loan, and deposit growth rates of 8.9 percent, 11.2 percent, and 8.6 percent, respectively, between 1993 and 2003. In comparison, commercial banks headquartered in nonmetropolitan statistical areas had growth rates of just 4.4 percent, 6.8 percent, and 3.8 percent, respectively.

Region by Region: Banking Conditions in 2007

declining customer base, this situation is slowly threatening the ability of many rural, community banks to obtain adequate funding and generate enough loans to remain in business. Many rural banks have opened branches in more vibrant counties, with varying results depending on the ability of bank management to operate in these new areas. To maximize profits in spite of a waning customer base, others have mastered operating efficiency by keeping costs down. Still other institutions have turned to the Internet as a source of deposits and loans. Although the Internet can be helpful to rural banks, it may also prove to be a “two-way street,” allowing large banks based in urban areas to successfully compete in rural areas.

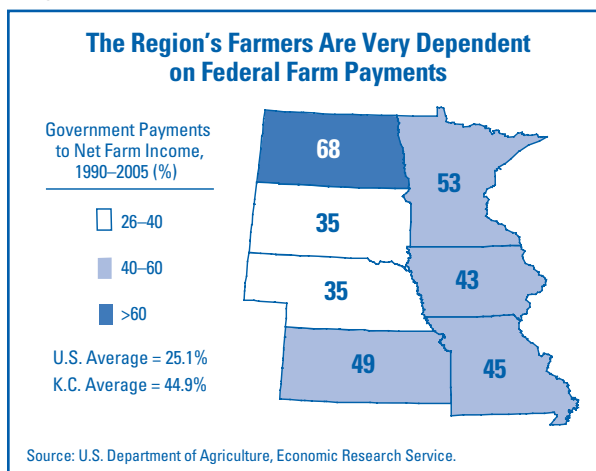
Rural depopulation is a slow-moving issue, and community banks have been able to adapt to its challenges thus far. It is likely that rural banks will continue to expand their reach to attract loans and deposits, which should stem major problems in the near term. Over the long term, however, continued depopulation could result in bank consolidation in rural areas. Also, as current managers retire, the ability to attract and retain qualified bank managers in rural areas is a concern that will likely become more pressing in coming years.

Prosperity of Farmers Depends Heavily on the Future of Federal Farm Policy

The Kansas City Region’s farmers rely heavily on the federal government for financial assistance in the form of price supports and emergency aid. Corn, soybean, and wheat crops are covered by government farm programs and are produced heavily in the Region. Consequently, government assistance to the Region’s farmers has been substantial. Over the past 16 years, the federal government has provided nearly half of the net farm income for the Region’s farmers compared with about a quarter for the rest of the nation (see Map 2).

Because of the Region’s dependence on farm programs, producers and rural constituents are paying close attention to congressional discussions of the 2007 farm bill. Some in Congress want to continue the 2002 bill, which is favorable to farmers; however, the bill has opponents in other countries who claim that price supports distort world agricultural prices. In fact, Brazil has threatened World Trade Organization (WTO) litigation against U.S. corn and soybean programs follow-

Map 2



ing successful challenges of the U.S. cotton program and the European Union sugar program. Others in Congress would like to take steps to reduce payments to farmers and replace them with funds for rural development.⁷ Still others would like to expand farm programs to include specialty crops, such as vegetables and fruits, which could cut funds for traditional program crops.

Given farmers’ historic and ongoing dependence on federal farm payments, any changes to current programs could hurt their cash flow positions. Policy changes also may affect the price of farmland, because federal farm supports, which have existed in various forms since the 1930s, have been capitalized into property values.⁸ For example, one *U.S. Department of Agriculture* study estimates that 69 percent of **North Dakota’s** farmland value may be attributed to this expected stream of government payments. From a lending standpoint, cuts in programs would affect the value of underlying real estate collateral and the ability of farmers to repay their loans. The Region’s rural economies would also be affected by cuts to traditional programs, although shifts in funding to rural development could offset some of the potentially negative consequences.

⁷ The WTO had been negotiating worldwide limits on agricultural support programs, which could have altered U.S. policy considerably. These negotiations, which had been ongoing since 2001, were suspended in July 2006 and are not expected to place mandates on the next farm bill. However, some members of Congress believe the next farm bill should take steps in the direction of the WTO discussions.

⁸ Bruce Gardner, “U.S. Commodity Policies and Land Values,” in *Government Policy and Farmland Markets*, ed. Charles Moss and Andrew Schmitz (Ames, IA: Iowa State University Press, 2003).

Long-Term Drought Conditions Continue to Stress Farmers

The ongoing drought is one more agricultural challenge facing the Kansas City Region. Much of the Region is experiencing drought conditions, and parts of the Region—western Nebraska and Kansas, in particular—are well into their seventh year of drought. Conditions have worsened considerably during the past year, as below-average rainfall has added to long-term water shortages, commonly referred to as “hydrological drought” conditions (see Map 3). Timely precipitation through the growing season helped farmers in most areas produce adequate crop yields. In Kansas, however, wheat yields in 2006 were down 21 percent compared with 2005 levels; during the 2006 growing season, the state received just 14.4 inches of precipitation, compared with 21.5 inches the year before.⁹

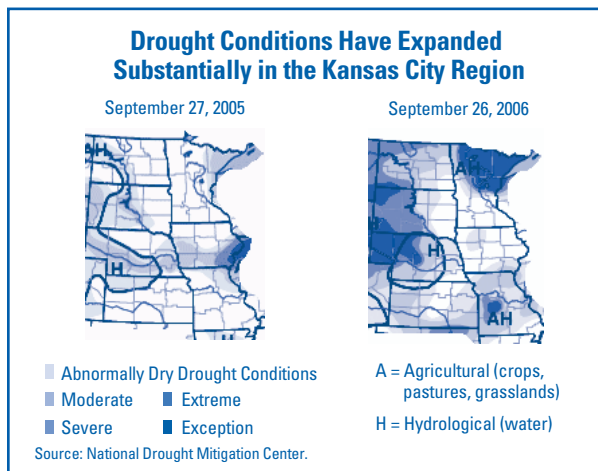
Hydrological drought conditions specifically refer to deteriorated levels in streams, reservoirs, and aquifers caused by several years of below-average rainfall and winter snowpack. In many areas of the Region, hydrological drought conditions are significant. For example, the Ogallala aquifer, a massive underground lake that sprawls beneath much of the Great Plains, has declined 30 feet in some areas over the past decade.¹⁰ In addition, Lake McConaghy, the largest reservoir in

Nebraska, is filled to only 22 percent of capacity.¹¹ Also, stream flows in Kansas are below the levels posted during the extreme droughts of the 1930s and 1950s.¹²

Water shortages have begun taking their toll on farmers who rely on irrigation to grow their crops, largely in Nebraska, Kansas, and South Dakota. For example, irrigation limits in Nebraska have been placed on about one-quarter of the state, and first-time limits will eventually encompass the rest of the state. In addition, more restrictive limits may be imposed in some areas. The reduction in available water for crop producers in the southern portion of Nebraska has already led to declines of 4.2 percent in irrigated land values in 2006, compared with an increase of 9.6 percent in land values statewide.¹³ The statewide average for irrigated cropland was \$2,150 in 2006, compared with \$1,450 for “dryland” (i.e., nonirrigated land). As irrigation limits become more restrictive, crop yields (and thus farm revenues) will be adversely affected, and irrigated farmland values will decline toward dryland values.

It will take a substantial amount of precipitation to cure problems caused by the Region’s hydrological drought conditions. Unfortunately, the forecast indicates there is an equal chance of drought conditions worsening or improving over the next 12 months.¹⁴ Bankers in the Kansas City Region are taking extra measures to mitigate loan portfolio risk, including conservatively valuing irrigated farmland, stress testing agricultural loans for yield shocks, and reviewing farm operations more frequently.

Map 3



Looking Ahead: 2007 and Beyond

Of the three rural and agricultural issues facing the Kansas City Region, farm policy could exert the greatest impact in 2007. The 2007 farm bill will be viewed by many as a major test of corn, soybean, and wheat producers’ political strength. Any reductions in federal aid would constrain the debt-repayment ability of farm borrowers and potentially deflate prices for farmland—

⁹ National Oceanic and Atmospheric Administration, “Climate at a Glance,” September 2006.

<http://lwf.ncdc.noaa.gov/oa/climate/research/cag3/ks.html>.

¹⁰ Editorial, “Irrigation Is Mining a Finite Resource,” *McCook Daily Gazette*, October 3, 2006.

¹¹ Central Nebraska Public Power and Irrigation District, Reservoir Elevation and Platte River Flow Data, September 2006.

¹² U.S. Geological Survey, “2000–2006 Flows at Some USGS Stream-gauges Lower than 1930’s or 1950’s Droughts,” August 10, 2006.

¹³ Cornhusker Economics, University of Nebraska, Lincoln, “Nebraska’s Agricultural Land Markets: Dynamic and Diverse,” March 22, 2006.

¹⁴ National Weather Service, Climate Prediction Center, September 2006.

Region by Region: Banking Conditions in 2007

a major source of collateral coverage. Meanwhile, long-term drought conditions are expected to affect the Region's farmers well into the future. Rural depopulation has the longest time horizon as the overall effects on the Region worsen each year as this trend accelerates.

Two issues on the national radar screen—slowing housing markets and high energy prices—will not affect the Kansas City Region to the same extent as other parts of the country. The Region's housing markets have not experienced the double-digit price increases seen in coastal markets, and, therefore, a slowdown in residential building and home sales is not expected to lead to outright declines in home prices. Rather, a deceleration in the already moderate rate of appreciation is more likely. In addition, higher energy costs have stressed the Region's paycheck-to-paycheck consumers but have not substantially constrained most consumer spending. However, energy costs *have* affected farm operations as the cost of energy for agricultural use is forecasted to increase almost 10 percent in 2006 on the heels of a 22 percent increase in 2005.¹⁵

John M. Anderlik, Regional Manager, janderlik@fdic.gov

¹⁵ Economic Research Service, 2006 Forecast.

Slower Housing Activity Clouds the Mid-Atlantic's Economic Outlook

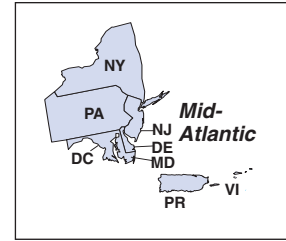
Continued strength on Wall Street and growth of the health care and education sectors have been instrumental in the Mid-Atlantic's current economic expansion.¹ However, recent weakness in the housing sector clouds the Region's economic outlook as home price appreciation is decelerating in a growing number of markets across the **Mid-Atlantic** states.² Job growth in the financial services and education and health care sectors may insulate the regional economy from a housing market slowdown. Nevertheless, given the importance of residential mortgage lending to the Mid-Atlantic's banking landscape—a third of the area's banks and thrifts specialize in residential mortgage lending—the slowing housing market may hinder earnings growth prospects for FDIC-insured institutions in the Mid-Atlantic.

Wall Street Activity Continues to Fuel Mid-Atlantic Economic Growth

The securities industry remains a critical element in the Mid-Atlantic economy because of the relatively high compensation (including salaries and bonuses) received by employees. According to the *Securities Industry and Financial Markets Association*, securities industry revenues have increased approximately 93 percent over the past two years. In addition, pretax profits are expected to be more than 60 percent higher in 2006 than 2005, which would make 2006 the highest annual performance in six years.³ Strong industry performance boosted bonuses in the industry to an all-time high in 2005, and estimates for 2006 indicate that bonuses exceeded last year's levels.⁴

Although employment in the Mid-Atlantic securities industry has not reached its pre-recession peak, compensation remains considerably higher than other

industries. Securities industry employment in **New York City**, the area's financial nucleus, is down 19 percent from the pre-2001 recession peak. However, the average Wall Street salary is more than five times higher than the average salary for other New York City industries. Annual compensation in the securities industry including salary and bonus averaged approximately \$290,000 in New York City in 2005 with the average Wall Street bonus of \$125,000.⁵ Security industry bonuses are estimated to increase 15 percent in 2006 from the 2005 level.⁶ High earnings in the financial sector continue to boost salaries and job gains in such ancillary industries as professional and business services. Moreover, new company formation, from financial advisory firms to hedge funds, has contributed to economic wealth in surrounding states.



Health Care and Education Have Emerged as Key Drivers of Mid-Atlantic Economic Growth

Education and health care have been two of the best-performing employment sectors in the Mid-Atlantic during the past 15 years, helping to offset weakness in the beleaguered manufacturing sector. Since 1990, the concentration of manufacturing jobs has declined by almost half, while the area's share of health and education jobs has increased moderately. Despite the recent housing boom, the proportion of real estate-related jobs to total employment has been relatively stable during this time (see Table 1).⁷ Among the Mid-Atlantic states, **Pennsylvania** had the greatest share of manufacturing jobs to total employment at 11.7 percent in third quarter 2006. Pennsylvania has lost almost 30 percent of its manufacturing jobs since 1990, exceeding the nationwide decline of 20 percent.

¹ The FDIC's Mid-Atlantic area includes Delaware, Maryland, New Jersey, New York, Pennsylvania, Puerto Rico, and the U.S. Virgin Islands. Because of data limitations, the economic discussion excludes Puerto Rico and the U.S. Virgin Islands.

² Office of Federal Housing Enterprise Oversight, "House Price Appreciation Slows Further," November 30, 2006.

³ Securities Industry and Financial Markets Association, "Financial Data of NYSE and NASD Firms," Income Statement and Selected Items, Third Quarter 2006. Fernandez, Frank, U.S. Securities Industry 3Q06 Results. *SIMFA Research Reports I*, no. 6 (December 13, 2006).

⁴ New York State Comptroller estimate, December 2006.

⁵ Office of the New York State Comptroller, "The Securities Industry in New York City," October 2006.

⁶ Office of the New York State Comptroller, "Wall Street Bonuses Set New Record," December 2006. The estimate represents an average for all securities industry employees. It does not include stock options that have not yet been exercised.

⁷ Real estate-related sectors include all construction and financial-related rental and leasing jobs, as defined by the Bureau of Labor Statistics.

Table 1

Growth in Mid-Atlantic's Health and Education Employment Has Offset Declines in Manufacturing		
Sector	Share of Total Employment	
	1990	2006
Manufacturing	13.6%	8.0%
Health/Education	12.8%	16.6%
Financial	7.7%	7.3%
Real Estate-Related	6.0%	6.5%

Note: Data are fourth quarter 1990 and third quarter 2006.
Source: Bureau of Labor Statistics, Haver Analytics.

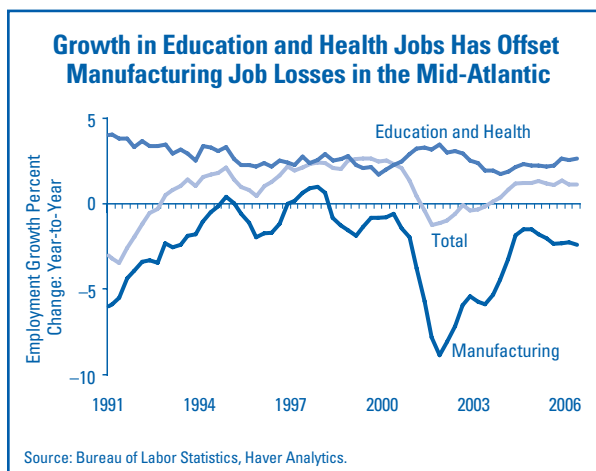
Contraction in the manufacturing workforce was more severe in the Mid-Atlantic than the nation and contributed to slower overall employment growth in the area. Among Mid-Atlantic states, only the **Delaware** job growth rate exceeded the nation for third quarter 2006.⁸ Long-term losses of manufacturing jobs have contributed to slower employment growth in some Mid-Atlantic areas as workers relocate to other parts of the country. However, steady growth in education and health care employment has mitigated the effect of manufacturing job losses on the Mid-Atlantic economy (see Chart 1). The area lost 36 percent of manufacturing jobs since 1990. Meanwhile, education and health care-related employment in the Mid-Atlantic expanded 48 percent, the most rapid growth rate among industry sectors. Still, many of the new education and health care-related jobs pay less than manufacturing jobs, diminishing the positive effects of growth in this sector. In 2006, the average manufacturing job in the Mid-Atlantic paid more than \$55,000 while the average salary among education and health care jobs was approximately \$41,000.

The emergence of the health care industry as a growth engine reflects, in part, the growing needs of the Mid-Atlantic's aging population. According to the **U.S. Census Bureau**, Pennsylvania has the third highest percentage of population age 65 and older in the nation (about 15 percent of the total state population).⁹ Coincidentally, Pennsylvania's share of health care jobs to total nonfarm employment also ranked third highest in the nation, a ranking that has not materially changed in more than 15 years.¹⁰ **New York** has the fourth largest concentration of health care jobs to total

⁸ Data are year-to-year quarterly job growth rates for third quarter 2006.

⁹ U.S. Census Bureau and Moody's Economy.com.

Chart 1



employment, although the state's share of the over-65 population ranks only 21st in the nation. Nonetheless, New York's presence as a national center for health care services contributes to the state's large share of health care jobs.

Slower Housing Activity Clouds the Mid-Atlantic's Economic Outlook

According to the Office of Federal Housing Enterprise Oversight (OFHEO), home price appreciation peaked in mid-2005 across most Mid-Atlantic housing markets and has trended down since then. For the first time in ten years, the OFHEO's home index in New York state declined slightly in third quarter 2006 compared with the second quarter 2006. In addition, a growing number of markets are experiencing price declines. These markets include some of the perennially weaker housing markets in western Pennsylvania and upstate New York as well as **Kingston** and **Long Island**, New York, and **Ocean City, New Jersey**, markets that had previously experienced rapid price appreciation.¹¹ History suggests that it could be a number of years until housing fundamentals catch up with home prices, which could result in stagnant or slightly lower prices in some Mid-Atlantic cities.¹² After rising sharply, the inventory of unsold homes in some Mid-Atlantic areas stabilized toward the end of 2006. However, the level of unsold

¹⁰ Data as of third quarter 2006.

¹¹ OFHEO, Third Quarter 2006 Report.

¹² Cynthia Angell and Norman Williams. "U.S. Home Prices: Does Bust Always Follow Boom?" *FYI: An Update on Emerging Issues in Banking*, February 10, 2005.

homes remains high, particularly in the Washington, D.C., metropolitan area.¹³

In addition, a number of metro areas in the Mid-Atlantic have seen elevated levels of investor home purchases. According to data collected by the *Federal Financial Institutions Examination Council*, Ocean City had the highest share of investor-owned housing in the nation in 2005 at 83 percent.¹⁴ In addition, **Atlantic City**, New Jersey, **Glen Falls**, New York, and **Salisbury, Maryland**, had higher percentages of investor-owned housing than the national average. An elevated level of investor ownership may exacerbate housing softness because investors may be more likely to sell a home in a declining market than someone who resides in the home.

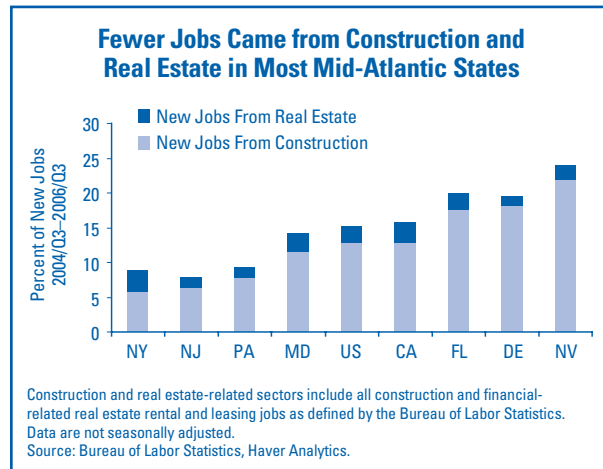
Although slowing appreciation and spot price declines suggest an end to the Mid-Atlantic's housing boom, there were fewer and less severe home price declines through third quarter 2006 in the Mid-Atlantic states than in other parts of the nation, particularly **California**. According to the OFHEO, quarterly price declines occurred in more than half of the 28 California housing markets, while only 8 of the Mid-Atlantic's 42 markets experienced price declines.

Mid-Atlantic Employment May Be Less Sensitive to Housing Market Softness

Employment conditions in the Mid-Atlantic states may be less vulnerable to a weaker housing sector than some other parts of the nation. Excluding Delaware, construction and real estate-related jobs contributed less to net new jobs in the Mid-Atlantic states than the nation and other states such as **Nevada** and **California** (see Chart 2).¹⁵

In addition, except for Maryland, which experienced a sharp slowing of real estate-related employment, Mid-Atlantic states recorded relatively stable rates of construction and real estate-related job growth through

Chart 2



the first nine months of 2006. Continued growth in this sector may be due to increased office construction and rehabilitation, particularly in Washington, D.C., and New York, which mitigated the effect of slowing residential activity on overall construction employment.¹⁶ Because employment is a lagging indicator, the effects of a housing slowdown on employment may be forthcoming.

Mid-Atlantic Residential Mortgage Lenders Experience Greater Net Interest Margin Pressure

A relatively high concentration of mortgage loans, even among institutions that do not specialize in these loans, suggests the Mid-Atlantic's banking industry continues to emphasize residential lending despite the continued growth in loans for commercial real estate (CRE).¹⁷ The median concentration of residential mortgage loans and mortgage-related securities to capital remains high among many banks and thrifts in the Mid-Atlantic states, with Pennsylvania, New Jersey, and Maryland ranking in the top ten nationwide.¹⁸ The median concentration level of CRE loans to capital, including loans secured by residential and commercial properties, has steadily increased. However, CRE

¹³ Data from Maryland Association of Realtors and the Metropolitan Regional Information System, which covers Maryland and parts of Virginia and West Virginia.

¹⁴ Data as of 2005. "Investor-owned housing" is defined as not owner-occupied home mortgages as a share of the sum of owner-occupied and not owner-occupied home mortgages. Federal Financial Institutions Examination Council under the Home Mortgage Disclosure Act (HMDA) via Moody's Economy.com.

¹⁵ Data as of third quarter 2006.

¹⁶ Dana Hedgpeth, "Vacancy Rates, Asking Rents Hold Steady," *Washington Post*, November 13, 2006.

¹⁷ The Mid-Atlantic median CRE loans-to-Tier 1 capital ratio is higher than in the early 1990s but remains just below the national average, at 180 percent of Tier 1 risk-based capital, compared with 197 percent for the nation as of June 30, 2006.

¹⁸ Median amounts as of June 30, 2006. Ratio includes loans secured by single-family residences and multifamily loans and mortgage-backed securities to Tier 1 capital.

concentrations in the Mid-Atlantic states are not as elevated as concentrations of residential mortgage loans and securities. Among Mid-Atlantic states, at mid-2006, Maryland had the highest ranking of concentration to capital for CRE and construction and development loans, ranking 14th and 17th highest in the nation, respectively.

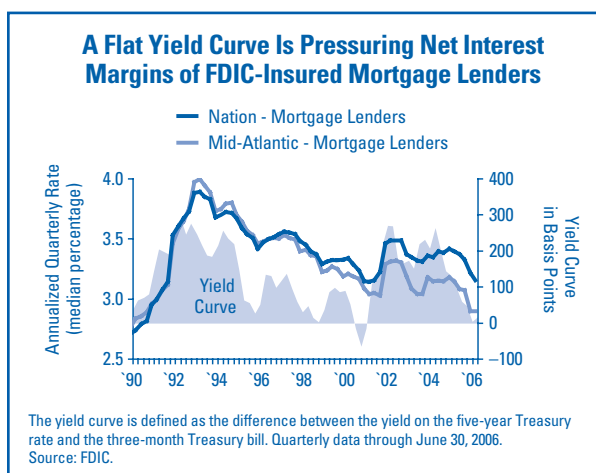
Although the Mid-Atlantic is home to some of the nation's largest and most diversified FDIC-insured institutions, almost one-third specialize in residential mortgage lending ("mortgage lenders"), which is three times the national average. Because of differences in the balance sheet structure of FDIC-insured mortgage lenders, these institutions tend to be more sensitive to changes in the yield curve and may be constrained by slowing housing activity. Mortgage lenders tend to borrow using short-term funding sources and invest in intermediate to longer-term assets. As a result, these lenders typically rely more on "spread" income—that is, the difference between short- and long-term interest rates—than other banking business models, resulting in greater vulnerability to a flat yield curve.¹⁹

Since mid-2004, the Mid-Atlantic's mortgage lenders have experienced more severe contraction in net interest margin (NIM) than mortgage lenders nationwide (see Chart 3). The differences in NIM performance are due, in part, to the higher level of long-term assets to total assets reported by Mid-Atlantic FDIC-insured institutions.²⁰ Long-term assets make earnings more "liability sensitive" because asset yields reprice more slowly than liability costs when interest rates change. After rising steadily during the late 1990s, the share of long-term assets to total assets is stabilizing, consistent with the increasing popularity of adjustable-rate mortgages. However, the Mid-Atlantic's median long-term asset ratio remains high at 55 percent, approximately equal to the 2000 level, compared with 43 percent for all mortgage lenders nationally.

¹⁹ For example, through second quarter 2006, the median ratio of noninterest income to average assets was 0.45 percent for all FDIC-insured institutions headquartered in the Mid-Atlantic, almost double the 0.26 percent median for the area's mortgage lenders.

²⁰ Long-term assets that mature or reprice in more than five years plus collateralized mortgage obligations with an expected life greater than three years as a percentage of total assets, as of the end of the listed period. Reported for Call Report filers only; this item is not available for FDIC-insured institutions that file thrift financial reports.

Chart 3



Housing Market Weakness Could Dampen Economic and Banking Outlook in 2007

Mortgage credit quality remained sound through mid-2006 as median past-due rates on total loans and residential mortgage loans reported by Mid-Atlantic-headquartered institutions were low and below the national median. However, the normal seasoning of new mortgage loans—coupled with slowing housing-related employment, decelerating rates of home price appreciation (and price declines), and higher mortgage interest rates—could result in some credit quality weakening in 2007 from historically low levels. In addition, given the relative importance of the Mid-Atlantic housing sector, even modest home price declines could have a dampening effect on some local economies.

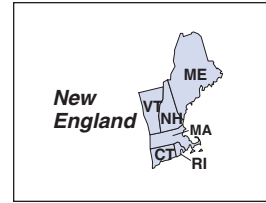
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Special thanks to Cameron Tabor, Financial Analyst, Boston Area Office

Slow Growth Ahead for the New England Economy



Employment in **New England** continues to expand, but concerns persist about the area's economic outlook (see Chart 1). Its growth rate during the past year has been half the national average, and, unlike the nation, it has not recovered all jobs lost during the 2001 recession. During the past several economic expansions, gains in the technology sector have contributed strongly to growth in the New England economy. However, since the last recession, jobs have been slow to return to this key sector. On a positive note, job losses in high-technology industries have been offset in part by growth in services employment.

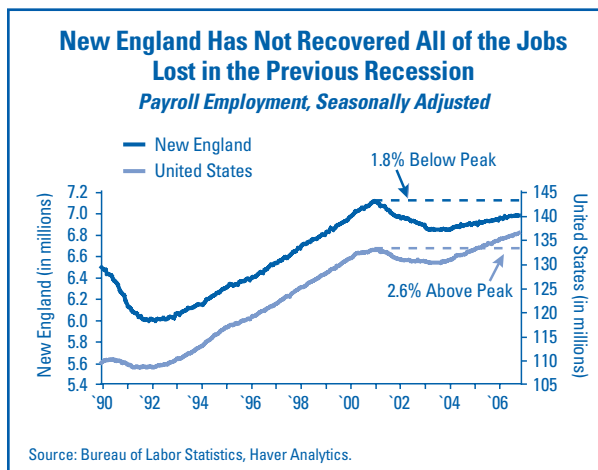
Lowered Expectations for the High-Tech Sector

The high-tech sector has long been a driver of the New England economy, even though this sector's performance has been somewhat volatile over time. The computer-related boom of the 1980s was followed by a bust early in the next decade. The communications boom of the late 1990s preceded the "tech wreck" early in this decade. Since then, employment in almost all technology-related industries, except biomedical research, has contracted. Job losses were particularly heavy in electronic, computer, and communications equipment manufacturing. However, in recent years, layoffs have slowed, and the high-tech sector is now contributing modestly to employment growth.

A review of high-tech employment trends in **Massachusetts** highlights broader regional trends in this sector during the first half of this decade.¹ Overall, weakness is not occurring to the same extent across all subsectors of high tech. High-tech *intensive* industries, those with relatively high shares of employment in high-tech occupations, include computer system design services, computer and other electronic manufacturing, software publishing, Internet service providers, and data processing. In addition to pharmaceutical, including biotech, and aerospace manufacturing (industries with slightly smaller shares of high-tech jobs), these industries represented 6.4 percent of total employment in the state in 2005—nearly double the 3.4 percent national average. Although impressive, this share of total employment was down from 7.7 percent in 2001. *Other* high-tech related industries (those with a considerably smaller share of high-tech related occupations) generated an additional 4.0 percent of all jobs in Massachusetts in 2005, equal to the national average and only moderately below 2001 levels. Falling into the "other" category are architectural and engineering services, medical and technical consulting services, medical equipment and supplies manufacturing, and certain durable and nondurable manufacturing industries.

Overall, the near-term employment outlook for the high-tech sector remains guarded, and prospects for growth are uneven across high-tech subsectors. The computer- and information-related industries have begun to recover jobs lost during the 2001 recession. However, these losses were considerable, and recent growth has been comparatively modest. Retooling for

Chart 1



¹ *High Tech Employment and Wages by Industry*, published by Massachusetts Department of Workforce Development, Division of Career Services, Economic Analysis Office, September 2006. Those industries identified as *high-tech intensive* industries are characterized by research and development (R&D) and high-tech occupations at least five times the average for all industries. Industries that have shares of R&D and high-tech occupations at least twice the average for all industries are identified separately as *other high-tech* related industries. Data for 2001 through 2005 are defined on the basis of the North American Industry Classification System and are not compatible with data from earlier years.

Y2K, which was a driving force during the last high-tech expansion, was a one-time phenomenon. At best, regaining peak employment levels in these industries appears years away.²

By contrast, the outlook for biomedical firms is brighter.³ This subsector has been bolstered by breakthroughs, including those in genetic mapping, which are contributing to new technologies and opportunities for drug development. Further, the aging of the baby boom generation is increasing demand for medical services and improving the potential return on investment in biomedical research. Although the overall number of employees in this industry subsector is comparatively small, these firms are distinguished by considerable investment in research and development (R&D), with high value added per employee. Employment in life science-related industries is projected to expand a favorable 26 percent from 2004 through 2014.⁴ Recent evidence of the strength of the New England biotech sector is the establishment of research facilities by Novartis and Bristol Myers Squibb, major pharmaceutical firms. On balance, however, the outlook for employment growth in the broadly defined high-tech sector is relatively modest, especially when compared to previous boom periods.

High Costs of Doing Business and Living Remain Obstacles to Growth . . .

In addition to weakness in the high-tech sector, the New England states face other challenges. High employee costs make it more difficult for New England businesses to stimulate and sustain economic growth, particularly in the greater **Boston** metropolitan area, home to roughly one-third of the area's total population. A review of salaries and bonuses shows that

metropolitan areas elsewhere in the country with relatively large shares of high-tech employment generally pay employees less than employers in the Boston area.⁵ Of six close competitors, only the **San Francisco-San Jose-Oakland** metropolitan area reported higher employee costs than Boston in 2005.

Long-term changes in the Consumer Price Index tell much about the cost of living in New England. For one, high housing costs are constraining the ability of the New England states to attract new businesses and retain skilled workers. From 1980 to 2005, the cost of living in the Boston metropolitan area increased 3.9 percent annually, exceeding the 3.5 percent national average. Much of the difference is due to the more rapid increase in the cost of shelter.⁶ In Boston, shelter costs rose 4.9 percent, compared with 4.2 percent for the country as a whole during this time.

In addition to the high cost of living, residents in the New England states pay more for electricity and natural gas than consumers in other parts of the country. The area literally is at the end of the nation's energy pipeline. Although the New England states are relatively efficient in their use of energy, New England lacks major indigenous supplies.⁷ Looking ahead, cold winters and heavy dependence on home heating oil are cause for concern, given the continuing uncertainties in the global oil market.

. . . And Weigh on Demographics

A relatively high cost of living and doing business may be contributing to slowing rates of population growth in New England. This, in turn, may constrain business opportunities. The area's population is growing more

² Employment in computer-related industries in 2014 is expected to be below 2004 employment levels. See *Massachusetts Employment Projections through 2014*, published by Massachusetts Department of Workforce Development, Division of Career Services, Economic Analysis Office, December 2006. See also accompanying report, *Current and Projected Employment by Occupation and Education and Training Requirements*, published concurrently by the Massachusetts Department of Workforce Development.

³ See *Massachusetts Employment Projections* and *Current and Projected Employment*.

⁴ *Ibid.*

⁵ *Occupational Pay Relatives, 2005*, published by the Bureau of Labor Statistics, USDL: 06-1680, September 28, 2006. The greater Boston metropolitan area covers most of the commuting suburbs surrounding the city of Boston, including those in southern New Hampshire.

⁶ Shelter costs include rent paid for primary residences, a similar rental valuation for homeowners' primary residences, and the cost of lodging away from home. Rental valuations for homeowners represent almost three-quarters of total shelter expenditures.

⁷ Energy Information Administration, *State Energy Data 2003: Consumption*, October 2006, Tables R1 and R2. Energy efficiency is measured by per capita usage of British thermal units.

slowly than the U.S. average, in part as a result of out-migration and the fact that the population is older than in any other area of the country.⁸ Five of the six New England states have reported slower rates of population growth than the nation among working-age individuals (25 to 64 years of age) during the past ten years (see Chart 2). Looking ahead to the next decade, the U.S. Census Bureau forecasts slower growth in this age group across the country, but the deceleration in the New England states is expected to be greater.

Taken together, unfavorable demographics and a high cost of living and doing business are making it increasingly difficult for firms in New England to remain competitive with other areas of the country as they attempt to hire and expand operations. For example, the August 2006 issue of the *Boston Business Journal* reported on the rising number of unfilled positions for many types of jobs and the fact that recruiters are facing significant challenges in finding suitable candidates.⁹

Emerging Growth in the Services Sector Is a Bright Spot

Given these trends, in addition to weakness in the high-tech sector, employment growth in the New England services sector is a welcome sign. Although

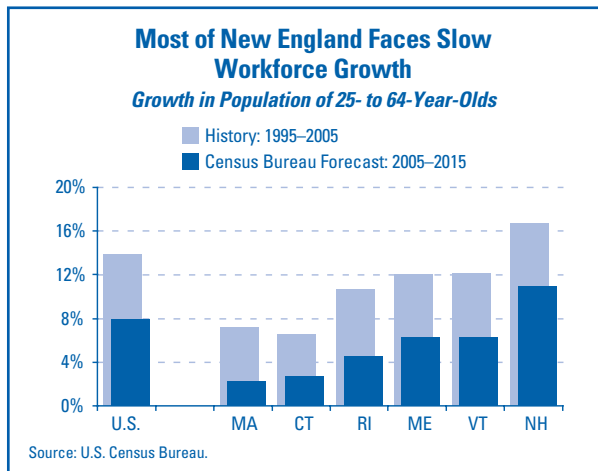
total growth in the services sector is modest, job growth in the professional and business services (which includes scientific research and development services) and education and health services subsectors is expected to be strongest.¹⁰ Employment in these two subsectors, representing more than 40 percent of New England services jobs, is expected to grow at a 1.9 percent annual rate from 2006 to 2010, more than double the rate of total employment growth.¹¹ In addition, employment in the financial services sector, traditionally a leading industry in New England, is expected to expand 0.9 percent annually through 2010.¹² These trends are examples of the ongoing shift of jobs out of the traditional manufacturing base of New England into service sector jobs. The large number of colleges and universities as well as the area's medical centers are contributing to a well-educated workforce that is supporting this transition to a knowledge-based, service-oriented economy.¹³ Going forward, emerging strength in the services sector may provide a much-needed stimulus to the New England regional economy, mitigating continued weakness in the high-tech sector.

Effects of the Housing Slowdown on New England Banks

FDIC-insured institutions in New England continued to report strong capital levels and favorable credit quality through third quarter 2006. However, earnings did decline during the first nine months of 2006. The median pretax return on assets of 0.86 percent was the lowest since second quarter 1992 and well below the national median of 1.39 percent.

This modest decline in profitability may be explained in part by the current unfavorable environment facing the nation's mortgage lenders. The New England states are home to the largest share of mortgage lending specialists in the nation.¹⁴ In fact, the share is more than four times the national average (41 percent of institutions compared with 10 percent nationwide).

Chart 2



⁸ For age and population growth data, refer to U.S. Census Bureau Web site at www.census.gov. For migration data, see David Agrawal, *New England Migration Trends*, Federal Reserve Bank of Boston, New England Policy Center, Discussion Paper 06-1, October 2006.

⁹ "Mass. Suffering Talent Shortage," *Boston Business Journal*, Vol. 26, No. 7, August 4–10, 2006, page 1.

¹⁰ Ibid.

¹¹ *New England Economic Partnership Economic Outlook 2006–2010*, November 14, 2006.

¹² Ibid.

¹³ *The Role and Impact of Colleges and Universities in Greater Boston Today*, a seminar conducted by Carol R. Goldberg Seminars and sponsored by the Boston Foundation (2005).

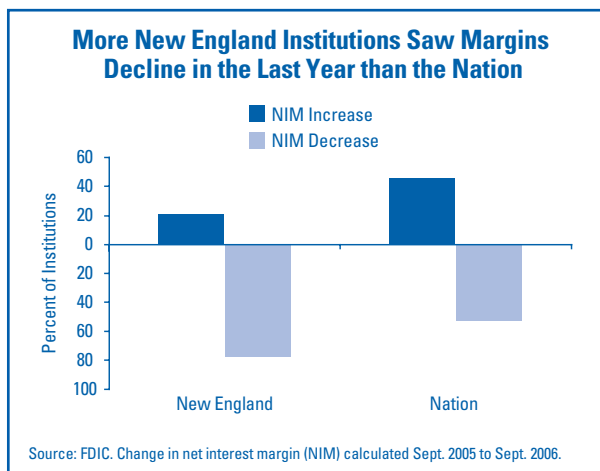
¹⁴ Mortgage lending specialists are defined as having more than 50 percent of total assets in one-to-four family residential loans and mortgage-backed securities.

Region by Region: Banking Conditions in 2007

This group of institutions typically operates on narrower margins given the lower risk assumed, and the naturally lower returns tend to constrain the overall profitability of banks and thrifts across New England. Seventy-eight percent of all insured institutions in the New England states and 85 percent of the mortgage lending specialists reported narrowing net interest margins during the year ending September 30, 2006, compared with 53 percent of all institutions and 78 percent of mortgage lenders nationwide. Funding costs, spurred by higher short-term interest rates, have increased more rapidly than asset yields for banks and thrifts in New England (see Chart 3).

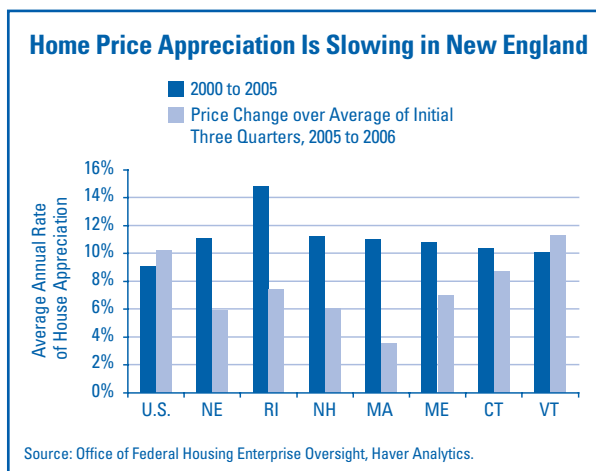
Signs of weakening in New England housing markets could affect the performance of the area's mortgage lenders. Single-family home prices in New England appreciated more rapidly than in many other areas of the country from 2000 through 2005, averaging 11.1 percent per year, 2.0 percent above the national average (see Chart 4).¹⁵ However, the rate of increase has decelerated across all New England states except Vermont during the past year. In third quarter 2006, home prices actually declined slightly in Massachusetts, New Hampshire, and Rhode Island. In addition to slowing rates of price appreciation, sales activity is

Chart 3



¹⁵ Office of Federal Housing Enterprise Oversight, House Price Index September 30, 2006, released November 30, 2006.

Chart 4

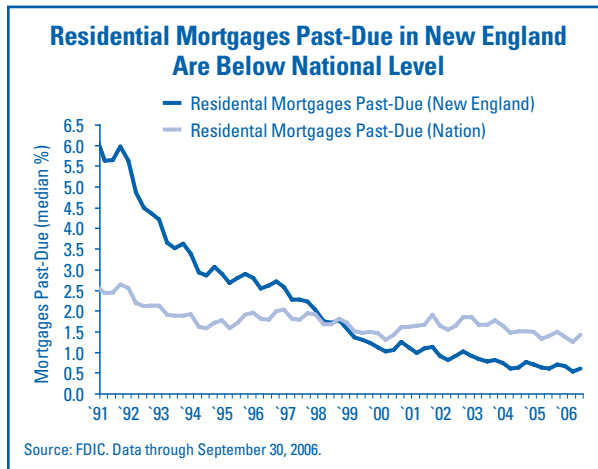


declining and inventories of unsold homes are rising, further evidence of a slowing housing market.

Despite this slowing, mortgage loan growth reported by New England-based insured institutions continued strong in 2006, with a median growth rate of almost 10 percent. However, growth in the home equity loan portfolio slowed dramatically, falling a median 4 percent during the year ending third quarter 2006, after expanding more than 20 percent in 2004 and the first half of 2005. Should housing sales and price appreciation continue to decelerate, mortgage loan growth likely will slow. FDIC-insured institutions concentrating in mortgage lending generally derive a large share of interest and fee income from mortgage-related activities, such as origination fees and servicing income, and these sources of revenue could decline with the current slowdown in the housing market.

Continuing strength in the banking industry is also reflected in favorable credit quality. New England insured institutions reported a low 0.55 percent median past-due ratio for one-to-four family residential mortgage loans in third quarter 2006, compared with 1.34 percent for the nation (see Chart 5). Overall, loan

Chart 5



quality is holding up well with a median total past-due ratio of 0.86 percent, compared with 1.40 percent for institutions elsewhere in the country.

As mortgage loan portfolios continue to season in the face of decelerating rates of home price appreciation (or price declines) and the possibility of higher mortgage interest rates, credit quality could weaken in 2007 from historically low levels of past-dues and charge-offs. Overall, however, banks and thrifts in New England appear prepared to weather the current slowdown in the housing market.

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Construction Sector Key to Growth in San Francisco Region

Robust construction activity, particularly for residential real estate projects, has driven the recent economic expansion in the **San Francisco Region**.¹ During the past two years, the construction sector has generated more than 250,000 new jobs across the Region and represented almost 20 percent of net job growth, compared with 12 percent for the rest of the country. As a result, commercial real estate (CRE) and construction loan growth has been strong, resulting in relatively high and increasing concentrations and improved asset yields for the Region's banks and thrifts. A slowdown in the critical construction sector, however, could jeopardize the sustainability of this strong performance. This article assesses the implications for the regional economy and FDIC-insured institutions of continued deceleration in building activity and explores the potential for other key sectors to balance this slowing.

Construction-Related Job Growth Is Vital for Several Western States

Favorable population growth and low interest rates have spurred housing demand and boosted construction activity in the West. Population growth for the San Francisco Region as a whole has outpaced all other areas of the country every year since 1990. Furthermore, **Nevada** and **Arizona** have reported the most rapid rates of population growth in the nation during the 1990s and are projected to continue to rank at the top through 2010, according to the **U.S. Census Bureau**. As a result of the continued influx of new residents and the need for more residential and commercial buildings, several state economies now rely heavily on the construction sector to generate job growth. In particular, the construction sector in **Idaho**, **Montana**, **Nevada**, **Utah**, and **Arizona** generated at least 20 percent of overall net job growth in second quarter 2006 (see Chart 1).

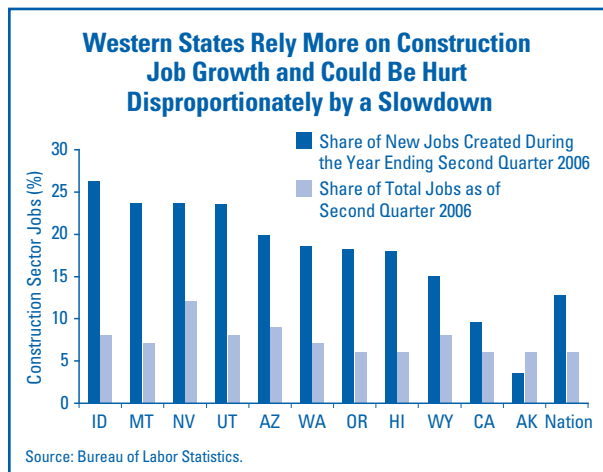
However, given recent signs of cooling in housing markets across the West, including declining home sales, slowing building activity, and decelerating rates of

home price appreciation, job growth in the construction sector could become more volatile. In particular, **California** and **Nevada** reported significant year-over-year declines in construction job growth in 2006. Furthermore, the ripple effect of slowing job growth in construction-related sectors, such as real estate agencies, mortgage finance companies, and retail trade (particularly home improvement retailers), could exacerbate the negative effects of a construction slowdown on local economies.

Going forward, commercial construction, particularly in the office and industrial sectors, could balance some of the anticipated declines in residential construction and buoy job growth overall in the construction sector. For example, data from **Torto Wheaton Research** show considerable new commercial property construction activity under way or planned in the **Las Vegas** market. These projects, involving general contractors as well as specialty trade workers such as electricians and plumbers, could compensate for slowing demand for residential construction in the Las Vegas market. Torto Wheaton Research also reports high levels of commercial construction under way in the **Riverside** and **Phoenix** metropolitan office and industrial markets that similarly could mitigate the negative effects of slowing residential construction activity.



Chart 1



¹For purposes of this analysis, the San Francisco Region includes Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, and Wyoming.

Services and Energy-Related Sectors Are Gaining Momentum in the West

Growth in the services sectors, particularly health care and business services, may also temper some of the anticipated weakness resulting from slowing residential real estate markets. Together, these two service sectors added more than 200,000 new jobs in the Region in the year ending third quarter 2006. Strong demographic trends in many western states continue to drive demand for consumer and business services. Population growth was strong among the baby boomer cohort, particularly in relatively affordable areas such as Nevada, Arizona, and **Oregon**. In states such as California, where the rising cost of living and declining housing affordability have resulted in the exodus of baby boomers and retirees, international immigration has supported overall population growth.² In fact, data from the *U.S. Census 2005 American Community Survey* indicate that 27.2 percent of California's population is foreign born, the highest share of any state in the nation and more than twice the 12.8 percent share that foreign-born residents account for in the nationwide population.

Higher energy prices have bolstered job growth and contributed to economic stability in some resource-dependent areas of the West, particularly **Wyoming**, but also in parts of Montana. Existing mining facilities have expanded, and favorable conditions have driven exploration and development of new mining sites. This upswing in the mining sector, in turn, has contributed to increased in-migration, encouraged higher residential and commercial construction activity, and stimulated job growth in other consumer services and retail sectors in many local economies.³ For example, as of third quarter 2006, Wyoming reported 4.2 percent year-over-year job growth, the most rapid rate in more than 15 years and the fourth highest rate among all states in the nation.

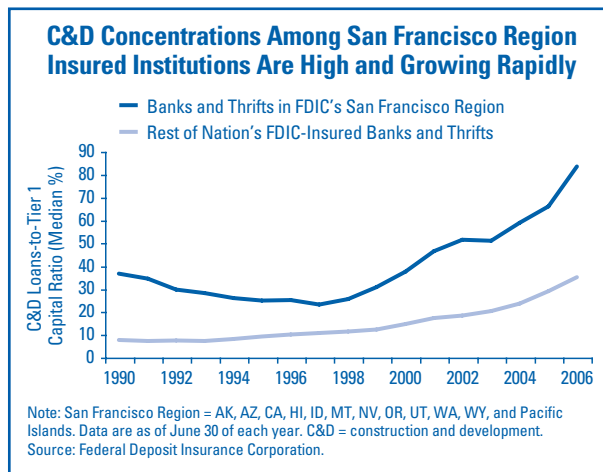
Construction Lending Has Contributed to Strong Profits for FDIC-Insured Institutions in the West

Construction and development (C&D) loans, a component of CRE lending, has been the most rapidly grow-

ing portfolio sector reported by banks and thrifts in the Region during the past several years.⁴ In second quarter 2006, C&D loan growth in 10 of the Region's 11 states outpaced the national median, and 6 of these states (Idaho, Nevada, Oregon, Utah, **Washington**, and Wyoming) ranked among the top 10 nationwide for growth in this lending segment.⁵ C&D loan concentrations correspondingly are higher among FDIC-insured institutions in the West. The Region's median C&D loans-to-Tier 1 capital ratio has been higher than the national average since at least 1990 and was more than twice the average for the rest of the country as of midyear 2006 (see Chart 2).⁶

Since 1998, pretax profits reported by FDIC-insured institutions in the West have exceeded those of banks and thrifts in the rest of the country (see Chart 3).⁷ During this time, expanding C&D and CRE loan portfolios among institutions in the San Francisco Region benefited net interest margins and other noninterest income.⁸ The results of a **Citigroup** study show how returns on C&D loans can bolster bank profitability.

Chart 2



⁴ For purposes of this analysis, CRE loans include nonfarm nonresidential real estate loans, multifamily housing loans, and C&D loans. Complicating this analysis somewhat is the fact that C&D loans, as reported in regulatory reports, include loans made for residential and commercial property construction.

⁵ C&D loan growth in Alaska matched the U.S. annual rate of 27 percent at midyear 2006.

⁶ CRE concentrations also are higher among FDIC-insured institutions based in the San Francisco Region with a midyear CRE loans-to-Tier 1 capital median ratio of 360 percent, compared with 188 percent for institutions outside the Region.

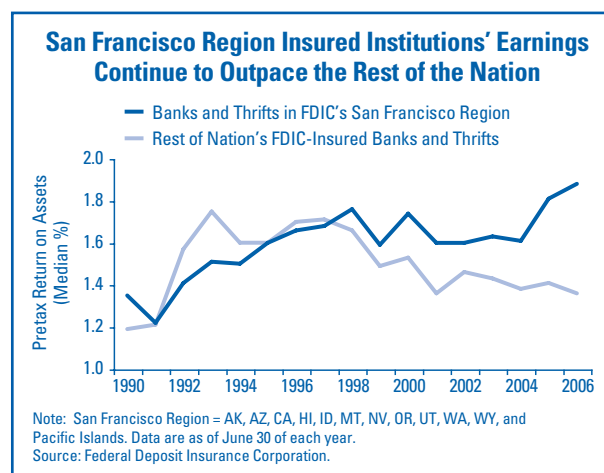
⁷ Pretax profits are used to improve comparability between the tax treatment for Subchapter S and other corporations.

⁸ C&D loans generate loan origination fees as well as interest income.

² "Regional Demographic Trends Affect Local Economies and the Banking Sector," *FDIC Outlook*, Spring 2006.

³ Kirk Johnson, "Flush With Jobs, Wyoming Woos Rust Belt Labor," *New York Times*, September 13, 2006.

Chart 3



This study estimates that C&D lending is second only to credit card lending in generating the highest return on assets; non-C&D CRE loans rank third.⁹

Low provision expenses during the favorable credit environment of the past several years also contributed to higher earnings results in the Region as well as across the country. However, even as the growth in C&D and CRE lending during recent years bolstered profits, earnings of many of the Region's FDIC-insured institutions now could weaken because of the ongoing retrenchment in the residential sector. Still, FDIC-insured institutions in the Region currently report favorable asset quality and strong capital positions. For example, seven of the Region's states ranked among the lowest in the country for past-due loan levels as of midyear 2006, while at the same time banks and thrifts in the majority of the states in the Region reported median Tier 1 capital-to-asset positions above the national average. Therefore, as a result of favorable asset quality and capital positions, the Region's FDIC-insured institutions appear well positioned to withstand continued slowing in the residential sector.

Net Interest Margins Likely Will Face Continued Pressure

Unlike banks and thrifts outside the Region, FDIC-insured institutions in the West reported a slight improvement in net interest margins (NIMs) during the year ending second quarter 2006; increases in net

⁹ Keith Horowitz, "CRE Disintermediation Is a Big Challenge for Mid Cap Banks," *Citigroup Industry Note*, June 9, 2006.

interest income outpaced growth in net interest expense in a rising interest rate environment. Similar to national trends, however, institutions based in the western states now rely more heavily on noncore funding sources; the median ratio of these somewhat more volatile deposits to average assets almost doubled during the past decade to 23 percent at midyear 2006.¹⁰ A housing sector contraction could amplify this trend by limiting sources of core funds from activities such as title and escrow deposits. At the same time, FDIC-insured institutions based in the San Francisco Region are developing Internet-based strategies to advertise and compete nationwide for customer deposits.¹¹ Collectively, these factors could result in a narrowing of NIMs for banks and thrifts in the Region.

Conclusion

Despite current strong economic and banking conditions in the West, increased reliance on historically volatile construction activity may stress local economies and the banking sector should the housing sector continue to weaken. An extended or sharp slowdown in construction activity could ripple through local economies and bank balance sheets and income statements. Although strength in other sectors—particularly the services sector—has emerged recently and could mitigate some of the negative effects of a slowing construction sector, elevated CRE and construction lending concentrations at FDIC-insured institutions will continue to be monitored closely for any signs of weakening in credit quality.

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¹⁰ This compares with a median of 22 percent for the rest of the nation. Noncore funding includes brokered deposits, time deposits more than \$100,000, and other borrowed funds, such as purchased federal funds.

¹¹ Although Internet-derived deposits carry a greater degree of volatility because of customer "rate-shopping," these deposits are considered "core" deposits if the amount is less than \$100,000.