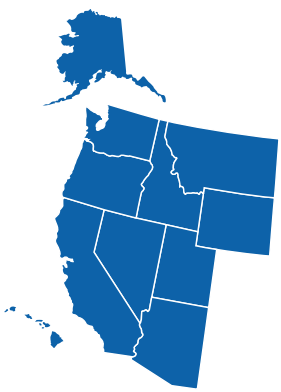
Regional Outlook

Federal Deposit Insurance Corporation — Third Quarter 2001

FDIC
San Francisco
Region



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A Message to Our Readers

The FDIC community extends its deepest sympathy to the families, friends, and co-workers of the victims of the attacks on September 11, 2001.

The articles in this edition of the *Regional Outlook* were prepared before the tragic events of September 11. We will assess the implications of these events in future issues of the *Regional Outlook*. The public can rest assured that deposit insurance is in full force—money is safe in an FDIC-insured account.

Regional Perspectives

◆ **Although the Region's economy slowed through second quarter 2001, employment growth continued to outpace the national average.** *See page 3.*

◆ **Should the economy continue to slow, revenues and employment could be further adversely affected in three of the Region's key industries: high-tech manufacturing, lumber, and tourism.** *See page 3.*

◆ **In addition to potential slowing in these three sectors, commercial and industrial loan quality could also be pressured by past weak underwriting standards, increasing concentration levels, and tighter staff ratios.** *See page 5.*

By the San Francisco Region Staff

In Focus This Quarter

◆ ***Slowing Economy Reduces Demand for U.S. Office Space*—A slowing economy has contributed to softening in many U.S. office markets during the first half of 2001. The office vacancy rate has recorded the largest six-month increase in the past 20 years. A combination of trends—a substantial drop in demand for office space and an uptick in construction activity in some markets—has led to this slackening.**

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness. It notes the role played by the changing fortunes of high-tech firms in a number of U.S. metro areas and how this situation has contributed to large increases in the volume of space available for sublease. Finally, the article focuses on the local construction and commercial real estate loan exposures of FDIC-insured banks and thrifts that have the task of managing their risks under changing market conditions. *See page 9.*

By Thomas A. Murray

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

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Regional Perspectives

- **Although the Region's economy slowed through second quarter 2001, employment growth continued to outpace the national average.**

- **Should the economy continue to slow, revenues and employment could be further adversely affected in three of the Region's key industries: high-tech manufacturing, lumber, and tourism.**

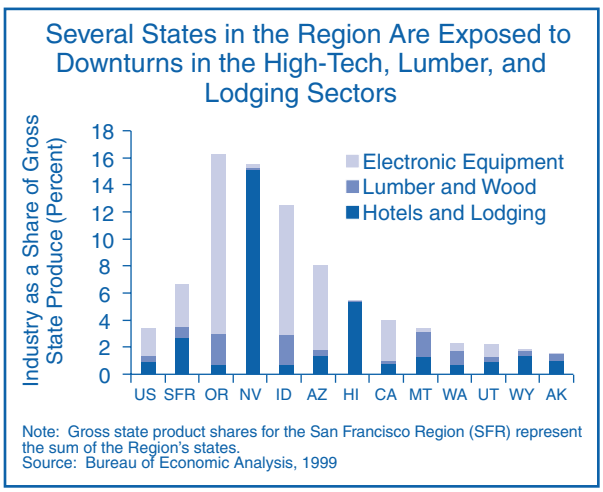
- **In addition to potential slowing in these three sectors, commercial and industrial loan quality could also be pressured by past weak underwriting standards, increasing concentration levels, and tighter staff ratios.**

The Region's Economy Continued to Slow in Early 2001

Despite slowing in the first five months of the year, particularly in the Region's previously robust high-tech metropolitan areas, the San Francisco Region economy remains relatively strong. The Region's nonagricultural employment grew 1.9 percent between May 2000 and May 2001, well above the 0.4 percent growth rate for the nation. Going forward, however, the worldwide economic slowdown and rising global competition could pressure the Region's already weakened technology and lumber sectors and the recession-sensitive tourism industry.

These three key industries already have experienced slowing employment growth and credit defaults. In aggregate, these three sectors significantly contributed to the gross state products of **Oregon, Nevada, Idaho, Arizona, Hawaii,** and **California** in 1999 (see Chart 1). Consequently, problems in these sectors, particularly in the high-tech manufacturing and lumber industries, have contributed to the Region's slowing nonfarm employment growth. In addition, these industries contain companies that either defaulted on their public obligations during 2000[1] or have an increasing probability of default.[2] Any further declines in revenue and employment in these sectors could adversely affect commercial loan portfolios at several of the Region's insured institutions. Insured institutions may not lend directly to these industries; however, they may lend to suppliers or surrounding businesses indirectly tied to these sectors. As a result, these institutions' commercial credit quality could be adversely affected as well.

CHART 1



High-Tech Manufacturing Has Suffered from Capital Expenditure Reductions

The high-tech manufacturing industry has slowed considerably since September 2000. Sluggish demand for computers, telecommunications, and other capital equipment weakened output and revenues in the high-tech manufacturing industry. In particular, industrial production fell in the semiconductor sector, which represents a significant component of the Region's high-tech manufacturing in Oregon, Idaho, Arizona, and Northern California (see Chart 2, next page). As a result, many semiconductor manufacturers announced layoffs and disappointing results during the first half of

[1] Moody's Investors Service. February 2001. *Default and Recovery Rates of Corporate Bond Issuers: 2000.* New York, NY.

[2] Using the Expected Default Frequency™ as measured by KMV LLC's Credit Monitor®. KMV's model uses options-pricing theory to derive market-based expected default probabilities or an expected default frequency. The model relies mainly on three pieces of information: (1) a firm's asset market value, (2) the volatility of a firm's asset market values, and (3) the firm's capital structure or financial leverage.

2001. According to **Gartner Dataquest,** semiconductor sales are expected to remain depressed through 2002.[3]

The Lumber Industry Faces Price Uncertainties and Rising Energy Costs

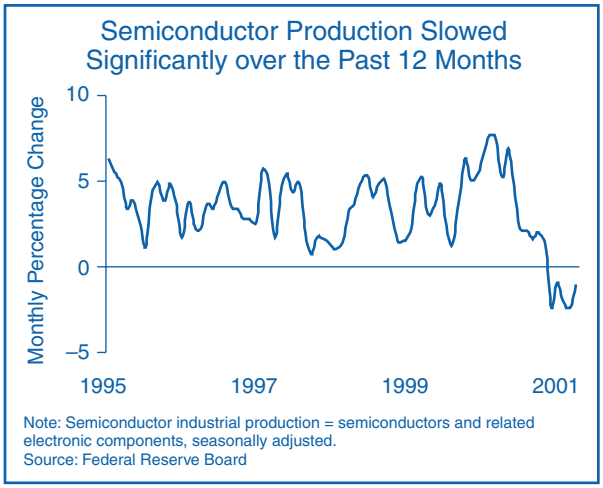
The lumber industry in Idaho, **Montana**, Oregon, and **Washington** ("the Northwest") has experienced commodity price and employment declines in the past few years (see Chart 3). Weak Asian demand, competition from Canadian imports, and higher energy costs have contributed to this trend, and a slowing global economy could further dampen lumber industry revenues and employment. Northwest lumber-related exports to Japan, which first declined during the 1998 Asian crisis, are not expected to increase substantially given Japan's continued slow economic growth. Furthermore, Canadian lumber imports into the United States, aided by a strong dollar, pressured prices for domestic softwood lumber through first quarter 2001. Expiration in March 2001 of the five-year U.S.-Canadian Softwood Lumber Agreement, which previously limited lumber imports from Canada, is another factor that may depress lumber prices. Additionally, higher electricity costs throughout the Western states have negatively affected lumber producers, because energy is a significant production input. Finally, a slowing U.S. economy could contribute to a decline in housing construction growth, which would constrain the construction industry's demand for framing lumber.

Tourism-Dependent Economies Could Also Experience Slowing

Although tourism in the San Francisco Region has generally been strong during the past several years, a slowing economy could dampen this important sector. Historically, flagging consumer confidence and corporate spending cuts have adversely affected leisure and business travel budgets during economic downturns. A decline in this business sector could hurt several states in the San Francisco Region, particularly Hawaii and Nevada, where the hotel industry alone accounts for 16 percent of employment. Visitor prospects in these states have shown some signs of weakness recently (see Chart 4). As of May 2001, Hawaii's year-to-date visitor arrivals by air declined over prior year volumes, and the Asian visitor counts have not yet fully recovered since

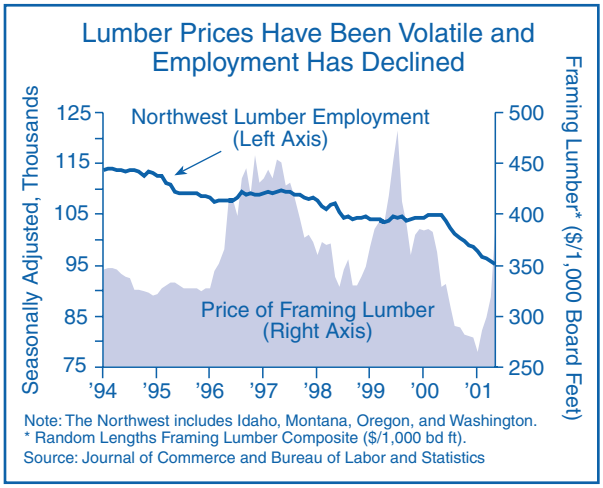
[3] Gartner Dataquest. Spring 2001. *Worldwide Semiconductor Revenue Forecast*.

Chart 2



Note: Semiconductor industrial production = semiconductors and related electronic components, seasonally adjusted.
Source: Federal Reserve Board

Chart 3



Note: The Northwest includes Idaho, Montana, Oregon, and Washington.
* Random Lengths Framing Lumber Composite ($/1,000 bd ft).
Source: Journal of Commerce and Bureau of Labor and Statistics

Chart 4

Note: Las Vegas data are based on visitor volume, whereas Hawaii's are based on visitor arrivals by air.
Sources: Las Vegas Convention and Visitors Authority and the Department of Business, Economic Development and Tourism of Hawaii

the Asian crisis, making the state more reliant on domestic visitors and the condition of the U.S. economy. **Las Vegas**, Nevada's most important tourist destination, recorded positive but slower visitor growth through the first five months of 2001. Furthermore, Las Vegas faces the uncertainties of rising energy costs and increasing competition from Native American-owned casinos and Internet gambling.

Commercial and Industrial Credit Risk Exposure Is on the Rise

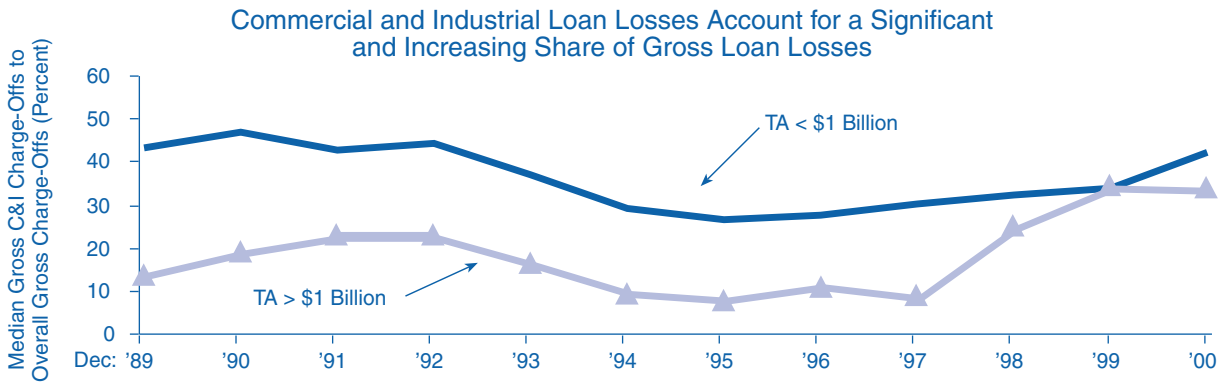
The commercial loan quality at the Region's insured institutions was generally strong in the second half of the 1990s; however, concurrent with the 2000 to 2001 economic slowdown, signs of commercial and industrial (C&I) credit quality softening began to emerge. Specifically, C&I delinquency and loss rates increased at many insured institutions, particularly large banks. Between year-end 1999 and March 31, 2001, delinquent C&I loan ratios climbed from 1.5 to 2.7 percent at the Region's large commercial lenders—well above the 2.1 percent delinquency ratio for similar-sized institutions nationally.[4] Although C&I deterioration was most notable among large institutions, nearly half of the Region's established community lenders also reported a year-over-year increase in C&I delinquency ratios as of March 31, 2001.[5]

Similarly, year-end 2000 C&I loss ratios increased at many of the Region's established commercial lenders, and gross C&I losses represented an increasing share of gross loan losses within the Region (see Chart 5). Overall, commercial loan delinquency and loss rates remain low by historical standards for most insured institutions; nevertheless, rising delinquency and loss trends are of concern, given that C&I lending contributes significantly to the loan portfolios and incomes of many institutions. Current C&I delinquency and loss trends are explained in part by the well-publicized increase in problem syndicated[6] C&I loans to troubled industries (see ***San Francisco Regional Outlook,*** first quarter 2001). In addition to aggressive C&I loan growth, previously lax underwriting standards, larger transaction sizes, and smaller staffing bases could heighten the level of credit risk.

Competition Has Driven Aggressive Underwriting at Some Institutions

Strong loan growth and relaxed underwriting standards at some institutions, driven by increased competition,

CHART 5



Notes: C&I = commercial and industrial; TA = total assets. Includes institutions more than three years old, with C&I loans greater than zero, that are not specialty consumer credit card lenders.
Source: San Francisco Region Bank and Thrift Call Reports

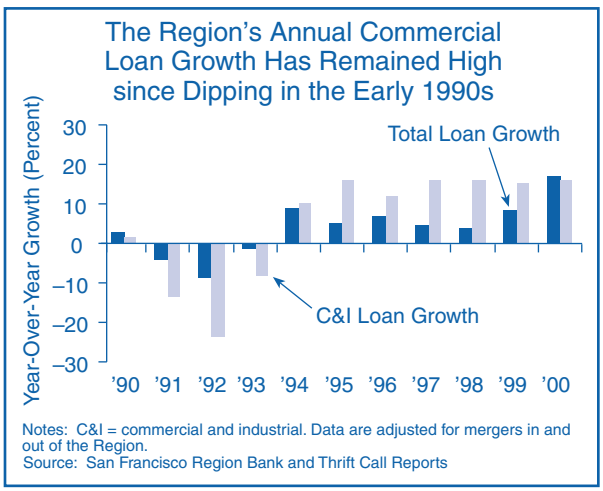
[4] Delinquency rates include C&I loans past due 30 days or more or on nonaccrual status as a percentage of total C&I loans. Large commercial lenders include insured institutions with total assets of at least $1 billion that reported C&I credit exposures; specialty credit card lenders are excluded.

[5] Includes only insured institutions that have C&I loans, that have less than $1 billion in total assets, and that were open for more than three years in both reporting periods. Because of Call Report limitations, delinquent C&I volumes might include past-due agricultural loans for certain institutions with less than $300 million in total assets.

[6] As defined under the interagency Shared National Credit review program, syndicated loans are defined as credits in excess of $20 million that are shared by at least three institutions.

could pressure C&I credit quality in the future. Between December 1990 and December 2000, the volume of funded C&I loans grew by 54 percent among the Region's insured institutions (see Chart 6). Concurrent with C&I portfolio growth during the late 1990s, loan officer and examiner surveys suggest that underwriting standards loosened. As seen in Chart 7, senior loan officers at the nation's largest institutions reported some easing of underwriting standards from 1996 through 1998, followed by a more recent period of tightening.[7] Underwriting surveys conducted by FDIC examiners at community banks suggest that underwriting standards at smaller institutions did not change significantly over this time period and that many community banks continue to engage in relatively risky credit risk management practices.[8] For instance, more than 20 percent of insured institutions surveyed either "frequently" or "commonly" made business loans to borrowers who lacked documented strength to support the loans. A similar share also "frequently" or "commonly" failed to monitor the collateral pledged on asset-based loans. Both banker and examiner surveys commonly cite competition and growth targets as driving the decision to loosen standards. Competition for C&I loans was particularly brisk during the 1990s because of the development of small business credit scoring, narrowing net interest margins at savings institutions, and relatively high rates of new bank formation.

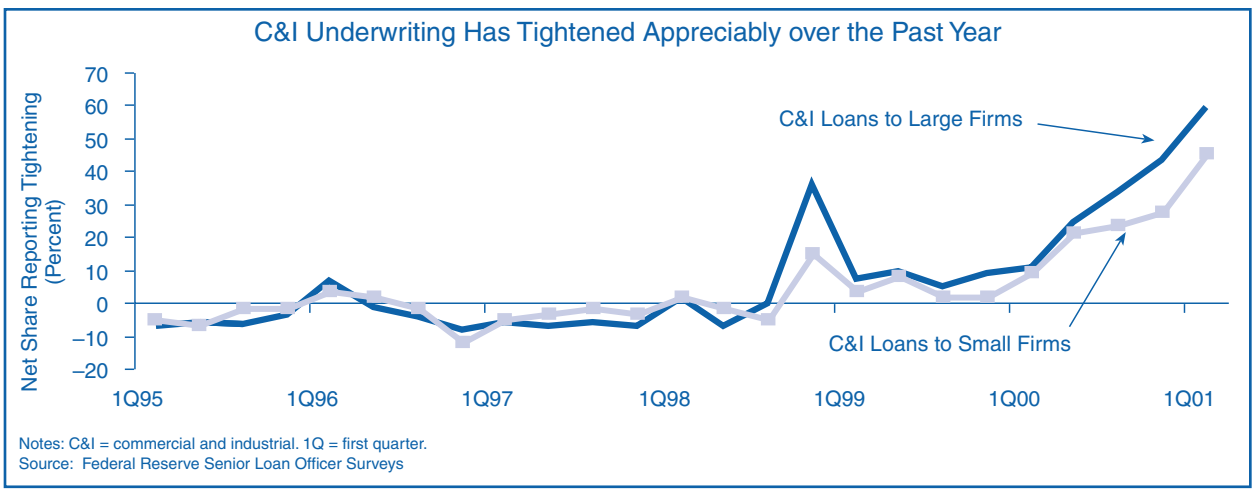
Chart 6



Notes: C&I = commercial and industrial. Data are adjusted for mergers in and out of the Region.
Source: San Francisco Region Bank and Thrift Call Reports

During the past decade, increased computer memory and processing speed made credit modeling and small business loan credit scoring more cost-effective. Although small business lending has historically been the niche of community banks, the increased use of credit scoring made the lending category more cost-efficient for larger institutions. Consequently, small to medium-sized institutions have faced increased competition for small business loans from large institutions in recent years.

Chart 7



Notes: C&I = commercial and industrial. 1Q = first quarter.
Source: Federal Reserve Senior Loan Officer Surveys

[7] Federal Reserve Board. May 1997 through May 2001. *Senior Loan Officer Opinion Surveys on Bank Lending Practices.* http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

[8] Federal Deposit Insurance Corporation. October 2000 through March 2001. *Report on Underwriting Practices,* http://www.fdic.gov/bank/analytical/report/2001mar/uw0103.pdf.

Community institutions are also facing increased competition from several new market entrants. For instance, net interest margin pressures at savings institutions prompted thrifts to expand their presence in the higher yielding commercial loan market. Between December 1998 and December 2000, C&I loans grew 35 percent at the Region's thrifts on a merger-adjusted basis. By March 31, 2001, three-quarters of the Region's 103 savings institutions reported some volume of C&I loans. Among these commercial lenders, the median C&I loans-to-Tier 1 capital ratio was 18 percent as of March 31, 2001, up from only 6 percent in 1990. Furthermore, to avoid commercial loan exposures in excess of regulatory limits, some thrifts have switched to commercial bank charters. Nationwide, 165 thrifts became commercial banks between 1990 and 1999. In contrast, only 42 commercial banks converted to thrift charters over the same period.

Increasing rates of new bank formation have also spurred C&I loan competition. Newly chartered institutions face core deposit challenges and extreme profit pressures, making C&I loan yields attractive. As of March 31, 2001, 86 percent of the Region's 105 de novo institutions[9] reported funded C&I loan balances, with a median C&I loans-to-total loans ratio of 26 percent.

Unfortunately, many of the competitive forces that have driven underwriting standards have several downside risks. In particular, some of the major small business-scoring models have been developed since the last recession, using a fairly narrow window of historical data.[10] Given the newness of these models in the commercial lending area and the limited historical data behind them, it is unclear how well this method of evaluating creditworthiness will compare with more traditional methods over the business cycle. As with credit scoring, other changes driving competition are largely not recession-tested. Specifically, many de novo management teams and traditionally consumer-oriented lenders entering the C&I business line have not experienced underwriting, monitoring, and managing larger C&I portfolios during an economic downturn.

[9] Defined as institutions in operation for three years or less.

[10] Matthews, Gordon. April 2001. "Small Biz Scoring to Face First Test." *US Banker.* Engen, John R. Nov./Dec. 2000. "Blind Faith." *Banking Strategies.* Chicago.

Increasing C&I Concentration Levels and Staffing Issues Also Could Pressure Asset Quality Should the Economy Continue to Slow

Lending concentrations could heighten risks for some insured institutions. Approximately half of the Region's insured institutions report C&I loans-to-Tier 1 capital ratios exceeding 100 percent. If insured institutions with elevated C&I concentrations have not diversified their portfolios across industries or geographies, economic slowing in one area or sector could significantly affect asset quality. Similarly, if an institution has lent large sums to a single borrower, the default of that one customer could significantly increase problem loan volumes in a short period. For instance, the notable increase in delinquent C&I loans currently being experienced by several large lenders is due in part to the size of the syndicated loan transactions involved.[11] Although community banks have not experienced the same degree of deterioration in their commercial loan portfolios, some appear to have increased their exposures to single borrowers. For instance, among the Region's small metropolitan commercial lenders,[12] the average small business loan[13] has increased from 10 percent of loan loss reserves in 1993 to more than 18 percent in 2000 (see Chart 8, next page). Because C&I loans are often unsecured or are secured with less marketable collateral, associated loan losses can be high in relation to other loan types. Consequently, loan loss reserves at insured institutions with high average loan sizes could be vulnerable in the event of elevated credit defaults.

Staffing levels could also prove critical in an economic downturn because covenant and borrower monitoring are key elements of commercial loan portfolio risk management. However, insured institutions have trimmed staff levels since the last recession. For instance, the volume of serviced assets[14] per employee at the Region's community institutions has risen nearly 50 percent over the past eight years. Additionally, the Region's serviced assets-per-employee ratio has recently increased faster than the

[11] See *Regional Outlook*, first quarter 2001.

[12] Defined as insured institutions with commercial loans that have less than $100 million in total assets. Specialty credit card institutions are excluded. By number, small metropolitan commercial lenders represent more than 20 percent of all insured institutions headquartered in the Region.

[13] A small business loan is defined as a commercial loan of less than $1 million. The average-sized loan was calculated by dividing the total volume of small business loans by the number of small business loans reported by institutions in June of each year.

[14] Defined to include the sum of assets, unfunded commitments, and mortgage loans serviced for others.

Chart 8

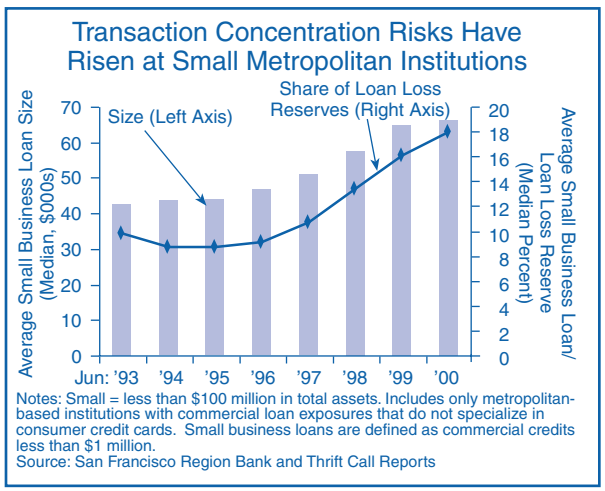
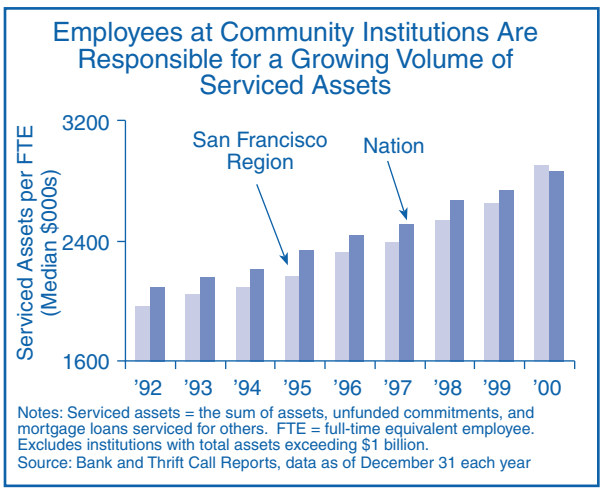


Chart 9



national average (see Chart 9). The increase is likely attributable in part to improved banking technologies and to the decline in problem assets at insured institutions over the period. However, insured institutions in some markets have reported a shortage of commercial loan officers, citing the decade-long expansion in commercial loan business and the discontinuance of training programs at many large banks.[15] Some observers consider inexperienced or declining staffing resources to be one of the top risks facing the industry today. For instance, Joseph May, an industry consultant and former chief credit officer of several large banks, voiced concern that "a whole generation of lenders...[has] never experienced [an economic] decline" and that "administrative support areas have been hit hard with a focus on efficiency."[16] Technological advances may have improved the efficiency of the asset management function; however, in the event of an economic slowdown, institutions with increasing levels of problem C&I loans could have difficulty managing these more labor-intensive commercial loan portfolios if they are not adequately staffed.

Economic and Competitive Factors Could Affect All Commercial Lenders in the Region

The confluence of economic and competitive factors could contribute to additional deterioration in commercial loan portfolios among the Region's insured institutions. C&I delinquency and loss rates have been higher among larger institutions; however, banks and thrifts of all sizes could be vulnerable to the ripple effects from weakness in the Region's economy, particularly in the high-tech manufacturing, lumber, and tourism industries. Additionally, credit-scoring models are not yet recession-tested, loan transaction sizes have increased, and cutbacks in loan department staffing could be problematic if the volume of problem loans increases significantly.

By the San Francisco Region Staff

[15] Reosti, John. February 26, 2001. "Wanted: A Few Good Commercial Loan Officers." *American Banker*.

[16] May, Joseph W. July 16, 2001. "The Top 10 Current or Prospective Lending Challenges in Large Financial Institutions." Emerging Issues in Large Financial Institutions. Federal Financial Institutions Examination Council.

Slowing Economy Reduces Demand for U.S. Office Space

- **Demand for U.S. office space contracted during the first half of this year as the amount of newly vacated space exceeded the amount of newly occupied space for the first time since at least 1981.**

- **The U.S. office vacancy rate jumped 250 basis points in the first half of 2001, from 8.3 percent to 10.8 percent.**

- **With construction levels remaining high and demand still weak, the vacancy rate could rise further by year-end.**

Overview

Commercial real estate (CRE) markets traditionally have been—and remain—highly cyclical. During the 1990s, most U.S. office markets experienced a strong upswing. However, declining office employment growth along with other recent signs point to a possible downturn. As reported by ***Torto Wheaton Research*** (TWR), the U.S. office vacancy rate, which stood at a 19-year low of 8.3 percent at the end of 2000, jumped in only six months to 10.8 percent, the largest six-month increase in the 20 years TWR has tracked these data. Office vacancy increases range from modest levels in some markets to high levels in markets where supply and demand imbalances are more pronounced.

An uptick in construction activity combined with a substantial drop in demand for office space has led to a slackening of office market conditions. In light of the ongoing uncertainty as to the near-term direction of the U.S. economy, these trends make the current situation difficult for office market participants to read.

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness.[1] It notes the role played by the changing fortunes of high-tech firms in a number of metropolitan areas and how this situation has increased the volume of space available for sublease. Finally, the article focuses on the local construction loan exposures of insured banks and thrifts that have the task of managing their risks under changing market conditions.

Vacancy Rates Have Risen Quickly from Cyclical Lows

At year-end 2000, the U.S. office vacancy rate stood at 8.3 percent—a 19-year low. Many individual metro areas posted even lower vacancy rates. For example, at year-end 2000, vacancies were 4.4 percent of available space in Seattle, 1.3 percent in San Jose, and 3.0 percent in Oakland. Beginning with first quarter 2001, as a result of a slowing economy and the fallout from the so-called "tech-wreck," the U.S. vacancy rate rose by 120 basis points to 9.5 percent—the highest absolute quarterly increase since these data were first published in 1981. Another record increase of 130 basis points occurred during the second quarter, bringing the vacancy rate to 10.8 percent. To put these increases in perspective, consider that the national office vacancy rate has increased more than 50 basis points in any given quarter only twice.[2] Nonetheless, the current vacancy rate of 10.8 percent remains low by historical standards, as the average rate for the past 20 years has been 13.9 percent.

Most of the nation's large metro areas saw increases in office vacancies during the first half of 2001. Forty-eight of the 53 major metropolitan areas tracked by TWR recorded a higher vacancy rate in June 2001 than at year-end 2000. Thirty-eight markets experienced increases of at least 100 basis points, and four markets saw vacancy rates jump by more than 600 basis points. As shown in Table 1 (next page), most of the markets experiencing the largest jump in vacancy rates also are home to concentrations of high-tech employment.[3] As

[1] For further discussion of demand and supply trends, see Sally Gordon, "CMBS: Red – Yellow – Green™ Update, Second Quarter 2001 Quarterly Assessment of U.S. Property Markets," *Moody's Investors Service,* July 6, 2001.

[2] TWR notes increases of 60 basis points in the second quarter of 1989 and in the first quarter of 1999.

[3] Seven of the ten markets with the highest first-half 2001 vacancy rate increases are also among the top ten cities having the greatest levels of high-tech employment.

Table 1

In Many Markets, Office Vacancy Rates Reflect Concentrations of High-Tech Employment

Metro Area	Vacancy Rate as of 6/30/01 (%)	Vacancy Rate as of 12/31/00 (%)	Increase in Vacancy Rate (basis points)	High-Tech as % of Total Market Employment
Austin	11.8	5.0	680	10.1
San Jose	8.1	1.3	680	27.4
Oakland	9.3	3.0	630	6.5
San Francisco	10.3	4.1	620	8.3
Seattle	9.4	4.4	500	6.6
Kansas City	15.9	11.0	490	2.7
Boston	8.7	3.9	480	8.2
Phoenix	16.9	12.5	440	4.7
Wilmington, DE	10.4	6.2	420	3.8
Washington, DC	7.8	3.9	390	7.8
Nation	10.8	8.3	250	4.8

Sources: Torto Wheaton Research, Economy.com, Inc.

high-tech markets spurred higher demand for office space in the recent past, these markets are now giving back greater quantities of previously occupied office space. Table 2 (see page 18) lists office vacancy rates and changes along with lending concentrations, construction activity levels, and high-tech employment percentages for 53 major metropolitan areas and for the nation.

Unlike the last cycle, during which office vacancies shot up primarily in overbuilt downtown areas, recent increases are occurring more sharply in suburban than downtown sections of metropolitan areas. As of June 30, 2001, the average downtown office vacancy rate was 8.5 percent, and the average for suburban markets was 12.1 percent. Increases in office availability are dispersed among Class A office properties as well as Class B/C properties, yet vacancy rates do show disparities across many submarkets. For example, the South of Market area in San Francisco reports significantly higher office vacancy rates than the Financial District.[4] Similarly, in the Washington, DC, metropolitan area, the technology-intensive northern Virginia office market has experienced higher office vacancy increases than downtown Washington, DC, or suburban Maryland.

[4] Louis, Arthur M. July 24, 2001. "Empty Offices, Economic Downturn, Overconstruction Leave Commercial Landlords with More Space on their Hands." *San Francisco Chronicle.*

Office Demand Drops

Net absorption, the primary indicator of demand for office space, was negative during first quarter 2001 for the first time since TWR began reporting the series.[5] (Negative absorption occurs when space returned to the market by existing tenants exceeds the space occupied by new tenants.) This negative performance was repeated in the second quarter. The decline in the volume of competitively leased space totaled 30 million square feet during the first half of 2001. (See Chart 1.)

The bulk of negative absorption in the first half of 2001 is due to the return of office space to the market through subleasing.[6] TWR reports that there were 43 million square feet of space "give-backs" through subleasing in the first half of 2001, and after offsetting absorption of 13 million square feet, negative absorption was 30 million square feet.

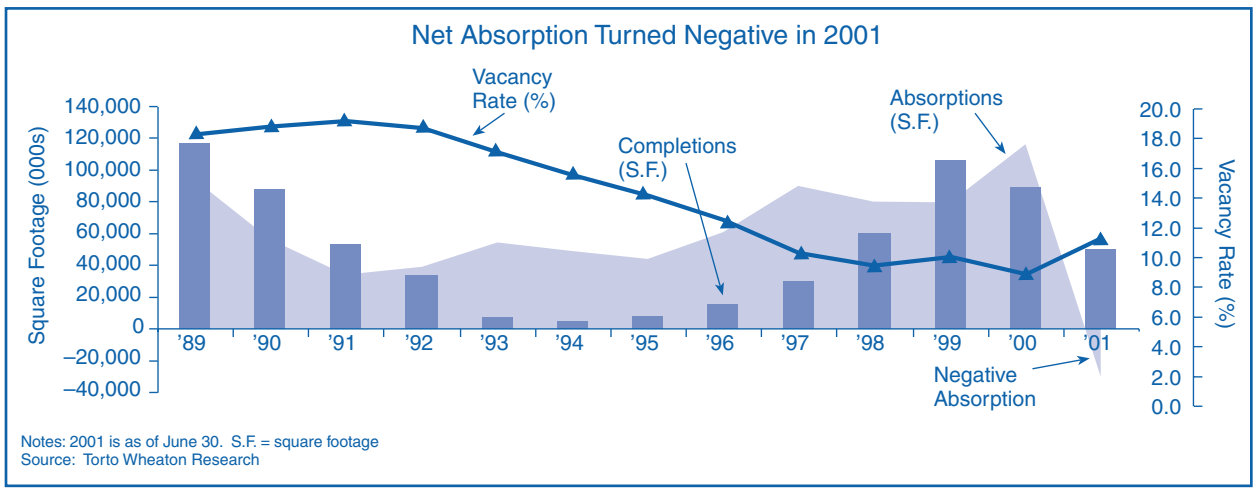
Office employment growth, the source of new office space demand, tends to be driven by the finance and services sectors.[7] Year-over-year job growth in the finance,

[5] Net absorption is the net change in total competitively leased space per period, as measured in square feet.

[6] In some metropolitan areas, over half the total office space available for rent (vacant space) is sublease space.

[7] TWR constructs its office employment index based on trends in the FIRE sector plus selected categories of the services sector. See *TWR Office Outlook,* Spring 2001, Vol. II, p. A.1.

CHART 1



Notes: 2001 is as of June 30. S.F. = square footage
Source: Torto Wheaton Research

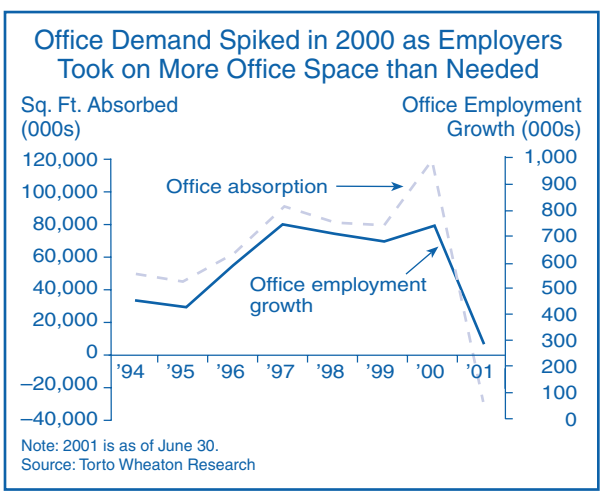
insurance, and real estate (FIRE) and services sectors combined was more than 3 percent in every month from January 1993 through June 2000. Since the middle of 2000, job growth in these sectors has fallen steadily to a year-over-year rate of less than 1.5 percent in June 2001. A spring 2001 survey conducted by ***Salomon Smith Barney*** indicated that tenants estimated their growth in office space demand to be only 0.6 percent over the following 12-month period.[8] Also contributing to reductions in demand are increases in worker layoffs. Announced layoffs during the first seven months of 2001 totaled over 983,000 individuals, more than triple the number of announced layoffs during the same period last year.[9]

The slowdown in the demand for office space contrasts sharply with the situation last year, when absorption rates and office employment growth were robust in most markets, and leases were executed quickly for newly constructed properties. As shown in Chart 2, absorption of office space in 2000 actually outstripped the trend in office employment by a considerable margin. Why? With relatively easy access to initial public offering and venture capital funding, many startup firms anticipated rapid growth and leased office properties accordingly. In fact, venture capital funding facilitated historically higher rates of office space absorption by high-tech and other startups. In active bidding wars, new high-tech firms increased their office space holdings. A phenomenon of *space hoarding* developed in which some high-tech companies leased large quantities of office space in anticipation of future expansion.

More recently, because of a slowing economy, curtailed funding, and failures to achieve sales expectations, many high-tech and dot-com firms have closed or scaled back operations significantly. At the same time, traditional firms have reconsidered plans to expand, adopting a "wait and see" attitude. Consequently, as demand for space declines, large blocks of office space are returning to markets for sublease.

Space available for sublease is similar to landlord-offered space available for rent—space under both categories should count toward a market's available rental space. However, in the case of subleasing, tenants, rather than landlords, offer properties for rent. Tenants may attempt to sublease the property themselves or use a broker; however, in general, only space handled by a broker is included in the tally of a market's available rental space. Consequently, current office vacancy increases could be higher than reported.

CHART 2



Note: 2001 is as of June 30.
Source: Torto Wheaton Research

[8] Boston, Gary, Ross Nussbaum, and Jonathan Litt. May 16, 2001. "Real Estate Demand Survey." *Equity Research: United States, Real Estate Investment Trusts.* Salomon Smith Barney.

[9] Data provided to Haver Analytics by Challenger, Gray & Christmas.

Meanwhile, Construction Continues

An uptick in office construction activity that began in many metro areas during the late 1990s has been a key element contributing to recent increases in office vacancies. According to the ***Bureau of the Census***, U.S. expenditures on office construction totaled $47.5 billion in 2000, continuing a seven-year cycle of expansion. Adjusted for inflation, this amount represents about 78 percent of the peak level of office construction expenditures that occurred in 1985. Recently, the pace of construction has slowed slightly, falling to an annualized rate of $44.3 billion in May 2001.

Reflecting these large dollar outlays on office construction, TWR projected in December 2000 that 111.3 million square feet of new office space (or 3.6 percent of existing stock) would be completed during 2001. This newly completed space will come on the market following a period of rising construction activity from 1998 through 2000, during which the volume of completed office space averaged 84.9 million square feet per year. As shown in Chart 3, however, current office construction activity as a percentage of existing stock falls well below that of the 1980s.

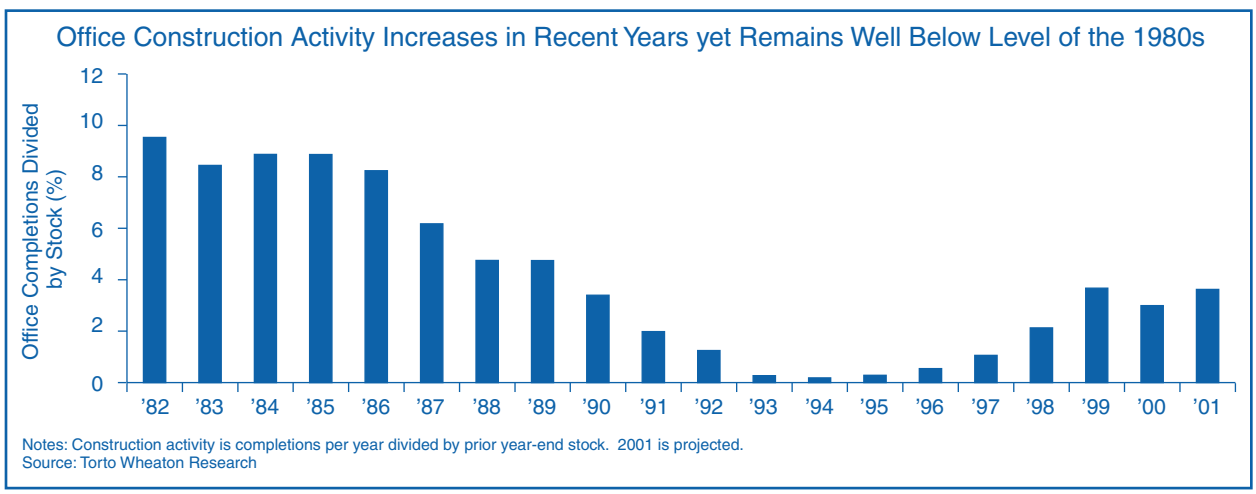
Many metropolitan areas currently experiencing high levels of construction activity also are seeing the largest increases in office vacancies. For example, cities that are positioned toward the upper right quadrant of Chart 4 are characterized by higher vacancy rate increases and more new office space construction. The ten cities with the highest first-half 2001 vacancy rate increases had total square footage of under-construction office space at 6.5 percent of existing stock as of year-end 2000.[10] By comparison, total office space under construction nationally was 4.5 percent of existing stock.[11]

Even as most projects move toward completion, some developers are reconsidering office construction plans. Builders have stopped construction of significant projects midstream in the Austin, Dallas, Seattle, and northern Virginia markets in response to retrenchment by major tenants and competition from subleased space.

Softening Extends to Other Commercial Real Estate

Other major commercial real estate markets are also feeling the effects of a slowing economy and, with the exception of the retail sector, are experiencing increasing vacancy rates.

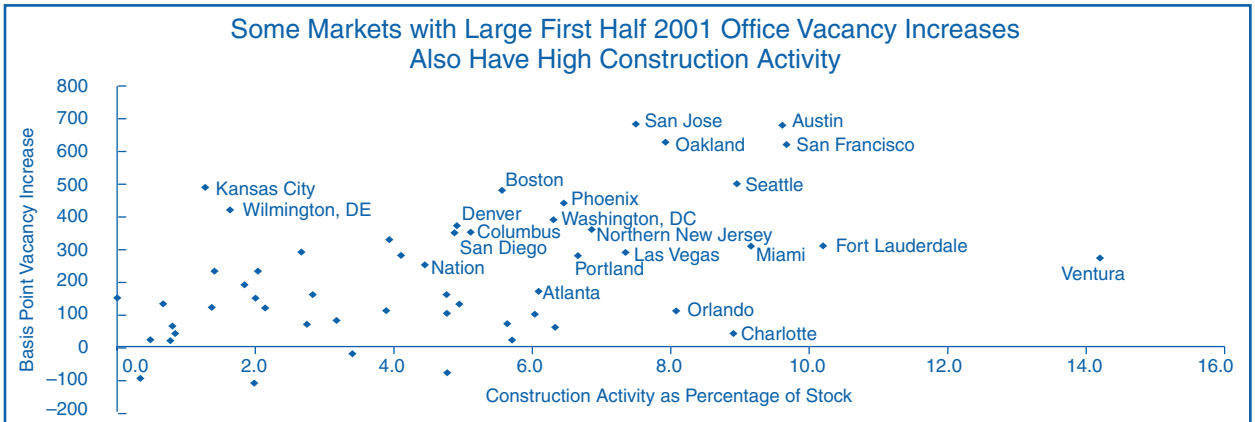
CHART 3



[10] One measure of a metropolitan area's exposure to overbuilding and rising vacancy rates is the degree of construction activity. This measure is found by dividing a metropolitan area's completions square footage or the under-construction square footage by the total stock of office property.

[11] The national 4.5 percent level for office properties *under construction* at December 2000 is higher than the 3.6 percent level for projected *completions* in 2001 because not all properties being built in 2001 will be completed during the year.

CHART 4



Note: Construction activity is measured by a market's under-construction square footage at year-end 2000 divided by total square footage in that market as of year-end 2000.
Source: Torto Wheaton Research, Spring 2001

Industrial vacancy rates had fared well in recent years. As of year-end 2000, the national vacancy rate of 6.7 percent was the lowest since 1984. Now, however, a 150-basis-point increase has occurred, with industrial vacancies increasing to 8.2 percent in the first half of 2001.[12]

As the economy and the nation's high-tech and manufacturing sectors continue to slow, demand for industrial space for research and development and storage and distribution is declining. Industrial property subleasing is on the rise, and negative absorption occurred in the first half of 2001. At the same time, completions of industrial space during 2001 are estimated to exceed 220 million square feet, the highest level since 1988. Landlords are offering concessions, such as lease terms of one year compared with five to ten years, in an attempt to attract new tenants.

Industrial properties are somewhat less exposed to risks from overbuilding than office properties because of shorter construction periods and the ability to respond quickly to any change in demand. An exception is the *telecommunication hotel,*[13] a new entry into this market. This property type is characterized by a longer construction cycle and the fact that it typically has a "single use" design. In recent months, construction of these structures began in many high-tech markets to provide enhanced levels of data service. With declining demand, some telecom hotels stand vacant.

The demand for **hotel** rooms is adversely affected by a slowing economy. Businesses have cut travel budgets and consumers have scaled back leisure plans, contributing to a decline in occupancy levels and revenue per available hotel room in most markets throughout 2001. Currently, upscale and luxury hotels are suffering more than limited service hotels. According to ***Smith Travel Research,*** limited service hotels, particularly budget hotels, represent the only lodging sector with higher occupancy levels through the first four months of 2001 when compared to the same four month period in 2000.

The supply of new hotel properties is lower than in the past, as financing for new hotel construction for the most part has been curtailed in recent years. However, limited service hotels are reported to be overbuilt in a number of markets in the Southeast and Southwest.[14] Annualized expenditures for new construction of all hotel types were $12.1 billion as of May 2001, falling to the lowest level since 1996.[15]

The **multifamily** sector has experienced robust construction and equally strong absorption in recent years as new household formation, the driver for apartment demand, continues to increase. Annualized construction expenditures of $25.5 billion as of May 2001 were at the highest level since 1989.[16] Despite the relative equilibrium between supply and demand for apartments in most markets, vacancy increases and rent declines are occurring in some locations. This decline has been most acute

[12] Torto Wheaton Research.

[13] Telecom hotels are large, high-energy-consuming warehouses that house machinery, servers, routers, and switches that are the physical underpinning of the electronic commerce conducted on the Internet. They are hotels in the sense that they house equipment belonging to many different telecommunication companies. John Holusha, "Home for Machinery of the Internet," *The New York Times,* August 16, 2000.

[14] Kozel, Peter P. June 18, 2001. "U.S. Commercial Property Markets in a Slowing Economy: Implications for CMBS Credit Performance." *Standard and Poor's Structured Finance.*

[15] Data provided to Haver Analytics by U.S. Bureau of the Census.

[16] Ibid.

in the more concentrated high-tech markets, such as San Francisco, where reported average rental rates dropped 8.1 percent between the end of March and the end of May 2001.[17]

Despite a slowing economy, the **retail** sector has performed reasonably well, as consumers maintain relatively high spending levels. Many of the store closings in 2000 and 2001 have been absorbed by new tenants as landlords have acted quickly to avoid letting vacant space linger. Meanwhile, robust construction has continued, with total expenditures in 2000 of $52.6 billion and an annualized level of $52.2 billion as of May 2001. Each of these two years' expenditure levels exceeds all previous years' retail construction amounts since data were first gathered in 1964.[18]

Taking note of the robust level of retail construction activity, a recent ***Moody's*** article finds that the nation's mall retail and "power center"[19] space grew by 3.3 percent in 2000, while population growth expanded by only 1.2 percent. The article raises concerns for potential excess supply of retail space resulting from a construction rate that is almost triple the population growth rate.[20] A negative consequence of the high rate of retail construction is found in a recent ***Standard and Poor's*** study. This article points out that most of the retail mortgages (held in commercial mortgage-backed pools of assets) that defaulted during 2000 did so because of competition from new retail establishments.[21]

Implications for Insured Institutions

Office vacancy rates during the first half of 2001 increased at an unprecedented rate. What does this mean for insured institutions? On the one hand, at mid-2001 vacancy rates remained below their 20-year average. Yet the speed of the increase and the number of metropolitan areas that have experienced softening make this a trend that deserves the close attention of insured institutions, especially those with significant concentrations in commercial real estate and construction lending.

Financial indicators of real estate credit quality in banking remain favorable, with losses and delinquencies trending up modestly from minimal levels. Noncurrent construction and development (C&D) loans as of March 31, 2001, remain at a relatively low .92 percent of all outstanding C&D loans. (Noncurrent C&D loans as a percentage of all C&D loans averaged .93 percent for the past five year-ends.) Similarly, noncurrent CRE loans[22] as of March 31, 2001, were .82 percent of all CRE loans, a level consistent with the average for this ratio of 1.08 percent for the past five year-ends. Charge-off ratios at March 31, 2001, for both C&D and CRE loans were each at .02 percent and remain below the averages of .05 percent for each for the past five year-ends. These favorable numbers are the legacy of a strong economic expansion, whereas current economic events suggest the potential for future deterioration in credit quality.

The outlook for commercial real estate credit quality depends on the depth and duration of the current economic slowdown and on the risk management practices of each institution. In this regard, as signs of increasing risk materialize in conjunction with a declining economy, lenders appear to be managing risks prudently and avoiding speculative lending.[23] Anecdotal information suggests that borrowers are pressed to obtain higher prelease commitment levels in order to gain loan approvals. In addition, lenders are requiring more up-front equity.[24,25]

The importance of risk management practices is magnified by the heightened lending concentrations currently prevailing at some banks. Institutions with elevated concentrations in CRE and C&D lending have been more likely to experience significant problems during times of economic stress (for further details,

[17] Associated Press, News in Brief from the San Francisco Bay Area, June 13, 2001.

[18] Data provided to Haver Analytics by U.S. Bureau of the Census.

[19] According to the Urban Land Institute, a power center is a community shopping center in which at least 75 to 90 percent of the selling space is devoted to multiple off-price anchors and a discount department store or warehouse club. It is the "power" of its anchors that gives the center its name.

[20] Sally Gordon, op. cit.

[21] Kozel, Peter P. April 20, 2001. "Outlook for Property Markets in a Slower-Growing Economy and the Implications for CMBS Credit Performance." *Standard & Poor's Structured Finance.*

[22] CRE loans are nonfarm, nonresidential loans secured by real estate.

[23] Speculative construction lending is defined as a loan not accompanied by a meaningful presale, prelease, or take-out commitment.

[24] "Capital Is Still Plentiful for Right Projects." *Midwest Real Estate News.* July 2001. Vol. 17, No. 7.

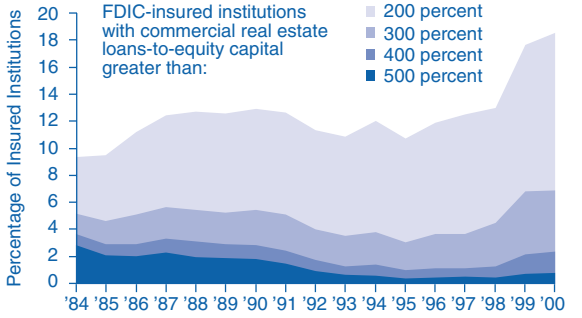
[25] Further information on bank underwriting practices can be found in Federal Deposit Insurance Corporation, Division of Research and Statistics, *Report on Underwriting Practices,* http://www.fdic.gov/bank/analytical/report/index.html.

see *History of the Eighties*[26]). As shown in Chart 5, the percentage of insured institutions with commercial real estate loan concentrations between 200 and 400 percent of capital is higher now than it was in the late 1980s. However, there are relatively fewer institutions at the highest concentration level, in excess of 500 percent of capital. In fact, fewer than 1 percent of insured institutions are at this level. A similar story holds true for construction loans, as the increasing concentrations are in the range of 100 to 300 percent of capital (see Chart 6).

There are a number of issues for construction lenders and commercial real estate lenders to consider going forward. Because uncovered loans (C&D loans made without assurances of a firm take-out commitment) tend to be higher-risk, an important part of managing the risk in construction lending has traditionally been the lender's ability to obtain a take-out commitment.

Sources of take-outs for C&D loans include other insured institutions, pension funds, foreign investors, and life insurance companies, along with public-market real estate investment trusts (REITs) and conventional mortgage-backed securities (CMBSs). Anecdotal reports indicate that shifts in market sentiment in recent months have resulted in lowered investments in REITs and consequently less available capital for REITs to purchase real estate.[27] Insured institutions

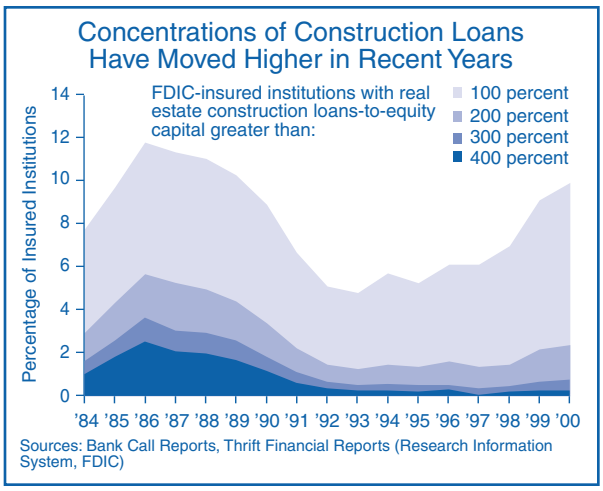
Chart 5



[26] Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s,* Chapters 9 and 10. 1997. Washington, DC: FDIC. http://www.fdic.gov/bank/historical/history/index.html.

[27] Smith, Ray A. August 1, 2001. "Property Held by Public Firms Drops." *The Wall Street Journal.*

Chart 6



may face increased challenges to convert construction and development loans into permanent loans should the reported REIT situation become a trend and other sources of permanent capital become less available to purchase C&D loans.

Monitoring economic trends in general, and local real estate trends in particular, becomes even more important during a time of rapid change in market conditions. For example, reliance on appraisals based on outdated or top-of-market assumptions can result in a divergence between expected and realized collateral values or cash flows. Similarly, while preleasing commitments offer significant risk-reduction benefits to lenders, during a time of weakening economic conditions there is at least the possibility that a prospective tenant will be unable to honor a lease obligation, as has been the case with some firms in the high-tech sector in recent months.

Conclusion

Office market trends cannot, of course, be considered in isolation. The recent softening in office markets is a symptom of a slowing economy coupled with a rapid decline in the fortunes of some high-tech firms. Considered in this broader context, the challenge for insured institutions is simply to ensure that risk-management strategies are in place that will succeed under a more challenging economic environment.

Thomas A. Murray
Senior Financial Analyst

Table 2

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
Albuquerque	11.6	-110	9	61.0	6.8	2.0
Atlanta	9.8	170	76	172.2	3.8	6.1
Austin	11.8	680	20	53.4	10.1	9.6
Baltimore	8.9	60	60	22.8	3.6	6.3
Boston	8.7	480	100	24.1	8.2	5.6
Charlotte	9.0	40	20	48.5	1.7	8.9
Chicago	8.9	130	225	33.5	4.5	4.9
Cincinnati	10.1	100	58	32.6	3.1	6.0
Cleveland	13.6	40	16	34.8	3.0	0.8
Columbus, OH	16.9	350	20	22.4	3.1	5.1
Dallas	16.4	110	75	84.5	6.5	3.9
Denver	12.7	370	45	70.4	5.2	4.9
Detroit	12.0	160	28	35.2	3.1	2.8
Ft. Lauderdale	12.8	310	13	19.1	2.7	10.2
Ft. Worth	16.4	130	36	71.8	3.4	0.7
Fresno	14.4	20	5	196.0	0.9	0.8
Hartford	14.0	150	11	25.2	3.5	0.0
Honolulu	12.6	-190	3	11.4	0.9	0.0
Houston	13.6	60	48	65.8	3.1	0.8
Indianapolis	15.8	120	21	29.6	3.3	1.4
Jacksonville	11.7	-20	11	65.2	1.8	3.4
Kansas City	15.9	490	86	70.8	2.7	1.3
Las Vegas	14.5	290	19	117.7	1.5	7.3
Long Island	10.9	190	6	19.1	5.3	1.8
Los Angeles	14.1	150	62	35.4	3.7	2.0
Miami	10.5	310	26	28.1	1.8	9.2
Minneapolis	10.8	20	119	44.0	6.0	5.7
Nashville	12.8	230	20	78.4	1.2	2.0
New York	5.1	230	34	10.5	2.4	1.4
Northern New Jersey	10.9	360	66	15.0	5.6	6.9
Oakland	9.3	630	12	120.0	6.5	7.9
Oklahoma City	20.3	20	44	57.8	2.6	0.5
Orange County	14.7	330	14	34.5	6.4	3.9
Orlando	13.1	110	23	72.1	2.3	8.1
Philadelphia	10.7	80	68	22.1	4.5	3.2
Phoenix	16.9	440	27	114.2	4.7	6.5
Portland, OR	9.9	280	14	118.8	6.6	6.7
Riverside	14.4	-100	18	143.5	1.6	0.3
Sacramento	6.6	70	11	106.9	3.9	5.6
Salt Lake City	15.3	280	14	111.7	4.5	4.1

Table 2 (continued)

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year-End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
San Diego	9.7	350	21	57.5	6.6	4.9
San Francisco	10.3	620	21	69.0	8.3	9.7
San Jose	8.1	680	5	174.5	27.4	7.5
Seattle	9.4	500	30	77.1	6.6	9.0
St. Louis	10.1	–80	80	40.4	2.6	4.8
Stamford	11.2	290	10	43.5	5.6	2.6
Tampa	14.8	70	33	40.0	4.2	2.7
Tucson	8.8	100	3	178.4	4.4	4.8
Ventura	14.2	270	8	49.7	5.4	14.2
Washington, DC	7.8	390	61	51.1	7.8	6.3
Wilmington, DE	10.4	420	12	28.4	3.8	1.6
W. Palm Beach	12.2	160	18	37.2	2.3	4.8
Westchester	12.5	120	4	19.5	12.3	2.1
Nation	10.8	250	(1) 3,801	(1) 40.1	(2) 4.8	(2) 4.5

Notes: Only community banks with construction loans are included in this table. Community banks are institutions with assets less than $1 billion. Noncommunity banks are excluded because their lending activities are likely to span a larger area than the MSA in which they are headquartered.
Sources: Torto Wheaton Research; Bank and Thrift Call Reports, FDIC Research Information System data; Economy.com, Inc.
1. Only community banks with construction loans and located within a MSA are included in these figures.
2. Percentages shown are the averages for the 53 metropolitan areas.

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