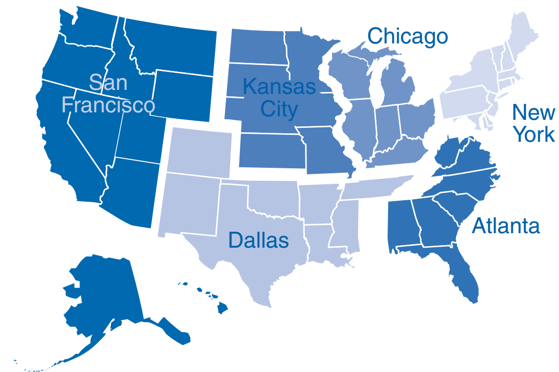
F I Outlook

SPRING 2003

In Focus This Quarter



The banking industry has fared well overall in a slow-growth economic recovery. Higher fee income and wide interest margins have thus far more than compensated for rising loan loss provisions. But the road to recovery from the 2001 recession has proved to be long and uneven. The downturn was dominated by the problems of the corporate sector, and the recovery continues to be slowed by restructuring in a number of troubled industry sectors. A rebound in business investment and employment has been slow to develop, and credit quality problems persist in commercial loan portfolios. At the same time, expansionary monetary and fiscal policies have helped to keep consumer spending strong in the absence of significant job growth. Progress in resolving the uncertainties associated with terrorism, Iraq, and corporate governance reform appears to be the key to establishing a stronger and more balanced economic recovery in 2003. *See page 4.*

By Staff of the Risk Analysis Branch

Regional Perspectives

Atlanta—The Region struggled in 2002 to emerge from the recession. However, exposure to certain stressed industries could weaken the recovery and contribute to further deterioration in insured institution asset quality. *See page 12.*

Chicago—Amid improving economic and generally healthy banking conditions, the evolving nature of residential lending may be challenging some lenders' risk management systems. *See page 16.*

Dallas

Midsouth—Job losses slowed in the manufacturing sector and overall. Credit quality deterioration abated and earnings improved among the area's insured institutions. However, option risk appears to be increasing in the securities portfolio. *See page 21.*

Southwest—Continued weak employment growth could contribute to deterioration in residential loan portfolios, particularly in markets in which home price appreciation outpaces household income. *See page 24.*

Kansas City—The nation's largest banks have benefited from inflows of deposits during the recent recession. However, growth of noncore funds continues to outpace increases in core deposits among the Region's community banks. *See page 28.*

New York

Mid-Atlantic—Insured institutions headquartered in metropolitan areas that lagged national employment trends reported generally favorable conditions. However, if local economies remain sluggish, credit quality could weaken. Securities gains by large banks partially offset declines in market-sensitive revenues. *See page 32.*

New England—Insured institutions continue to report sound conditions. Rates of home price appreciation may be unsustainable in some of the Region's markets, but the potential that home prices will decline is modest. *See page 37.*

San Francisco—Home price appreciation may slow in some areas because of weak employment and low affordability. Shifts in mortgage portfolio composition and changes in underwriting standards may challenge lenders in certain markets. *See page 42.*

By Staff of the Regional Operations Branch

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Letter from the Executive Editor

To the Reader:

The goal of the ***Regional Outlook*** is to provide useful, risk-focused information to bankers, examiners, financial regulators, policy makers, and the public. To strengthen these efforts, we are moving to a single issue format that tells the national economic and banking story and, at the same time, relates this story to regional economic and banking trends. The new format continues to give us flexibility to include feature articles about issues that may affect all insured institutions as well as provide analysis of trends affecting banks and thrifts in specific geographic areas.

In addition, in response to feedback from our readers, we are pleased to offer ***FDIC State Profiles***, a new, Internet-based publication. In an executive summary format, this publication provides an analysis of state-level economic and banking trends and financial performance data on institutions domiciled within each state. ***FDIC State Profiles*** have been provided to bankers at outreach events during the past year and have been well received. ***State Profiles*** can be found at www.fdic.gov.

And finally, in light of the change in format and in line with our goal of providing forward-looking information about the national and regional economies and banking sectors, we are changing the name of our publication to ***FDIC Outlook***. After you have read this edition, we would like to hear from you. Your feedback is essential as we strive to improve how we present risk-related information. E-mail your comments to *rmiller@fdic.gov*.

Sincerely,

Maureen E. Sweeney
Executive Editor

Resolving Uncertainties in the U.S. Economic Outlook

Introduction

Most economic analysts would agree that the recession that began in March 2001 probably ended in early 2002. Based on current data, it appears that the U.S. economy has expanded for five consecutive quarters, beginning in the fourth quarter of 2001, following three quarters of contraction. U.S. gross domestic product (GDP) grew at an inflation-adjusted rate of 2.4 percent during 2002, far outpacing the 0.3 percent rate of growth in 2001.

Why the delay in declaring an end to the recession? Business cycle turning points are officially designated by the ***Business Cycle Dating Committee of the National Bureau of Economic Research (NBER)***. The official designation of the beginning or end of a recession is typically made some months after the fact, once revisions have been made to the relevant data. The NBER bases its calls on four main indicators: industrial production, real income, wholesale-retail sales, and employment. While the first three indicators were generally positive in 2002, the fourth—and arguably most important—indicator has not yet turned decisively upward. Accordingly, the NBER released a statement on February 12 saying that “additional time is needed to be confident” as to the direction of the economy.[1] The lack of net job growth in 2002 has prompted comparisons with the recovery of 1991–92, the so-called jobless recovery.

Why the sluggish recovery? In spite of a strong performance by consumers and homebuyers, as well as considerable monetary and fiscal stimulus, two factors account for the lackluster recovery. One factor is the ongoing problems of the corporate sector. Earnings growth overall has been slow in a difficult operating environment, and certain troubled industry sectors are undergoing painful restructuring. At the same time, significant progress is being made toward leaner cost structures, lower levels of indebtedness, and improved profit margins—factors that should lead to greater hiring and investment spending and an improvement in corporate credit quality once the U.S. economic recovery gathers momentum.

A greater impediment to the current economic recovery appears to be the uncertainties associated with terrorism, Iraq, and corporate governance reform. These uncertainties make it difficult for investors and business executives to price transactions and make investment plans, thereby slowing economic activity. Although the banking industry on the whole has fared well in the recent slow-growth environment, bankers also must contend with these uncertainties. In a broad sense, the outlook for the economy and the banking industry in 2003 will be shaped by the progress that is made in restructuring troubled industry sectors and resolving uncertainties.

Cleaning Up from the Corporate-Sector Recession

While each recession is different, most downturns of the past 50 years have been associated with supply constraints or price shocks that raised inflation and interest rates and depressed business investment and consumer spending. For the most part, these traditional factors appear to be absent in the current downturn, with inflation and interest rates remaining at historically low levels. The recession that began in March 2001 might better be characterized as a corporate-sector recession, as most of the bad economic news has been corporate news. Corporate profits declined by 2.2 percent in 2000 and 7.2 percent in 2001 before stabilizing in the first three quarters of 2002. Business investment spending experienced the sharpest decline in a quarter century, with nonresidential business investment falling by 5.2 percent and 5.8 percent in 2001 and 2002, respectively.

In a sense, this latest downturn may be viewed as a product of forces driving the so-called New Economy of the late 1990s—as well as its excesses. During the expansion, some people used the term New Economy to claim that changes in market dynamics and the increasing importance of knowledge as a corporate asset were rendering traditional accounting methods obsolete as a guide to the true economic value of high-tech firms. These ambitious claims appear to have

[1] The NBER statement can be found at http://www.nber.org/cycles/recessions.html.

largely collapsed with the subsequent large-scale decline of equity prices among high-tech firms. However, others were using the term New Economy to refer to long-term structural changes that were taking place in the economy, including increased global competition, productivity-enhancing technological innovations, and a greater reliance on market-based financing.[2] These changes appear to have had longer-lasting effects, bringing lower inflationary expectations, higher productivity, and greater market efficiency. The downside of these changes is a very difficult operating environment for the U.S. corporate sector and a drawn-out period of restructuring for troubled industry sectors.

Global Competition and Slow Revenue Growth

Corporate revenues and earnings have been hit hard by the recession, and, as a result, job growth and business investment in this recovery have been significantly weaker than the historical norm (see Chart 1). Global competition was a driving force behind the investment in new technologies and growth in merger activity in the late 1990s that helped U.S. corporations cut costs. But as inflation rates declined, global competition has increasingly placed downward pressure on output prices—first in manufacturing but increasingly in other sectors. Import prices for capital goods and consumer goods other than automobiles have fallen consistently since the mid-1990s.

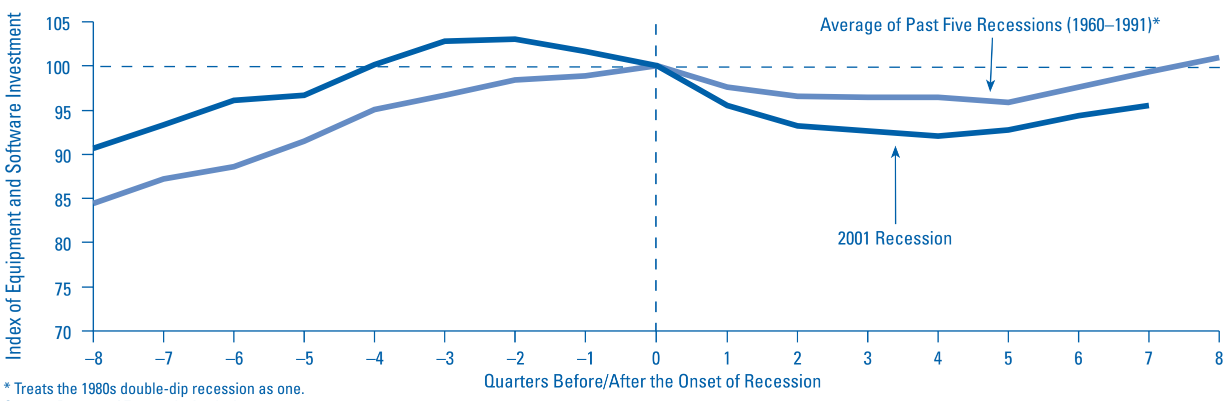
As a result, revenue growth has slowed or even become negative. Output prices measured by the core producer price index (PPI) grew by a mere 0.1 percent in 2002, down from 1.4 percent in 2001. Net sales for S&P 500 companies grew by only 0.7 percent in the first three quarters of 2002 from the same period in 2001. Net income for the S&P began to recover slowly in the second half of 2002, after declining for five consecutive quarters.[3] However, this modest recovery in earnings growth appears to be largely attributable to cost cuts and layoffs, which have hurt job growth and business investment spending.

Equity Market Bubble and Corporate Governance Scandals

During the period of rising stock prices leading up to early 2000, new companies by the hundreds issued equity to the public, while mature companies stayed ahead of competitors by investing heavily in new equipment and merging with rivals. This activity sparked a boom for financial markets and institutions that facilitated these transactions. Between 1997 and 2000, more than 1,500 new companies issued equity shares to the market. Corporate debt issuance totaled about $ 3.6 trillion during this period, and 36,175 mergers were consummated, with a total deal value of $4.6 trillion.[4] At the time, this dynamic appeared to be a relatively healthy response to the challenges of intense competition and changing technologies,

Chart 1

Recovery in Equipment and Software Investment Has Been More Subdued than in Past Recessions



* Treats the 1980s double-dip recession as one.
Source: Bureau of Economic Analysis

[2] See "Banking Risks in the New Economy," *Regional Outlook*, second quarter 2000, 3–13, http://www.fdic.gov/bank/analytical/regional/ro20022q/na/index.html.

[3] As of mid-February 2002, Thomson First Call was estimating that earnings for S&P 500 companies had increased by about 11 percent in the fourth quarter of 2002 from the same quarter a year earlier.

[4] Data from IPOHome (www.ipohome.com/marketwatch/review/2002main.asp), Haver Analytics, and Mergerstat (www.mergerstat.com).

allowing new companies to pursue opportunities and older companies to restructure operations.

Despite the efficiency with which the financial markets facilitated these transactions, the collapse of the technology bubble and recent corporate governance scandals exposed serious flaws in the system. In retrospect, stock valuations based on so-called intangible assets were largely illusory. A series of corporate scandals revealed earnings overstatements and conflicts of interest involving senior management, boards of directors, auditors, investment bankers, and equity analysts. Just as the investing public was becoming comfortable with the idea of buying and holding equities for the long run, serious questions were raised about the quality of information upon which investment decisions are made and the trustworthiness of major players in the capital markets. Reflecting investor wariness, equity prices remain depressed. The tech-heavy National Association of Securities Dealers Automated Quotations (NASDAQ) index currently trades about 75 percent below its March 2000 peak. In sum, the market value of equity shares traded on U.S. exchanges has fallen by about $7.5 trillion since early 2000.

Industrial Overcapacity

Many companies in the fastest-growing industries of the late 1990s used low-cost debt and equity capital to invest in new technologies and expand productive capacity. Annual U.S. growth in real spending on equipment and software averaged over 10 percent between 1993 and 1999. But by the late 1990s, companies found themselves with excess capacity as demand fell short of expectations. The overall capacity utilization rate for U.S. industries fell sharply beginning in third quarter 2000, hitting bottom at 74.6 percent in December 2001 and improving only a little in 2002. High-tech industries—telecommunications in particular—have experienced a rapid and uninterrupted decline in capacity utilization since mid-2000.[5] The capacity utilization rate for the communications equipment industry stood at only 49.2 percent as of December 2002.

Wide Credit Spreads

While low stock prices have significantly raised the cost of equity financing for publicly traded firms, a sharp rise in risk premiums in corporate bond markets has also increased the cost of debt financing. In particular, yield spreads between investment-grade and speculative-grade bonds widened significantly, signaling volatility in the capital markets. The yield spread between speculative-grade and investment-grade bonds, which was approximately 300 basis points in mid-1999, rose as high as 800 basis points following the September 2001 terrorist attacks and remained near 600 basis points as of early 2003.[6] This adverse trend in the credit markets was especially bad news to low-rated firms that needed to roll over maturing debt, and many of them were forced to default on their loans.

Lower investor confidence affected not only speculative-grade borrowers but also some investment-grade borrowers. For example, the commercial paper market, which many investment-grade borrowers have used as a cheap source of funding, also appeared to be characterized by a higher degree of risk aversion beginning in early 2000.[7] After reaching a peak of $351 billion outstanding in November 2000, the volume of commercial paper outstanding issued by nonfinancial companies had shrunk dramatically to $153 billion by January 2003. Some companies, fearing that sources of liquidity would not be available, secured term-out options for revolving lines of credit or backup commercial paper lines as a secondary source of liquidity.[8]

Impaired Credit Quality

Among the most telling measures of corporate distress are default rates and ratings trends on corporate bonds. The total default rate for U.S. bond issuers, which peaked in the last recession (March 1991) at a record-high 5.1 percent, rose again in the recent recession to as high as 4.9 percent (January 2002).[9] The increase in default rates over the past two years has been attributed primarily to the low-quality issuers that came to market in the late 1990s. From 1996 to 2000, some 33 percent

[5] High-tech industries include computer and office equipment, communications equipment, and semiconductors and related electronic components.

[6] Data from Merrill Lynch Global Bond Indices, Bloomberg.com.

[7] For a discussion on liquidity concerns in the commercial paper market see "The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead," *FDIC Regional Outlook*, third quarter 2002, 3–8. http://www.fdic.gov/bank/analytical/regional/ro20023q/na/index.html.

[8] A term-out option allows the borrower to convert the revolving credit, which generally matures in one year or less, into a term loan and repay it over a longer period of time. A commercial paper backup line is a commitment to provide a liquidity support for a company's commercial paper program. The rationale is that the borrower does not intend to use the backup line, which generally costs more than issuing commercial paper, unless the commercial paper cannot be rolled over or repaid.

[9] Issuer-based default rates used here are 12-month trailing default rates calculated by Moody's Investors Service.

of new issuers were rated B+ or below. Already, 31 percent of those issues have defaulted. Of those that remain, 61 percent are rated B+ or below, and 20 percent are rated B– or below.[10] But investment-grade issuers have also experienced higher default rates. The investment-grade default rate rose to a record high of 0.2 percent in 2001 and promptly set a new record with a default rate of 0.5 percent in 2002. Last year was also a record year for "fallen angels," as some 70 investment-grade companies with debt totaling over $200 billion were downgraded to junk status.[11] On average, there were 18 new fallen angels per quarter in 2002—three times the quarterly average between 1995 and 2000.

Following a record high of 257 Chapter 11 bankruptcy filings by public companies in 2001, another 191 public companies filed for bankruptcy in 2002. The most common factor that ultimately causes companies to file for bankruptcy is a liquidity crisis brought on by financial weakness or suspicion of fraud. ***Moody's*** reports that 652 U.S. companies experienced ratings downgrades in 2002 (with a deterioration in liquidity being the most common cause), while ratings upgrades numbered just 132 (see Chart 2). Still, companies that have remained highly rated have managed to take advantage of the benefits of lower interest rates. Total issuance of corporate bonds was a record 1.25 trillion in 2001, a level that declined only modestly over the first three quarters of 2002.

Consumers Lead the Economic Recovery

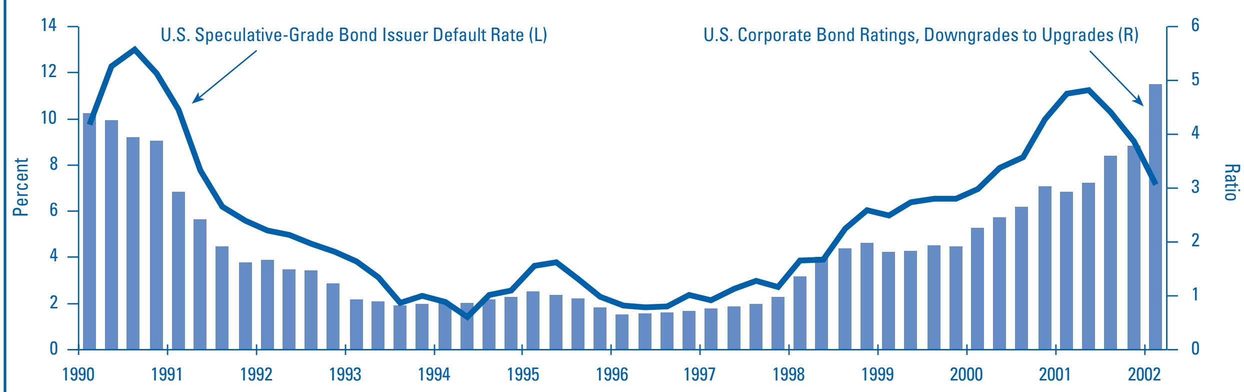
Despite the problems of the corporate sector, strong growth in consumer spending and residential real estate activity kept the recession relatively short and mild. Real consumer spending grew by 2.5 percent in 2001 and 3.1 percent in 2002—a vastly better performance than during the last recession. Consumer spending accounted for nearly 90 percent of all economic growth in 2002, as the recovery began to take hold. Key factors supporting consumer purchasing power during this period have included low inflation, aggressive monetary and fiscal stimulus, and the continued productivity gains that are a byproduct of corporate restructuring.

Monetary policy has played a central role. After holding the federal funds target rate at 6.5 percent during the last half of 2000, the Federal Reserve reduced the rate eleven times in 2001, totaling 475 basis points. The additional 50-basis point rate cut in November 2002 brought the federal funds rate down to 1.25 percent. This aggressive policy of rate easing (fortuitously initiated two months before the recession officially began) pushed short- and long-term rates down to levels not seen for 40 years, which helped boost consumer spending in durable goods and housing.

In this favorable interest rate environment, many consumers have been able to reduce debt service and

Chart 2

Credit Quality Impairment in 2002 Nearly Matched Previous Recession Levels



Source: Moody's

[10] "Corporate Defaults Peak in 2002 Amid Record Amounts of Defaults and Declining Credit Quality—Hazards Remain," Standard & Poor's, January 23, 2003.
[11] *Credit Trends Weekly Commentary*, Moody's Investors Service, January 20, 2003.

maintain household spending by refinancing existing mortgages at a lower interest rate. Homeowners refinanced some $2.58 trillion single-family mortgages in 2001 and 2002, in many cases reducing monthly debt payments.[12] Many refinancing borrowers also chose to liquefy some of the built-up equity in their homes by "cashing out" an estimated $145.3 billion. In addition, homeowners added roughly $150 billion to home equity lines of credit and $161.7 in nonresidential consumer debt during this two-year period.[13] A recent study by the Federal Reserve estimates that refinancing activities may have contributed some $23 billion to consumer spending between January 2001 and March 2002.[14]

Fiscal easing, in the form of the 2001 Economic Growth and Tax Relief Reconciliation Act, also turned out to be extremely well-timed. Tax rebate checks totaling $38 billion were mailed in mid-2001; they appear to have arrived near the deepest part of the downturn but before the recession was generally recognized. In addition, personal income tax cuts that took effect in 2002 helped offset weaker gains in wages and salaries. Personal tax and non-tax payments fell by 13.5 percent in nominal terms in 2002—the largest annual decline since World War II.[15] Unemployment insurance benefits provided additional financial support to the household sector. Government unemployment insurance payments rose from $20.5 billion in 2000 to $31.9 billion in 2001. With the extension of eligibility for federal unemployment benefits in March 2002, these transfer payments nearly doubled in 2002 to $62.9 billion.

Even without the increase in federal unemployment benefits, personal income more or less held ground throughout the downturn. Although real total labor income declined in the second half of 2001 and the first quarter of 2002, it still managed to grow slightly on an annual basis during both years. By comparison, real total labor income fell on an annual basis during each of the past three recessions. The ability of real incomes to continue growing throughout the downturn in part reflects a combination of two key factors: low inflation, which increased the consumer's purchasing power, and large increases in productivity, which supported wage gains. The productivity of the business sector, as measured by output per hour, rose by 4.7 percent in 2002, the highest annual increase in over 50 years (see Chart 3). These gains in labor productivity help to explain why the total compensation of salaried workers rose 3.4 percent last year, or more than twice as fast as the rate of inflation.

A long-term increase in rates of productivity growth may be one of the lasting contributions of the New Economy. Although it is often accomplished through job cuts, as firms find ways to produce more with fewer workers, rising productivity growth over the long term makes the pie bigger in terms of corporate profits, labor compensation, lower consumer prices, or some combination of the three. In recent years, households appear to have captured much of the gains of higher productivity through lower prices and high rates of wage growth. The flip side of these gains, however, has been the near absence of net job growth—a fact that places the financial burden of corporate restructuring disproportionately on a relatively small number of U.S. households.

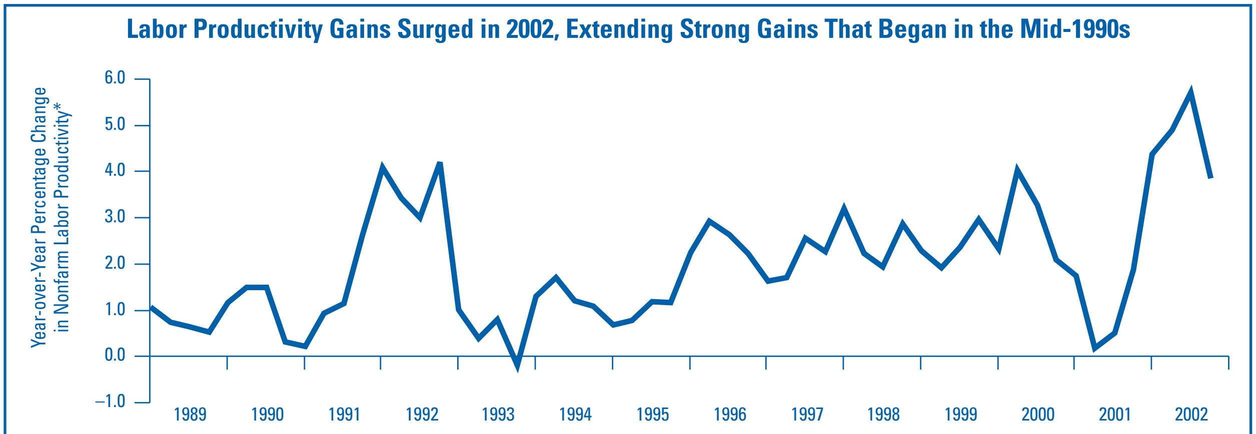
Banks Fare Well in the Slow-Growth Recovery

Thus far, the 2001 recession has had a limited net effect on the profitability of the U.S. banking industry. Despite significantly higher credit losses associated primarily with commercial loans to large corporate borrowers, U.S. commercial banks earned a record $23.4 billion in the second quarter of 2002, a mark that was nearly equaled in the third quarter. Insured thrift institutions managed to set earnings records in both the second and third quarters, at $3.9 billion and $4.0 billion, respectively.

Three key factors have helped to insulate the banking industry from the full effects of the corporate sector recession. One relates to how banks have managed risks. With generally strong capital positions and earnings, banks have had an incentive to recognize losses promptly and move impaired loans off the balance sheet. Chart 4 shows that provisions for loss by the industry have slightly exceeded net charge-offs, even as loan losses have risen sharply in recent years. In addition to reducing problems through charge-off, the ability to sell problem loans has been enhanced by the

[12] *Mortgage Finance Forecast*, Mortgage Bankers Association of America, January 7, 2003.
[13] "The Economic Contribution of the Mortgage Refinancing Boom," Economy.com, December 2002, and the Board of Governors of the Federal Reserve System *Consumer Credit Report* (G.19).
[14] Canner, Glenn, Karen Dynan, and Wayne Passmore, "Mortgage Refinancing in 2001 and Early 2002," *Federal Reserve Bulletin*, December 2002, http://www.federalreserve.gov/pubs/bulletin/2002/1202lead.pdf.
[15] Non-tax payments to the federal government include a variety of fees, penalties, donations, and unclaimed bank deposits.

Chart 3



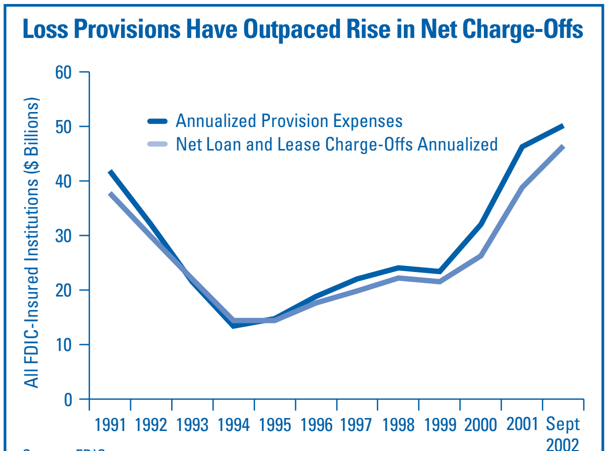
*Output per hour, all persons.
Source: Bureau of Labor Statistics

development of an active secondary market for loans. The 2002 ***Shared National Credit (SNC)*** report shows that nonbanks hold a disproportionate share of classified syndicated loans, suggesting that banks have been successful in selling riskier loans and participating out bigger shares to nonbanks. Banks have also managed risks in commercial loan portfolios by increasing the use of credit derivatives. The total notional value of credit derivative positions held by U.S. commercial banks has risen from virtually nothing in 1996 to $573 billion as of September 2002. These instruments have proved useful in reducing the net losses imposed on banks in large corporate defaults.

The second key factor mitigating the effect of problem loans on net income has been the changing structure of the income statement itself. Chart 5 shows that noninterest income rose from 32 percent of net operating revenue in 1990 to 43 percent in 2000.[16] The increasing influence of noninterest income tends to offset the effects that loan loss provisions would otherwise have on bottom-line net income. For example, loss provisions totaled 19 percent of net operating revenue in both 1990 and 1991, but this ratio was held to just 12 percent in 2001 and in the first three quarters of 2002. Moreover, the benefits of strong fee income have not been restricted to large institutions. While revenues from capital-market-related activities declined in the first three quarters of 2002, fee income related to deposit services rose strongly, boosting noninterest revenues for the industry as a whole.

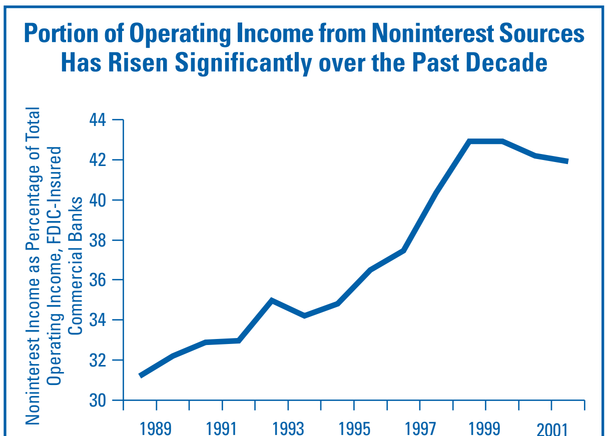
[16] Net operating revenue is defined as the sum of noninterest income and net interest income.

Chart 4



Source: FDIC

Chart 5



Source: FDIC

The third, and perhaps most important, factor in boosting bank earnings has been the effect that a steep yield curve has had on net interest income. The average yield spread between ten-year and six-month Treasury instruments in 2002 was 2.94 percent—a full 125 basis points higher than the average for 2001 and a level that has been exceeded in only two years since 1960. The steep yield curve helped raise bank net interest income by $19.3 billion during the first three quarters of 2002 compared with year-ago levels, significantly exceeding the $7.2 billion increase in loan loss provisions and helping boost net income to $68.5 billion for the first three quarters of the year.

The ability of the banking industry to continue to earn record profits in the face of commercial loan losses of this magnitude is uncertain. However, there are signs that the credit quality picture may improve over the course of 2003. As noted above, significant progress has been made in restructuring troubled industry sectors and improving corporate profit margins. A pick-up in the pace of economic activity in 2003 would help this process and could lead to a reduction in the number of problem commercial loans on bank balance sheets by the end of 2003. One factor that should come into play this year is the fact that bank lending standards to corporate borrowers have been progressively tightened since credit problems began to emerge in 2000.[17]

Moreover, the factors that have helped to offset rising loan loss provisions—namely higher levels of noninterest income and net interest income—should remain largely intact over the course of the year. A factor that would threaten to impair net interest income is a substantial rise in short-term interest rates. Because the interest-rate sensitivity of bank portfolios appears to have risen in recent quarters, rising interest rates could significantly reduce net interest margins, particularly at smaller institutions. However, such an outcome would be unlikely to take place in the absence of a resurgence in economic activity that would bring offsetting positive effects on bank credit quality. So while the course of the economy in 2003 remains uncertain, it is reasonable to expect that the offsetting relationship between loan loss provisions and the other major components of the bank income statement will remain in place for the foreseeable future.

[17] See Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices," http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.

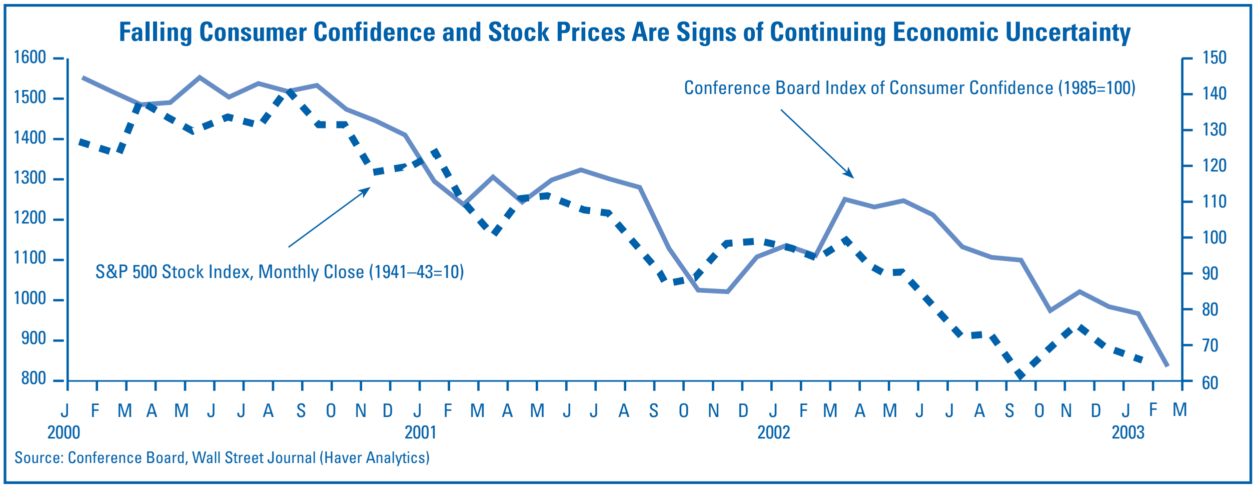
The Importance of Resolving Uncertainties

Before September 11, the greatest uncertainties facing the country were economic. When stock prices began to decline in early 2000, investors wondered how large the market correction would be and how business would be affected. Rising unemployment in early 2001 added job security to the list of concerns on the minds of consumers. After September 11, however, a number of noneconomic uncertainties emerged. The attack itself depressed consumer and business expectations for months, and the possibility of additional terrorist attacks has heightened the general level of uncertainty since that time. If this were not enough, the Enron bankruptcy in late 2001 marked the onset of public concern about corporate accounting practices that would intensify with the emergence of similar episodes; in particular, the $100 billion collapse of WorldCom in July 2002. During the past six months, the possibility of war with Iraq has become a growing source of concern, with unclear implications for the price of oil and the economy in general. The combined effects of these uncertainties is shown in Chart 6, which tracks steady declines in both stock prices and consumer confidence that began in early 2000 and as yet have shown few signs of reversing themselves.

For consumers and business executives, uncertainty complicates spending and investment plans. With greater uncertainty, it is harder to accurately predict future outcomes, including commodity prices and investment returns. If consumers and investors do not believe that they have enough experience and information to reasonably anticipate the future, they may choose to postpone transactions until the situation improves. Uncertainty, then, can impose real costs on an economy by delaying consumption and investment that would otherwise occur. Although it is not possible to quantify the costs of delayed spending and investment, they are widely perceived to be the key impediments to the economic recovery.

Experience suggests that the prospects for resolving these uncertainties during 2003 are reasonably good. In the case of governance reforms, the ***Securities and Exchange Commission*** adopted a set of new rules in January 2003 covering corporate disclosure, auditing, and conflicts of interest, as required under last year's Sarbanes-Oxley reform legislation. These rules come on the heels of new rules filed in 2002 by the ***New York Stock Exchange*** and ***NASDAQ*** that deal with codes of conduct, independent directors, audit committees,

Chart 6



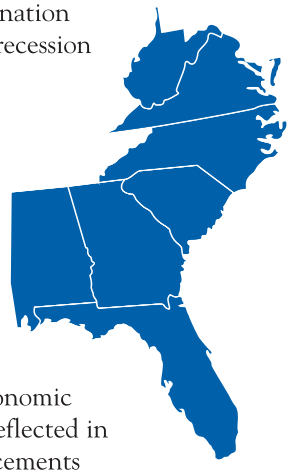
and other issues. While observers continue to debate the relative merits of these rules and the need for additional reforms, these developments mark significant milestones in moving beyond the governance scandals of 2001 and 2002 and restoring investor trust in U.S. corporations.

With regard to a possible conflict with Iraq, from an economic perspective it would clearly be preferable to resolve the surrounding uncertainty sooner rather than later. A reduction in the general level of uncertainty could provide a significant boost to the U.S. economy. In this regard, the best historical precedent would be the 1991 Gulf War, when a range of economic indicators moved sharply in the positive direction after the successful conclusion of the war. For example, the Conference Board reported that the expectations component of the consumer confidence index rose from a cyclical low of 55 in January 1991, as the air war in Iraq was beginning, to 101 in March 1991, after the successful conclusion of the war. While the precise outcome of the current crisis is difficult to predict, there are good reasons to believe that this particular source of economic uncertainty could be resolved in the first half of 2003.

Staff of the Risk Analysis Branch

Atlanta Regional Perspectives

Certain Key Industries Remain under Stress

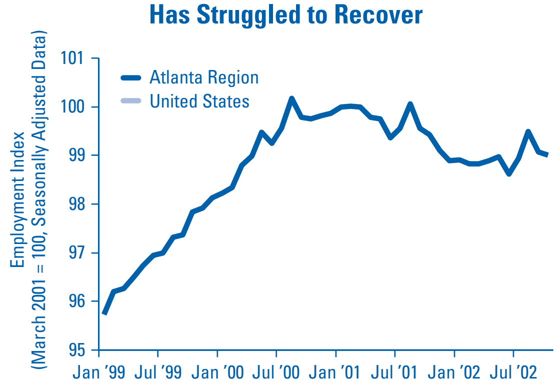


The Atlanta Region and the nation struggled to emerge from the recession during 2002 as initial modest employment gains earlier in the year gave way to renewed economic fragility (see Chart 1). The comparative weakness of the Region's economy was compounded by the fact that the recovery early in the year bypassed some local markets. The softening in economic conditions late in 2002 was reflected in the number of layoff announcements (see Chart 2), an indication that several industries remained under stress. This article looks at the Region's stressed industries, examines their relative importance and geographic location, and assesses the implications for community banks headquartered in these areas.

To provide a framework for our examination of the Region's stressed industries, we grouped the ten industries that reported the greatest number of layoffs during October and November 2002 into four categories: manufacturing and high-tech, transportation, financial services, and government (see Table 1).

Chart 1

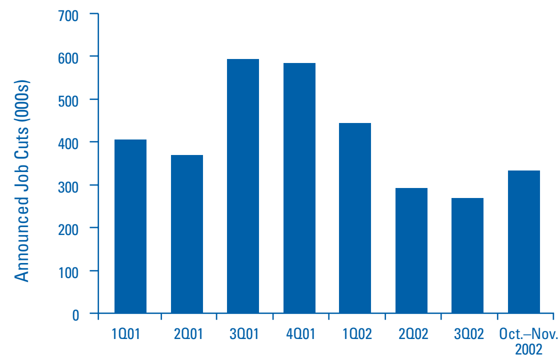
Employment in the Atlanta Region Has Struggled to Recover



Source: Bureau of Labor Statistics/Haver Analytics

Chart 2

Job Cuts across the Nation Increased Late in 2002 Following Declines in the Previous Four Quarters



Source: Challenger, Gray, and Christmas, Inc./Haver Analytics

Exposure to Stressed Industries Varies Widely in the Atlanta Region

The exposure is greatest in the manufacturing and high-tech industries, which employed more than 2.3 million workers in the Region in 2001. The government and transportation sectors each employed more than 800,000, while the financial services sector employed 645,000. However, the *actual* impact of continued industry weakness in these categories on the Atlanta Region economy likely would vary by location and an individual company's financial health. To determine the *potential* exposure in a local economy, we calculated location quotients[1] by county for each of the weak industries. We can then see where industries are concentrated in the Region.

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[1] A location quotient measures an industry's share of local employment relative to the corresponding national share. Algebraically, the calculation is shown as:

Industry Location Quotient (LQ) =

[Local Industry Employment/Total Local Employment]/
[National Industry Employment/Total National Employment].

If the calculated ratio is greater than one, an industry is more concentrated locally than nationally. As an example, we can calculate the telecommunications industry location quotient for Gwinnett County, Georgia, as follows:

$$\text{Telecom LQ}_{\text{Gwinnett}} = [\text{Telecom Employment}_{\text{Gwinnett}}/\text{Total Employment}_{\text{Gwinnett}}]/[\text{Telecom Employment}_{\text{US}}/\text{Total Employment}_{\text{US}}]$$

Or

[6,892/315,252]/[2,044,034/146,361,949]

$\text{Telecom LQ}_{\text{Gwinnett}}$ = 152 or the telecom industry is 52 percent more highly concentrated in Gwinnett County than at the national level. Employment data source: Global Insight, Inc.

Table 1

Job Cuts Occurred in Several Key Industries in the Atlanta Region Late in 2002			
	October–November 2002 Announced Job Cuts	Share of Total Cuts (%)	Share Rank
Total Announced Job Cuts	333,518		
Manufacturing and High-Tech			
Telecommunications	50,710	15	1
Computers	42,734	13	2
Aerospace	23,884	7	6
Electronics	19,974	6	7
Industrial goods	17,719	5	8
Automotive	15,591	5	9
Consumer goods	13,566	4	10
Financial	30,419	9	3
Transportation	29,536	9	4
Government	28,131	8	5

Source: Challenger, Christmas, and Gray, Inc./Haver Analytics

High-Tech and Manufacturing Sectors Displayed Renewed Weakness Late in 2002

The Atlanta Region's manufacturing sector began to show signs of recovery early in 2002; however, by summer's end, industrial payrolls had begun to fall again. Weakness in the manufacturing industry was evidenced by the fact that the ***Institute for Supply Management*** manufacturing index has fallen below 50, although it only rebounded to slightly above 50 in December 2002.[2] Affected industries ranged from high-tech manufacturing sectors, such as telecommunications and computers, to traditional industries, such as apparel.

High-Tech: Telecommunications, Aerospace, Electronics, and Computers

High-tech industries generally have not recovered from the significant decline in the NASDAQ and the effects of the recent recession, as evidenced by their comparatively poor stock performance. During the first two months of fourth quarter 2002, the Region's high-tech sector lost more than 135,000 jobs, more than 40 percent of job cuts announced nationwide. Industry location quotients for several counties in large metropolitan areas in the Atlanta Region exceed one, an indication of an industry concentration above the national average. During the past year, continuing layoffs in high-tech industries throughout the Region have adversely affected the **South Florida**, **Melbourne**, **Raleigh**, and **Atlanta** metropolitan statistical areas (MSAs). Further layoffs in these industries could constrain the economic recovery in these areas, especially as the effects of these layoffs are felt throughout the local economies.[3]

Manufacturing: Consumer Goods, Industrial, Automotive

Employment in the consumer goods, industrial, and automotive sectors is more highly concentrated in rural and smaller metropolitan areas of the Atlanta Region than employment in high-tech industries. Consumer goods include the production of furniture, a sector that has traditionally been a mainstay of the western **North Carolina** economy. This industry experienced sharp losses during the recent recession. Textiles, a component of industrial goods production, historically have dominated many of the Region's rural economies. Automotive production, however, is a comparatively recent addition to the Atlanta Region industrial mix.

Job cuts continue to occur at relatively high levels in these industries. It is important to note that layoffs in these sectors did not increase during late 2002, as they did in the high-tech sector. However, consumer debt levels remain high and job income growth is weak, increasing the potential for consumer spending to falter, further weakening these industries. Evidence of weakness may have appeared in the automotive sector

[2] An index of 50 or above indicates that the manufacturing sector is expanding; an index below 50 indicates that the sector is contracting.

[3] The banking industry has experienced the effects of exposure to weakening in the high-tech industry. During 2002, the quality of large syndicated credits in the telecommunications and cable industries declined sharply; 27 percent of these loans were classified, up from just under 4 percent a year earlier.

as sales of light-weight vehicles fell substantially in November 2002, despite continued low interest rates and dealer incentives. Also, in October 2002 retail sales fell on a year-over-year basis for the first time since the 1990–91 recession.

Transportation Services Continue to Be Hurt by the Effects of September 11

The transportation industry, especially air services, continues to suffer from the aftermath of September 11 and the recent recession. For example, the transportation industry announced nearly 30,000 job cuts during October and November 2002. The Atlanta Region, home to several airline hubs, is highly exposed to the industry's financial difficulties, as reflected by relatively high location quotients in several counties. The US Airways Chapter 11 bankruptcy filing in August 2002 contributed to layoffs at the **Charlotte** hub and reservations centers in **Orlando** and **Winston-Salem**. Delta Airlines has trimmed payrolls substantially in the Atlanta metro area, where it is the largest employer, and recently announced plans to cut at least 7,000 more jobs by mid-2003. Northwest Airlines also plans to scale back its presence in Atlanta. Further transportation industry layoffs in the Region likely will continue to constrain the recovery.

The Recent Recession Has Affected Government Budgets Adversely

The recent recession has hurt state tax revenues. During 2002, state tax revenues declined from year-ago levels in all Atlanta Region states except **Florida** and **West Virginia**. Nationwide, combined state budget gaps are expected to reach $60 billion in 2003. Should the recovery take hold, budget problems could persist, perhaps resulting in reduced expenditures, increased taxes, or both. Downsizing state governments would be expected to affect employment more significantly in capital cities, where location quotients are well above one.

Many Developments Have Contributed to Layoffs in the Financial Services Sector

Accounting scandals, weak equity market performance, high costs to the insurance industry because of losses on September 11, and cost-cutting following merger and acquisition activity in the banking industry contributed to job cuts in the financial services sector early in 2002. Although layoffs were at relatively high levels, they have moderated during the year. Industry exposures in the Atlanta Region, reflected by comparatively high location quotients, tend to be concentrated in regional banking centers, such as Winston-Salem, Charlotte, Atlanta, **Birmingham**, and South Florida. Additional cost-cutting and layoffs related to consolidation in the banking industry could weaken the recovery.

Large Banks Have Performed Well in the Atlanta Region

Commercial banks headquartered in the Atlanta Region with assets over $10 billion (excluding credit card banks) reported solid performance in third quarter 2001. Year-over-year, the median return on assets ratio improved to 1.28 percent by September 30, 2002, up from 1.07 percent two years earlier. Gains in net interest income were primarily responsible, as the median net interest margin rose to 3.96 percent as of third quarter 2002, 28 basis points higher than a year earlier. In addition, lower provision expenses and increased efficiencies at these banks helped to bolster profitability.

After slowing in 2001, loan growth rebounded as of September 30, 2002. The loan-to-asset ratio improved to just over 66 percent, a 140 basis point increase from a year before. Spurred by low interest rates and consumer spending, significant growth occurred in the 1- to 4-family and consumer loan categories. Credit quality among large insured institutions has remained sound; the median noncurrent loan level for all loan types was stable at 0.86 percent as of September 30, 2002.

However, the commercial and industrial (C&I) loan portfolio continued to show signs of weakness. The median past-due and nonaccrual C&I loan ratio rose 50 basis points to 3.5 percent at year-end September 30, 2002, but remained below the national median of 4.2 percent. Although the Region's median past-due and nonaccrual C&I loan ratio has more than tripled during the past five years, the bulk of these past-due loans were less than 90 days old at the end of third quarter 2002.

Large banks headquartered in the Region have reported significant increases in core deposits during the recent period of stock market volatility. Should interest rates rise and funds begin to return to the equity markets, concern about liquidity and interest rate risk could increase.

Table 2

Atlanta Region Metro Areas with High Exposures* to Multiple Stressed Industries Could Face the Greatest Challenges (MSAs ranked by year-over-year percentage point change in noncurrents)

Name	1- to 4-Family Noncurrents (%)	Year-over-Year Percentage Point Change in Noncurrents	Job Growth (%) October 2002 Year-over-Year	Exposure to Stressed Industries										
				Aerospace	Automotive	Computers	Consumer Goods	Electronics	Financial	Government	Industrial Goods	Telecom	Transportation	Count of Industries
West Palm Beach, FL	2.15	1.72	0.74	x					x			x		3
Raleigh, NC	1.12	0.64	0.87			x	x	x		x	x	x		6
Charlotte, NC	0.55	0.41	1.55		x	x	x	x	x		x	x	x	8
Washington, DC	0.61	0.36	–0.69		x	x	x		x	x	x	x	x	8
Greensboro, NC	0.73	0.33	–0.35		x		x	x	x		x		x	6
Tampa, FL	0.68	0.30	0.07	x		x		x	x			x		5
Macon, GA	0.83	0.29	–0.27	x	x	x		x	x			x	x	7
Savannah, GA	0.49	0.09	–0.36	x					x	x	x	x	x	6
Atlanta, GA	0.70	0.08	–2.82	x	x	x	x	x	x	x	x	x	x	10
Norfolk, VA	0.31	0.06	0.20		x	x				x		x	x	5

* If an MSA has a location quotient above one in at least one of its component's counties, this exposure is designated by an "x" in the corresponding industry under "Exposure to Stressed Industries."

Sources: Bank and Thrift Call Reports, September 30, 2002; Global Insight, Inc.; Bureau of Labor Statistics/Haver Analytics

Implications for Insured Institutions

Although the Atlanta Region economy has experienced modest improvement in employment growth, continued weakness in stressed industries could constrain the pace of the recovery. Consumer loan delinquencies typically have increased during times of rising unemployment rates and weak job growth.[4] Community banks[5] headquartered in several of the Region's metro areas have reported some weakening in asset quality over the year ending third quarter 2002, which likely is related to industry layoffs. Such deterioration could be further exacerbated in markets such as the Atlanta MSA, where job losses have been severe in several key industries (see Table 2). Any additional slowing in local economies stemming from continued industry layoffs could further pressure asset quality and contribute to a decline in loan growth. Consequently, management of insured institutions that hold relatively high exposures to these stressed industries should continue to monitor economic developments as the nation moves toward recovery.

Conclusion

If the recovery remains weak, local economies in the Atlanta Region with exposures to industries that have been slow to emerge from the downturn could be most vulnerable. Insured institutions could experience some weakening in consumer credit quality, as personal bankruptcy filings and mortgage foreclosure rates have continued to climb across the Region. Increased job cuts would further pressure consumer credit quality. Downturns in specific industries also could affect commercial real estate and construction adversely, resulting in continued weak absorption rates. Key sectors of the economy to watch going forward are nondefense-related manufacturing, transportation, state and local government, and, to a lesser extent, financial services. Local economies with relatively high exposure to more than one of these sectors may be most vulnerable.

Jack M. W. Phelps, CFA
Scott C. Hughes
Pamela R. Stallings
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[4] Russ Wiles, "Growing Consumer Debt Brings Out the Collectors," *The Arizona Republic*, October 25, 2002.

[5] "Community banks" are defined in this article as insured institutions that hold assets less than $1 billion. This definition does not include de novo or specialty institutions.

Chicago Regional Perspectives

The Region Experiences Improving Economic Conditions and Generally Healthy Banking Conditions

The Region's economic conditions improved in the year ending third quarter 2002, but progress was modest and uneven. Growth remains tepid following the 2001 recession and as restructuring continues in some troubled industries.

Employment during third quarter 2002 in the Region and the nation was about 0.8 percent below year-earlier levels (see Table 1). The recent pace of job loss in the Region was less severe than during the year ending third quarter 2001. In contrast, the nation shifted from marginal job growth to a mild decline. The Region's relatively better performance partly reflects its low exposure to high-tech firms, airplane production, and some other sectors undergoing sharp contractions. Even so, exposure to telecommunications, airline services, steel, and other troubled industries dampens growth in the Region.

Table 1

Employment Trends Reflect Varying Rates of Improvement among States in the Region

	Percent Change from Four Quarters Earlier	
	3Q01	3Q02
Total Payroll Employment:		
Nation	0.1	–0.8
Chicago Region	–1.3	–0.7
Illinois	–0.9	–1.3
Indiana	–2.1	–1.2
Kentucky	–0.2	1.0
Michigan	–2.2	–0.8
Ohio	–1.3	–0.9
Wisconsin	–0.5	0.4
Manufacturing Employment:		
Nation	–5.2	–4.8
Chicago Region	–5.9	–2.0
Illinois	–4.8	–2.1
Indiana	–7.2	–2.7
Kentucky	–5.6	–1.7
Michigan	–6.2	–1.6
Ohio	–6.0	–1.8
Wisconsin	–5.5	–2.2

Source: Bureau of Labor Statistics

The contrast between the Region and the nation is more noticeable in the manufacturing sector, where the Region's rate of job loss slowed noticeably in 2002, but the nation's did not. This disparity partly reflects the fact that employment among the types of manufacturers found in the Region declined sooner than in other manufacturing sectors (before the cyclical peak) and improved sooner when the recovery took hold. Similarly, the varying industrial composition of the Region's states is contributing to uneven degrees of improvement. States with high exposure to the motor vehicle-and-parts industry,[1] for example, fared relatively well, as strong vehicle sales spurred third-quarter production of vehicles and parts to a level 11 percent higher than a year earlier. Although motor vehicle production may advance only modestly in coming quarters, the strengthening in manufacturers' new orders during 2002, following six quarters of decline, bodes well for continued improvement in other parts of the Region's manufacturing sector.

Activity in residential housing markets was surprisingly robust in the past year. Nationwide, measures reflecting the affordability of homeownership for first-time buyers and repeat buyers were higher in 2002 than in 2000, despite the recession and job losses in the interim. As was the case with vehicle sales, unusually low interest rates contributed to strong home sales in the Region during 2002.

In this economic environment, the Region's banks and thrifts report healthy profitability and generally sound conditions. Their profitability as a group rose sharply, with third quarter, year-to-date annualized return on assets of 1.33 percent, which compares favorably with 1.02 percent a year earlier. This improvement is largely attributable to higher net interest margins.

Aggregate data show 2.69 percent of total loans as past due[2] in the third quarter (see Table 2). This percentage is below the 2.86 percent a year earlier, yet above the 2.12 percent two years earlier, before the recession began. Among the Region's community

[1] The share of employment in the motor vehicles-and-parts sector is at least 65 percent higher in Michigan, Indiana, Kentucky, and Ohio than in the nation.

[2] The term "past due" includes loans delinquent by 30 days or more plus loans on nonaccrual status.

Table 2

The Region's Insured Institutions Report Varying Past-Due Rates

	Percentage of Loans Past Due			
	3Q99	3Q00	3Q01	3Q02
All Loans	2.02	2.12	2.86	2.69
Commercial and Industrial	2.22	2.37	3.74	3.69
Commercial Real Estate				
Nonresidential Real Estate	1.73	1.64	2.31	2.24
Multifamily Residential	1.13	1.05	1.24	1.21
Construction and Development	2.43	2.38	2.76	2.95
Residential Real Estate*	1.82	1.99	2.67	2.77
Loans to Individuals (excluding real estate loans)	2.78	2.98	3.13	2.54
Addendum:				
Residential Real Estate*				
Large Banks (assets of $1 billion or more)	1.86	2.08	2.82	2.94
Community Banks (assets under $1 billion)	1.76	1.80	2.24	2.22

* Includes first and subordinate liens on 1- to 4-family residential properties.
Source: Call Report Data, aggregated across all institutions in the Region

institutions,[3] the percentage of loans 30 to 89 days delinquent declined 21 basis points in the year ending September 30, 2002, suggesting that an improvement in nonperforming loans (those delinquent by 90 days or more plus those on nonaccrual status) may follow.

Growth in aggregate nonperforming loans caused community institutions' reserve coverage of these loans to fall to 105 percent in third quarter 2002 from 147 percent at year-end 2000. This decline suggests that some institutions may need to reevaluate reserve levels; however, increases in capital and the ratio of reserves to total loans during the past two years provide some cushion. In addition, profitability of the Region's insured institutions appears sufficient to support somewhat higher provision expenses, should they become necessary.

Banking and Economic Indicators Suggest Changing Dynamics for Residential Lenders

Bankers and regulators often consider residential real estate loans[4] to be a low-risk lending activity because such loans historically experience relatively low delinquency and loss rates. In fact, recent loss rates on residential loans held by community institutions headquartered in the Region are the lowest among major loan types, and net charge-offs remain very low, at only 8 basis points per annum.

However, the gap between past-due rates on residential and all other loans held by the Region's community institutions narrowed in the mid-1990s and did not expand during the 2001 recession, as occurred around the 1990–91 recession (see Chart 1). Indeed, while the past-due rate on residential loans remains below that of other loans, it consistently moved in line with the past-due rate for all other loans in recent years.

To provide perspective for this discussion, residential real estate loans are the largest asset class held by the Region's community institutions. Even so, their 40 percent share of total loans in third quarter 2002 was down from 44 percent a decade earlier. Over the same period, the share of revolving, open-end loans within residential loan portfolios rose to 11 percent from 7 percent. **Ohio** is home to four of the Region's five metropolitan statistical areas (MSAs) in which community institutions hold median exposure to residential loans exceeding 55 percent of total loans.[5] This high share reflects the fact that 39 percent of Ohio's community institutions have thrift charters, and thus

[3] "Community institutions" are defined in this article as insured banks and thrifts that hold assets of $1 billion or less and are not de novo or specialized (e.g., credit card) entities.
[4] Residential real estate loans include first and subordinate liens on 1- to 4-family properties.
[5] Only MSAs that are headquarters to at least ten community institutions are considered.

Chart 1

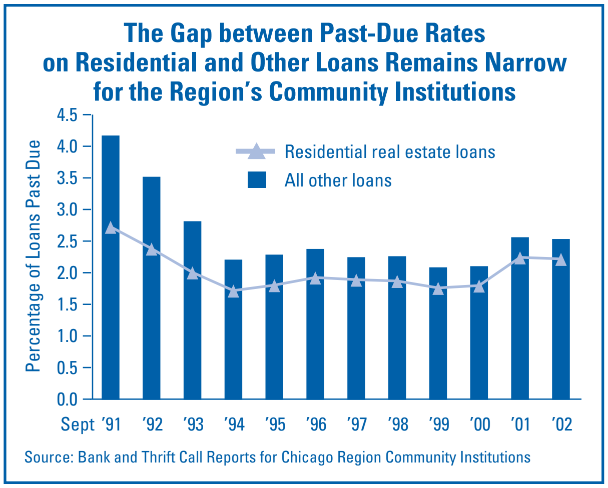
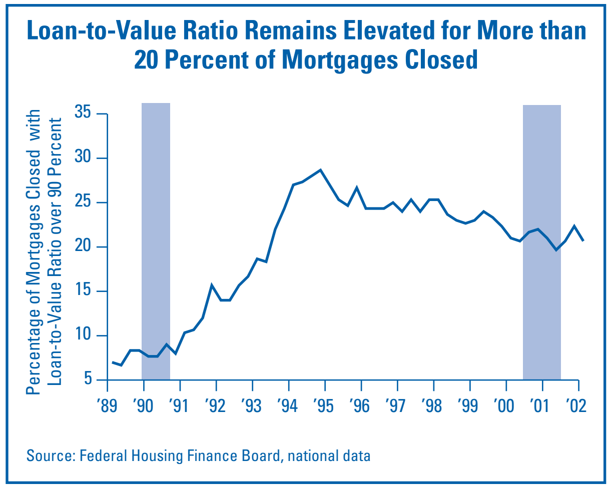


Chart 2



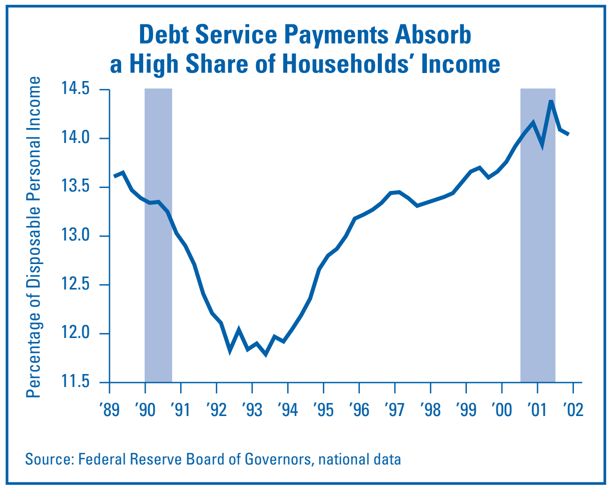
a focus on residential lending, in contrast with 15 percent elsewhere in the Region.

Banking Considerations

As the Region's economic recovery unfolded through third quarter 2002, the performance of residential and nonresidential loan portfolios was better than immediately after the prior recession (see 1991 and 1992 in Chart 1). Even so, the shift to higher loan-to-value ratios on mortgages since 1994 (see Chart 2) and households' rising debt service burdens (see Chart 3) leave lenders exposed to borrowers' financial setbacks, such as layoffs, stock market losses, or high leverage. The high level of subprime mortgages in foreclosure and delinquent by at least 90 days[6] suggests that at least one subset of borrowers has encountered significant debt-servicing problems.

The share of past-due residential loans held by insured institutions in the Chicago Region as of September 30, 2002, surpassed past-due rates for nonresidential loans to individuals and several components of commercial real estate portfolios (Table 2). Only residential loans and construction and development loans posted higher past-due rates than a year earlier, while other loan types showed modest improvement. The most pronounced deterioration in residential credit quality since late 2000 occurred among large institutions with assets of $1 billion or more, as indicated in the addendum to Table 2.

Chart 3



Economic Considerations

The 2001 recession and moderate recovery to date undoubtedly contributed to the rise in past-due rates on residential loans. In addition, pockets of local economic weakness likely heightened strains on residential loan quality in particular areas. For example, employment in **Decatur, Illinois,** has declined significantly since late 2000, and local lenders there report one of the highest median past-due rates on residential loans among MSAs in the Region.[7]

Declines in mortgage interest rates since mid-2000 and a rise in refinancing activity probably helped temper the recent increase in mortgage delinquencies. In the

[6] Based on September 2002 data reported by www.loanperformance.com in *The Market Pulse*, 2002, Vol. VIII, Issue 5.

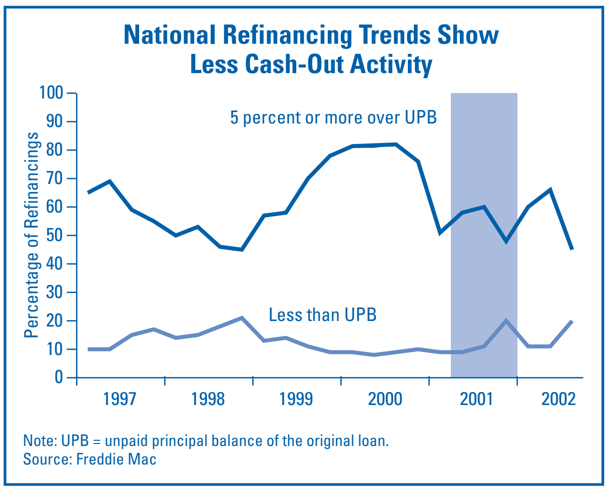
[7] In Decatur and elsewhere, the past-due rate reflects not only the impact of economic conditions but also individual institutions' business plans and risk tolerances.

aggregate, however, declining employment and slower income growth overwhelmed the benefits to borrowers of lower mortgage rates and restructured balance sheets.

Shifts in the nature of recent refinancings likely reflect household caution and reduced net worth as well as tighter underwriting criteria. Twenty percent of refinanced mortgages in third quarter 2002 were for less than the unpaid principal balance (UPB) of the original loan (see Chart 4). Such refinancings, often termed "cash flow" refinancings, typically lower borrowers' debt burdens. At the same time, a declining share of refinancings—but still high, at 45 percent—were "cash-out" actions, in which new mortgages add 5 percent or more to the UPB of the original loan.

To the extent that refinancings allow households to restructure their balance sheets, they enhance borrowers' ability to handle current and future debt loads.

Chart 4



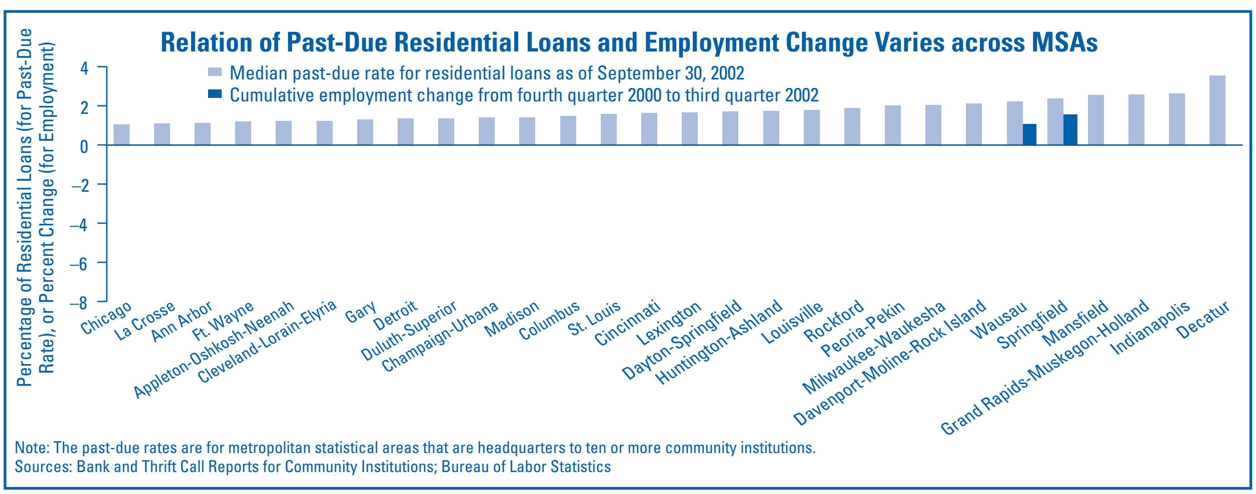
Moreover, a rising share of recent mortgage originations involves fixed-rate loans, which reduce borrowers' vulnerability to future increases in interest rates. Indeed, fixed-rate mortgages represented about 85 percent of conventional mortgages closed nationwide in fourth quarter 2002, according to the ***Federal Housing Finance Board***.

At the MSA level, housing markets in the Region are not characterized as "overheated" or facing housing price bubbles. Behind the aggregate data, however, are some submarkets where demand is weak relative to supply, triggering longer periods before a sale is made, falling home prices, or both. In any market characterized by sustained declines in home prices and weak economic conditions, the probability of payment default increases and the ability of homeowners to sell properties at prices sufficient to pay off mortgages diminishes. In such situations, the accuracy of appraisals, underwriting standards, and oversight by lenders assume heightened importance.

Successful Residential Lending Depends on Many Factors

It is not possible to specify that weak economic conditions account for a certain percentage of the recent (or any future) rise in residential past-due rates, while changes in mortgage underwriting standards, marketing strategies and lending practices account for the remainder. As important as employment and income are to households' ability to service debt obligations, a market's aggregate job losses or gains are not the only factor influencing the performance of residential portfolios, as illustrated in Chart 5. Other important

Chart 5



factors include variations in loan-to-value ratios, lenders' pricing power, competition for prime (and perhaps subprime) credits, underwriting standards, the pace of economic growth, households' debt-service burdens, the extent of refinancing activity, and home price appreciation (or stagnation).

Currently, strong profitability and healthy conditions enable mortgage lenders to address problem credits and adjust risk management systems where necessary. Nonetheless, management should evaluate the changing nature and relative risks of this business line to determine how to operate profitably and safely in the current environment. For example, waves of refinancing, which were unheard of a decade ago, can quickly change the duration of lenders' residential loan portfolios. Meanwhile, insured institutions facing competition from not only other local lenders but also nationwide institutions may respond to reduced pricing power by relaxing standards for loan-to-value ratios or borrower leverage limits. Others have focused on originating and selling mortgages in the secondary market, which involves a different set of potential risks and rewards than traditional make-and-hold lending.[8] All told, residential mortgage lending is no longer a homogeneous business line, with one strategy and one set of risks facing most participants. As the environment for residential lending continues to evolve, lenders may need to reevaluate their traditional view about the relative risks of residential lending.

Chicago Staff

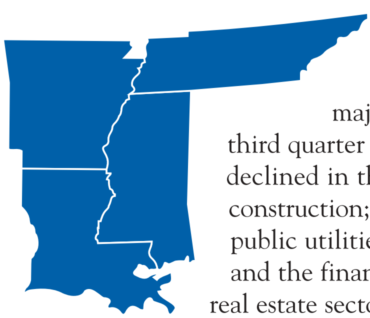
[8] For further discussion of evolving lending practices and associated risks for mortgage lenders, see "Housing Market Has Held Up Well in This Recession, but Some Issues Raise Concern," in *Regional Outlook, National Edition*, first quarter 2002.

Dallas Regional Perspectives

Midsouth Economic and Banking Conditions

Job Losses Continued in Many Areas of the Midsouth during 2002; Some Signs of Improvement Have Emerged

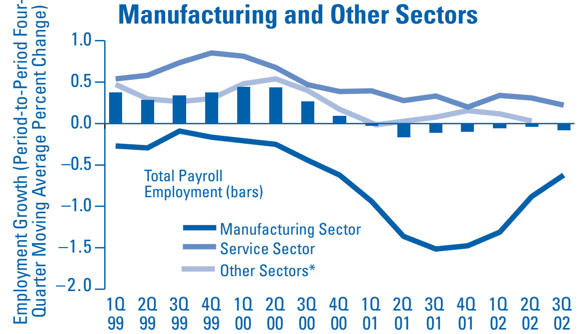
The Midsouth[1] economy continued to lose jobs during the first nine months of 2002. However, the pace of losses abated in the third quarter, and employment levels varied across individual states. The Midsouth economy was on track to lose almost 13,000 jobs during 2002, but this estimate represents less than half the number of jobs lost in 2001 and suggests that the area's economic malaise may be ending.[2] The **Mississippi** economy already may have emerged from decline, with modest job gains reported during the first three quarters of 2002. Employment levels were flat in **Arkansas** during this period, and minimal job losses were reported in **Louisiana** and **Tennessee**.



Midsouth employment trends varied among the area's major industries during third quarter 2002. Employment declined in the retail trade; construction; transportation and public utilities; manufacturing; and the finance, insurance, and real estate sectors (see Chart 1). Job losses in the manufacturing sector continued, but at a slower pace during the first nine months of 2002 compared with the previous year, providing some evidence that contraction in this sector may be ending.[3] Job gains in the services (concentrated in health care) and local government sectors somewhat mitigated employment declines in other sectors. However, revenue collections for Midsouth state and local governments were down during 2002, suggesting that the favorable employment trends in this sector may not continue into 2003. The sustainability of the Midsouth's nascent economic recovery is tied to employment trends in the manufacturing and government sectors, which represent one-third of area jobs.

Chart 1

Job Growth in the Midsouth Services Sector Somewhat Offset Weakness in Manufacturing and Other Sectors



*Other sectors include construction; finance, insurance, and real estate; government; mining; trade; transportation and public utilities.
Source: Bureau of Labor Statistics

Manufacturing Job Losses Slow, but the Potential for Continued Improvement Is Uncertain

The manufacturing sector is still a key economic driver in the Midsouth economy. Although the share of total employment in this industry steadily declined during the past two decades, almost one out of every six jobs in the Midsouth economy remained in the manufacturing sector as of third quarter 2002. It is important to note that average wages in the manufacturing sector exceed those in certain areas of the service sector with skill and education requirements similar to those in manufacturing, such as food service.[4] In addition,

[1] The Midsouth area includes the states of Arkansas, Louisiana, Mississippi and Tennessee.

[2] According to the *Bureau of Labor Statistics*, the Midsouth economy lost 9,500 jobs during the first three quarters of 2002, 3,500 of which were lost in the third quarter. The annualized 2002 employment decline is 12,700, compared with 27,100 for 2001.

[3] Midsouth manufacturing employment declined by 15,400 jobs during the first nine months of 2002, compared with a decline of 66,900 in 2001. Job gains in the services and government sectors partially offset losses in manufacturing, resulting in the net job loss figure mentioned in footnote 2. Manufacturing jobs represent 16 percent of total employment in the Midsouth, compared with 13 percent for the nation.

[4] In 2001, the average hourly rate for Midsouth manufacturing jobs was $13.45, or 188 percent of the average wage for food service jobs.

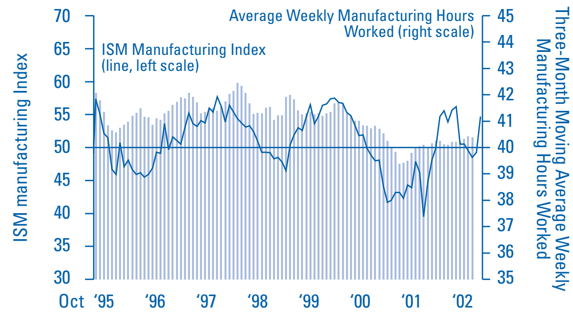
almost 20 percent of the Midsouth's gross state product was attributable to manufacturing in 2000.[5]

Manufacturing employment declined during the first nine months of 2002 and has done so every year since 1995, except during 1998, when employment increased modestly.[6] All nondurable manufacturing segments (comprising apparel, chemicals, food products, paper, and textiles) recorded job losses during the period, except for food products.[7] These declines primarily result from migration of low-skilled jobs to countries with cheaper labor costs. In contrast, jobs were added overall in the durable manufacturing segments (electronics, furniture and fixtures, industrial machinery, lumber and wood, and transportation equipment) until 2000.[8] Employment declines since 2000 in the durable manufacturing sector primarily result from the cyclical slowing of the U.S. economy and reduced demand, particularly for items businesses use to produce other goods.[9]

Job losses in the manufacturing sector appear to have peaked at almost 67,000 in 2001 (see Chart 1). However, erosion has continued, and prospects for employment in this sector in 2003 remain unclear (see Chart 2). Average hours worked in the manufacturing industry in the Midsouth now exceed the low point reached during spring and summer 2001. However, this figure remains well below levels during the latter half of the 1990s.[10] The ***Institute for Supply Management*** manufacturing index finished 2002 above 50, indicating that purchasing managers expect businesses to expand in terms of resource utilization. However, December is the first month in which the index topped 50 since August 2002, an indication that this recent improvement may be somewhat tenuous.[11]

Chart 2

The Institute for Supply Management Index and Hours Worked Indicate Possible Improvement in Midsouth Manufacturing Employment Conditions during 2003



Note: ISM = Institute for Supply Management.
Source: Bureau of Labor Statistics

Credit Quality Deterioration Appears to Have Abated, and Earnings Improved in Third Quarter 2002

Although economic weakness persisted during third quarter 2002, insured institutions headquartered in the Midsouth reported sound credit quality and earnings. Furthermore, credit quality has improved among banks and thrifts operating in each of the Midsouth states since reaching cyclical lows during fourth quarter 2001.[12] However, trends in past-due loan levels varied by state as of third quarter 2002. Insured institutions headquartered in Arkansas and Louisiana reported a slight increase from a year ago in the median past-due ratio, while institutions in Mississippi and Tennessee reported declines of 29 and 20 basis points, respectively. Median past-due loan ratios increased for Midsouth agricultural institutions but declined for most other institution types compared with year-ago levels.[13]

Overall, earnings have improved for insured institutions in the Midsouth during the past year. Rising net interest margins, resulting from favorable trends in market interest rates and declines in funding costs, boosted the median return on assets (ROA) from just

[5] Data as of year-end 2000 represent the most recent gross state product figures available.
[6] Midsouth manufacturing lost 166,100 jobs between year-end 1995 and third quarter 2002. Job losses occurred in each of the intervening years except 1998, when employment grew only 1,100.
[7] Midsouth food product manufacturers employed 148,900 in third quarter 2002, almost 32 percent of all nondurable manufacturing jobs. Employment in food products increased an average of .4 percent per year between 1995 and third quarter 2002.
[8] Jobs were not added in the electronics and lumber and wood segments of the durable goods industries.
[9] Overcapacity in the trucking and commercial passenger air service industries as well as steel mills has contributed to a significant reduction in demand for durable goods.
[10] Generally, manufacturers' initial response to increased orders is to increase overtime hours for existing staff. New hiring usually is deferred until an increase in demand appears permanent.
[11] An index of 50 or above indicates that the manufacturing sector is expanding; an index below 50 indicates that the sector is contracting.
[12] Median reported past-due loans were 2.68 percent of total loans in third quarter 2002, comparable with the previous quarter and down from 2.71 percent a year ago. The median past-due ratio peaked at 3.04 percent at year-end 2001, the highest level since June 30, 1992 (3.28 percent).
[13] Agricultural institutions are defined as insured institutions holding at least 25 percent of total loans in agricultural production and farm real estate. The median past-due loan ratio for these institutions was 3.28 percent as of third quarter 2002, an increase of 37 basis points from a year earlier.

Option Risk in Securities Portfolios Appears to Have Increased among Insured Institutions Headquartered in the Midsouth

During the recession, loan growth slowed among insured institutions headquartered in the Midsouth.[14] In an effort to maintain or boost earnings, some Midsouth institutions have begun to increase holdings of securities that carry option risk.[15] Although overall no *significant* shift from loans to securities has occurred, migration toward higher-yielding instruments in the securities portfolio has been reported.[16]

The widening spread between the current yield on fixed-rate mortgages and comparable maturity U.S. Treasury securities has increased the attractiveness of mortgage-related investments. For example, the spread between the yield on 30-year fixed-rate mortgages and 7-year constant maturity Treasury notes was 2.58 percentage points as of September 30, 2002, compared with an average of 1.85 and 2.09 percentage points during 2000 and 2001, respectively. As a result, holdings of mortgage-backed securities have increased steadily and reached a historical high among insured institutions in the Midsouth during third quarter 2002 (see Chart 3).[17] Moreover, an increasing percentage of pass-through securities are repricing or maturing after five years. These trends likely will continue should interest rate spreads remain near late 2002 levels.

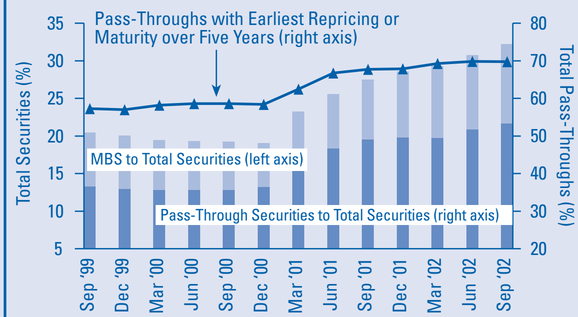
High and increasing concentrations of pass-through securities and other mortgage-backed securities are likely to contribute to increased option risk in securities portfolios. Option risk generally is categorized as follows:

- **Extension risk:** the possible deceleration of principal payments that occurs in a rising or high interest rate environment, which causes many mortgage-backed securities to lengthen in duration and decline in value.
- **Reinvestment risk:** the possible acceleration of principal prepayments in a declining or low interest rate environment that likely will cause mortgage-backed securities to shorten in duration and decline in value.

Reinvestment risk likely will remain a concern at least into early 2003, as the historically low interest rate environment is expected to encourage further mortgage refinancing activity.[18]

Chart 3

Mortgage-Backed Securities Represent a Growing Share of Securities Portfolios among the Midsouth Region's Insured Institutions



Note: MBS = mortgage-backed securities.
Source: Call reports for community commercial banks

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[14] Merger-adjusted loans grew 5.7 percent in third quarter 2002, compared with double-digit growth in 2000. The median loan-to-asset ratio reported by insured institutions headquartered in the Midsouth peaked at 64.7 percent in third quarter 2000 and declined to 63.4 percent by September 30, 2002.

[15] Option risk refers in this article to the prepayment option mortgage holders typically grant borrowers.

[16] Aggregated securities for Midsouth community commercial banks represented 24 percent of total assets in third quarter 2002, 1 percentage point higher than a year earlier.

[17] Mortgage-related securities (mortgage-backed securities and mortgage derivative securities) represented 32.2 percent (aggregated) of total securities held by Midsouth commercial banks in third quarter 2002, up from 19.2 percent in third quarter 2000 and 27.5 percent in third quarter 2001. Thrifts are not included because of a lack of comparable information on securities maturities and repricing.

[18] According to the *Mortgage Bankers Association (MBA)*, total mortgage originations are projected at $2.46 trillion for 2002, declining to $1.77 trillion for 2003 (the third highest volume since 1970). Mortgage refinancings represented 58 percent of all mortgage originations, according to the MBA.

below 1 percent in third quarter 2001 to 1.14 percent in third quarter 2002 (see Table 1).[19] Median ROAs did not increase noticeably between the second and third quarters of 2002, an indication that narrowing interest rate spreads have begun to affect earnings.

Table 1

Insured Institutions Headquartered in the Midsouth Reported an Increase in the Median Return on Assets as of Third Quarter 2002

	Median %		
	3Q02	3Q01	2Q02
Arkansas	1.15	1.02	1.13
Louisiana	1.11	0.99	1.11
Mississippi	1.17	1.08	1.13
Tennessee	1.08	0.94	1.11
Midsouth	1.14	0.99	1.12
Nation as a whole	1.10	1.00	1.08

Source: Bank and Thrift Call Reports

Funding costs also may have reached a functional floor. In addition, less attractive reinvestment options are now available for funds coming from repayment (including prepayments on mortgages) of loans and securities extended or purchased during periods of higher interest rates. Midsouth insured institutions reported an increase in the median ratios for loan loss reserve coverage to total loans and noncurrent loans in third quarter 2002 compared with year-earlier levels. In contrast, insured institutions located outside the Midsouth reported virtually no change in median loan loss reserves to total loans and coverage of noncurrent loans during this period.[20]

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[19] The median cost of funds as a share of earning assets dropped from 4.08 percent in third quarter 2001 to 2.51 percent in third quarter 2002.

[20] The median allowance for loan and lease losses to total loans ratio in third quarter 2002 was 1.32 percent for insured institutions in the Midsouth and 1.23 percent for insured institutions elsewhere in the nation. Median coverage ratios were 157 percent of noncurrent loans for Midsouth institutions and 166 percent for institutions elsewhere in the nation.

Southwest Economic and Banking Conditions

Are Certain Housing Markets Vulnerable to Home Price Depreciation?

Although a majority of economists polled by the ***National Association of Business Economics***[1] do not expect U.S. home prices to decline nationwide in the near term, some believe prices in certain metropolitan areas could fall because of deteriorating market conditions. This article identifies metropolitan statistical areas (MSAs) in the Southwest Region that could be vulnerable to the effects of declining home prices and discusses the factors that are contributing to this vulnerability.

Generally, a housing price bubble exists when the expected rate of increase in home prices exceeds what market fundamentals will support. The potential for the development of "bubbles" can be determined in several ways; however, two commonly used approaches rely on either an econometric model or a price-to-income ratio.[2] Our analysis uses the *ratio of median home price to per capita personal income*,[3] an approach based on the premise that, although home prices can rise rapidly relative to income growth in the short run, housing price appreciation cannot significantly exceed personal income growth over time.

[1] See "NABE Outlook Panel: Recovery on Solid Footing without Further Stimulus," September 2002, http://www.nabe.com/mem/mac02/mac0209.pdf.

[2] For a discussion of modeling house price bubbles using an econometric model, refer to Jesse M. Abraham and Patric H. Hendershott, "Bubbles in Metropolitan Housing Markets," *Journal of Housing Research*, Vol. 7, Issue 2, 1996 (Fannie Mae Foundation). A discussion of the price-to-income ratio method appears in Shelly Dreiman, "Using the Price to Income Ratio to Determine the Presence of Housing Price Bubbles," *House Price Index Fourth Quarter 2000*, March 1, 2001 (Office of Federal Housing Enterprise Oversight).

[3] For more detailed information on this methodology, refer to Michael D. Youngblood, "Is There a Bubble in Housing? New Evidence from 123 Housing Markets," *The Market Pulse*, Vol. VIII, Issue 4, 2002.

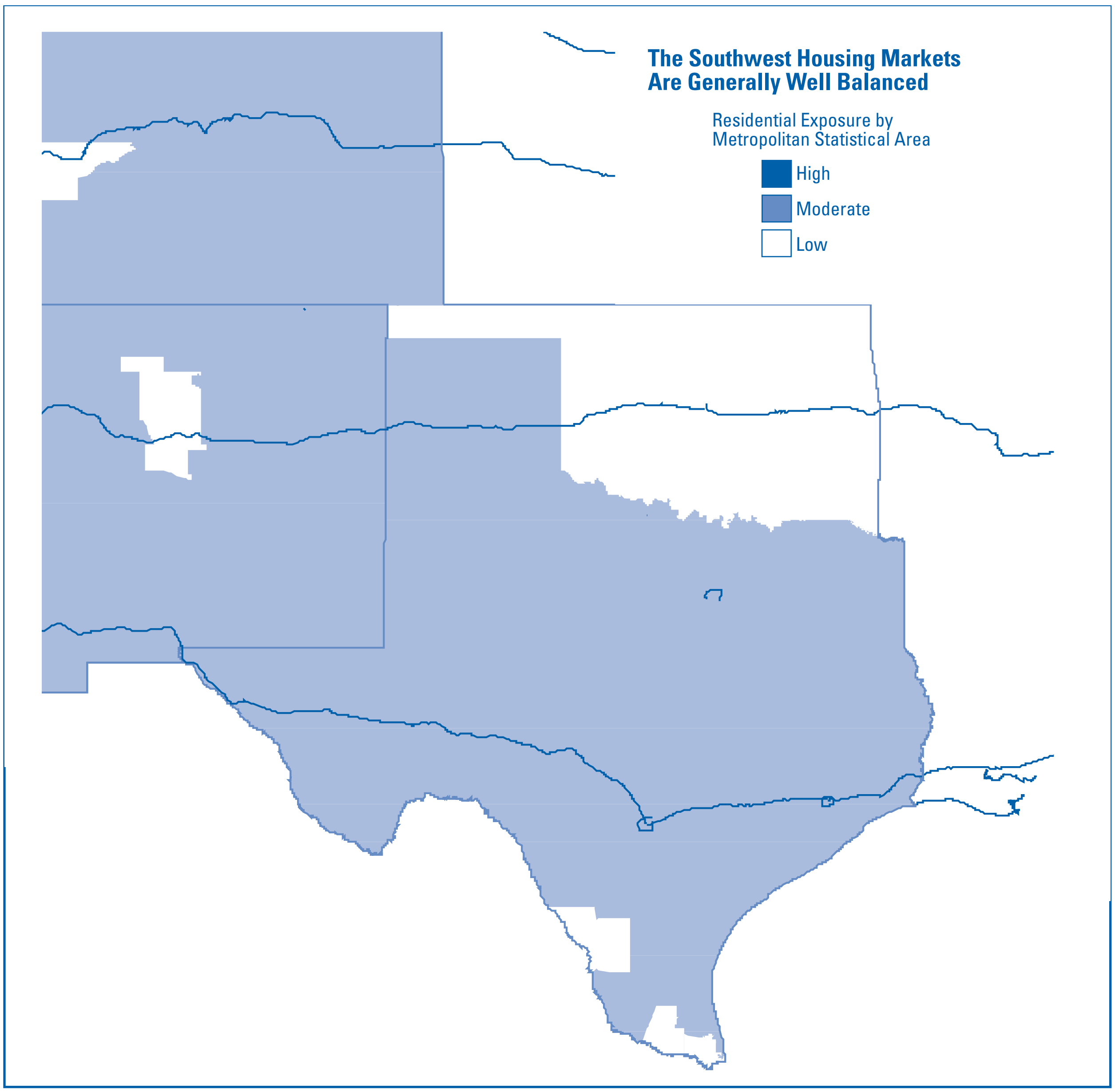
Our analysis identified three MSAs in the Southwest Region as vulnerable to the development of housing price bubbles: **Colorado Springs**, **Denver**, and **Greeley, Colorado** (see Map 1).[4] Home price appreciation has begun to slow (see Chart 1, next page) and is expected to weaken further in these markets during 2003 because of continuing weakness in the local economies and relatively low affordability.

[4] Forty-two metropolitan areas were studied using median home price data from the ***National Association of Realtors*** and per capita personal income figures from the ***U.S. Bureau of Economic Analysis and Bureau of the Census***. Economy.com provided both data series.

Employment continues to slump in the high-tech manufacturing and telecommunications sectors in the Denver and Colorado Springs MSAs. Layoffs are occurring in these metro areas, and in 2002 both MSAs are expected to record the first annual job declines since the mid-1980s. Moreover, the recovery in the information technology sector in these MSAs likely will lag the U.S. recovery; as a result, ***Economy.com*** is forecasting a second consecutive year of job declines for these two MSAs in 2003.[5]

[5] Economy.com *Précis Metro* report, December 2002.

Map 1

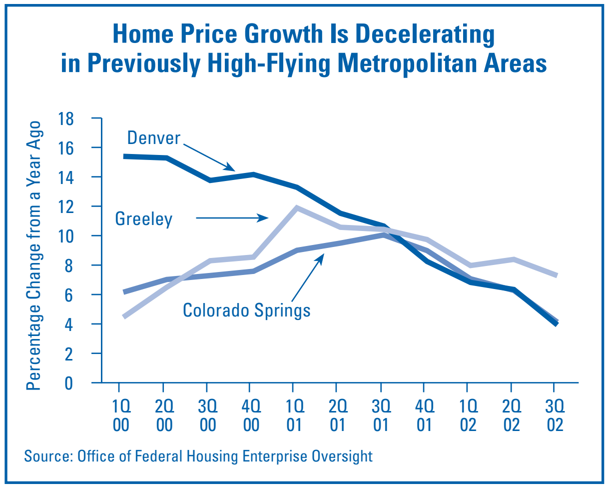


Job losses have contributed to declines in personal income growth in these two metro areas, trends that are constraining the demand for housing in the near term. Despite the lowest mortgage rates in more than 30 years, demand for housing in these MSAs has waned during the past year as the number of unsold homes has surged.[6] Moreover, an oversupply of homes[7] has occurred despite a slight decline in single-family housing permits during the first 11 months of 2002. Any further softening in demand could contribute to additional slowing of home price appreciation. Economy.com has identified the housing markets in these two MSAs as "highly overpriced" and vulnerable to a decline in home values.[8]

The Greeley, Colorado, economy continues to contract because of weakness in the manufacturing, construction, and trade sectors. The Greeley MSA housing market is slowing due to declining employment growth, weaker income growth, and a tapering off in housing demand. Consequently, home price appreciation has decelerated and, according to Economy.com, an oversupply of single-family housing has developed since the late 1990s.[9] The combination of weak employment and income growth and relatively low affordability is expected to constrain home price appreciation in the Greeley MSA to levels at or below the general rate of inflation in 2003.

While our analysis did not flag the **Austin** and **Dallas** MSAs' housing markets as being vulnerable to the development of home price bubbles, they deserve mention. Employment losses in these MSAs equaled or exceeded the national average during 2001 and 2002. Slumping employment already has placed downward pressure on home prices, particularly in the Austin metro area, that may carry over into 2003. The fact that appreciation in home prices already has begun to slow, allowing the gap between home prices and income to narrow,[10] helps to explain why our approach did not identify these two MSAs.

Chart 1



The deterioration in employment growth in the Austin MSA is the result of weakening demand and a buildup of excess capacity in the personal computer and semiconductor industries. This situation was aggravated by the stock market decline, problems in the technology industry, and drying up of venture capital and initial public offerings. The Dallas MSA was adversely affected by the recent recession and the fallout from September 11, which resulted in significant layoffs in the high-tech (particularly telecommunications) and travel industries, pushing the metro area's unemployment rate to 7 percent in third quarter 2002.

Employment growth is expected to remain subdued in Austin and Dallas during much of 2003,[11] as relatively high exposure to the ailing computer, telecom, semiconductor, airline, and energy industries is expected to slow economic recovery. Slower job growth and continued high levels of single-family housing construction likely will constrain home price appreciation in these markets. According to a study conducted by ***PMI Mortgage Insurance Co.*** in September 2002,[12] the Austin and Dallas MSAs were considered to be at high and medium risk, respectively, of slowing in home price appreciation because of continuing employment weakness.

In addition to vulnerability to slowing in home price appreciation, sustained economic weakness like that in the Denver, Colorado Springs, and Greeley MSAs

[6] Listings of homes for sale in December 2002 were up 25.5 percent in Colorado Springs (*Pikes Peak Association of Realtors*) from a year ago, and 23 percent in the Denver area (*Denver Metro Chamber of Commerce*) for the 12-month period ending October 2002.
[7] Colorado Office of State Planning and Budgeting, *Colorado Economic Perspective*, December 20, 2002, p. 38.
[8] Celia Chen, "House Price Bubbles," *Regional Financial Review*, Vol. XIII, No. 8 August 2002.
[9] Economy.com *Précis Metro* report, Greeley, Colorado, December 2002.
[10] Home price growth in the Austin MSA declined from 15 percent in third quarter 2000 to slightly below 4 percent in third quarter 2002. Home price appreciation in the Dallas MSA, which averaged 6 to 7 percent in recent years, slowed to around 2 percent by mid-2002 (Sources: National Association of Realtors and Economy.com report).

[11] Economy.com forecasts annual employment growth of 1.4 percent and 0.6 percent for Austin and Dallas, respectively, in 2003, well below the long-term growth rates of the 1990s.
[12] PMI Mortgage Insurance Co., *Economic and Real Estate Trends*, Walnut Creek, California, September 2002.

could exacerbate any deterioration in residential credit quality. The next section provides an overview of banking industry fundamentals in the Southwest Region.

Weakness in Residential Credit Quality Has Not Yet Emerged among Mortgage Lenders in the Southwest Region

Low mortgage rates have contributed to a robust housing sector and have helped to fuel home price appreciation in many metropolitan markets across the nation. The lowest mortgage interest rates in more than 30 years also have spurred record purchase and refinancing activity. The ***Mortgage Bankers Association*** estimates that more than $2.4 trillion in mortgage volume will be originated in 2002, the highest amount on record. However, at the same time, past-due and foreclosure rates for certain types of mortgage loans continue to climb. FHA (Federal Housing Administration) and VA (Veterans Administration) loans reported near-record past-due levels of 11.6 percent and 7.8 percent, respectively, as of September 30, 2002.[13] At 3.0 percent, conventional mortgage past-due rates are among the highest since the 1990–91 recession. Foreclosure rates for FHA and conventional mortgages also are at relatively high levels. These trends are problematic given the record number of new homebuyers who have purchased homes at higher prices. Should home values decline or price appreciation slow dramatically, past-due and foreclosure rates could climb higher.

In light of these trends, we may expect deterioration to emerge in insured institution mortgage portfolios, particularly among banks and thrifts lending in markets discussed in this article. However, insured institutions in the Southwest Region reported a past-due ratio of 2.13 percent for direct residential mortgages[14] held as of September 30, 2002, slightly lower than a year ago.[15] Nationally, insured institutions reported similar levels of past-due mortgage loans.[16] Banks and thrifts in the Southwest Region and nationwide also reported significantly lower residential charge-off rates than conventional, FHA, or VA mortgages.

It is important to note that mortgage lenders operating in the MSAs discussed in this article[17] have not reported higher past-due or charge-off rates than insured institutions in other metro areas in the Southwest Region. This can be explained, in part, by the fact that banking performance generally lags economic performance, suggesting that should the current economic weakness continue, particularly in markets in which home price appreciation continues to outpace household income, deterioration in residential portfolios may yet emerge. Second, most insured institutions have greater proportions of conventional mortgage loans, rather than FHA and VA loan pools, which feature higher loss and delinquency rates. Third, equity as a percentage of total home value was 56 percent for third quarter 2002, according to data provided by the ***Federal Reserve Board Flow of Funds.*** Although this ratio has declined from 70 percent 20 years ago, the equity position continues to provide an opportunity for borrowers to work out problems by selling the property or refinancing to lower cash flow requirements. Finally, low interest rates and competition for mortgage originations have allowed many homeowners to refinance and tap home equity. However, should interest rates rise, refinancing activity would be expected to slow.

Trends to Watch

Overall, insured financial institutions headquartered in the Southwest Region continue to report strong profitability and equity levels. During the nine months ending September 30, 2002, institutions reported an aggregate return on assets of 1.45 percent, the highest level since 1993. Similarly, equity plus the reserve for loan and lease losses reached a peak of 10.14 percent of total assets as of the end of third quarter 2002. Although weakness in insured institution residential credit quality has not emerged, some banks and thrifts may be susceptible to earnings pressure if mortgage originations fall. The Mortgage Bankers Association forecasts mortgage originations in the amount of $1.7 trillion for 2003, the third highest level on record. However, this projection represents a 28 percent decline from 2002 estimates and could adversely affect the profitability of insured institutions that rely on mortgage lending to generate fee income.

Southwest Staff

[13] Data provided by the Mortgage Bankers Association.

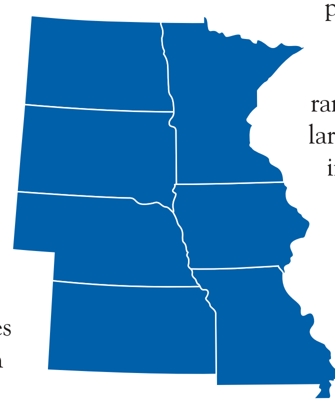
[14] Direct mortgages refer to mortgages originated and held in an insured institution's mortgage portfolio, which may or may not be underwritten under conventional mortgage guidelines.

[15] FDIC Bank and Thrift Call Report data.

[16] The average past-due rate for insured institutions in the nation was 2.14 percent as of September 30, 2002.

[17] Insured institutions considered in this analysis hold more than 25 percent of loans in direct mortgages and report total assets less than $5 billion. As of September 30, 2002, there were 451 such insured institutions in the Southwest Region, or one-third of the Region's banks and thrifts.

Kansas City Regional Perspectives



The Kansas City Region economy was affected adversely during 2002 by the national recession and severe drought conditions. Employment growth[1] was negative in 2002 for the second consecutive year as manufacturing layoffs continued (see Table 1). Heavy layoffs in **Missouri's** manufacturing and retail sectors, two industries that employ a disproportionately high share of the state's workers, were announced in 2002. The **North Dakota** and **Minnesota** economies also were affected significantly by contraction in the manufacturing sector, as well as in the mining industry. Despite substantial layoffs among **Wichita's** aircraft manufacturers and **Overland Park's** telecommunications sector, the **Kansas** economy posted a relatively high level of employment growth compared with other states in the Region. Continued strength in transportation and government employment helped to offset losses in other industries.

Table 1

The Region's Employment Growth Was Negative Again in 2002

	Year-over-Year Employment Growth (%)				
	2002	2001	2000	1999	1998
Nebraska	0.5	0.1	1.8	1.9	2.5
Kansas	0.4	1.0	1.3	1.1	3.4
South Dakota	0.4	0.4	1.1	2.7	2.4
Iowa	–0.2	–0.6	0.7	1.8	2.6
North Dakota	–0.4	0.8	1.3	1.3	1.6
Minnesota	–0.6	0.0	2.4	2.3	2.6
Missouri	–1.5	–0.6	0.8	1.5	1.7
Kansas City Region	–0.5	–0.1	1.4	1.8	2.4
Nation	–0.3	0.2	2.3	2.3	2.6

Sources: Bureau of Labor Statistics; Haver Analytics

The slowdown in employment also has affected the Region's commercial real estate markets adversely. For example, office vacancy rates in the **Minneapolis** metropolitan statistical area (MSA) reached 18.6 percent by September 30, 2002 (compared with 16.1 percent for the nation), up from 12.2 percent at year-end 2001.[2] The Minneapolis MSA vacancy rate ranked 15th among the nation's 53 largest metropolitan areas. Vacancy rates in the **Kansas City** and **St. Louis** office markets also are above the national average. Industrial market vacancy rates in these MSAs have almost doubled since 1999. However, only the St. Louis metropolitan area, with an industrial vacancy rate of 11.4 percent, exceeds the national rate of 10.9 percent.

Severe drought conditions continue to affect the Region's western states. Normally, drought conditions abate somewhat with fall precipitation, but continued dry weather has left drought conditions unchanged since midsummer 2002. Nebraska continues to be affected most adversely, with approximately two-thirds of its land area in "severe" or "exceptional" drought.[3] The state's corn, wheat, and soybean harvests declined about 20 percent compared with 2001 levels, and hard-hit pasturelands made it difficult for ranchers to feed their herds. Farmers' strong equity positions and reliance on crop insurance appear to have mitigated much of the drought's negative effect in 2002. However, if drought conditions continue into the summer of 2003, local economies dependent on the agricultural sector may weaken considerably.

Despite the weak economy and the effects of the drought, the Region's community banks[4] continued to report sound conditions and performance during third quarter 2002 (see Table 2). Earnings remained healthy as measured by posttax and pretax measures. Net interest margins were bolstered early in 2002 by a steeply

[1] National recessions typically are measured by total output; however, state-level performance typically is measured by employment growth.

[2] Vacancy rate data are provided by Torto-Wheaton Research. Vacancy rates for major markets in the Kansas City Region are calculated as the ratio of unleased space to total leased and unleased space.

[3] *U.S. Drought Monitor*, December 10, 2002. http://drought.unl.edu/dm. The *U.S. Drought Monitor* is a joint project of the National Oceanic and Atmospheric Administration and the United States Department of Agriculture.

[4] "Community banks" are defined in this article as insured institutions that hold $250 million or less in assets, excluding de novo and specialty institutions. Thrifts were excluded because of their dissimilarities to commercial banks.

Table 2

The Region's Community Banks Continue to Report Healthy Conditions	3Q02	3Q01	3Q00	3Q99	3Q98
Return on Assets (%)	1.31	1.17	1.26	1.22	1.28
Pretax Return on Assets (%)	1.63	1.48	1.65	1.63	1.76
Net Interest Margin (%)	4.24	4.10	4.28	4.20	4.34
Past-Due and Nonaccrual Loan Ratio (%)	2.22	2.31	2.02	2.09	2.16
Leverage Capital Ratio (%)	10.52	10.38	9.92	9.91	10.40
Loan Loss Reserves/Loans (%)	1.39	1.40	1.41	1.46	1.46

Source: Call Reports, commercial banks in the Region with less than $250 million in assets, excluding new banks and specialty banks

sloped yield curve, which helped community banks recover some of the 2001 margin losses caused by rapidly declining interest rates. Levels of past-due loans remained moderate in the aggregate at September 30, 2002. However, 11 percent of the Region's community banks reported past-due ratios exceeding 5 percent, a relatively high industry benchmark. Capital levels remain high compared with historical levels, and loan loss reserves are keeping pace with the level of problem loans.

Despite Recent Deposit Growth, Community Banks Continue to Face Funding Challenges

Throughout most of the 1990s, funding among the Region's insured institutions steadily shifted from core funds to noncore funds.[5] This shift contributed to a rise in community banks' cost of funds, driving net interest margins downward and pressuring banks to engage in strategies that may have heightened the level of credit risk. The weak economy and significant declines in the stock market have prompted the greatest shift of deposit funds into the banking system since the early 1990s. Although community banks have shared in this deposit boom, most of the benefit has accrued to the nation's larger banks. Funding pressures have been alleviated, at least temporarily, but could resume if the economic recovery takes hold and equity markets strengthen.

Noncore Funds Grew in Importance in the 1990s

The national median core funding ratio[6] declined from a peak 91.4 percent in December 1992 to 81.2 percent by September 2000 (see Chart 1, next page). Strong equity markets during the 1990s were a primary contributor, attracting a significant volume of funds from lower-yielding bank deposits. The Wilshire 5000 index posted double-digit returns for six straight years beginning in 1995, with returns in excess of 20 percent from 1996 through 1998. This high-return environment made it difficult for banks to compete for funds when time deposits were paying single-digit rates.

In addition, the proliferation of investment options during the 1980s and 1990s—for example, money market mutual funds, which compete directly with core bank deposits—blurred the distinction between bank and nonbank products. The share of household deposits invested in money market mutual funds grew from 0.3 percent in 1974 to 23.1 percent by 2001.[7]

The funding shift in the Kansas City Region tracked the national trend during the 1990s. The median core funding ratio declined from a peak 93.9 percent in December 1992 to 84.0 percent in September 2000. Although the Region's decline tracks the nation's, this decline holds greater significance for banks in the Region because of differences in bank size and geographic location. Community banks typically rely more on core deposits than do larger banks, and the Kansas City Region has a higher concentration of community banks than the rest of the nation (see Table 3, next page). Larger banks consistently operate with

[5] Core deposits include checking account deposits, savings account and money market account deposits, and time deposits in denominations under $100,000. Noncore funds include time deposits in denominations of $100,000 or more and other borrowings, such as federal funds purchased, securities sold under agreements to repurchase, and borrowings such as Federal Home Loan Bank advances.

[6] The core funding ratio is calculated by dividing core deposits by the sum of total funds.

[7] Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States—Flows and Outstandings," reported via Haver Analytics.

substantially lower volumes of traditional core deposits than smaller banks (see Chart 1). This is not surprising given that larger institutions typically have access to a greater array of noncore funding sources, such as commercial paper and sales of asset securitizations.

These noncore funding sources often are associated with revenue-producing activities other than traditional loan and investment interest income. Larger banks typically have been more successful at diversifying revenue streams. Nationally, net interest income represented 75 percent of total income for banks with assets over $1 billion in 2001, compared with 87 percent for community banks headquartered in the Kansas City Region. Moreover, core funding takes on added importance for community banks with a significant presence in rural communities facing long-term negative growth. The Kansas City Region is experiencing severe, widespread rural depopulation.[8] Core funds, long the staple of rural banks, are becoming difficult to attract or retain.

Greater Reliance on Noncore Funds Increases the Cost of Funds and May Heighten Credit Risk

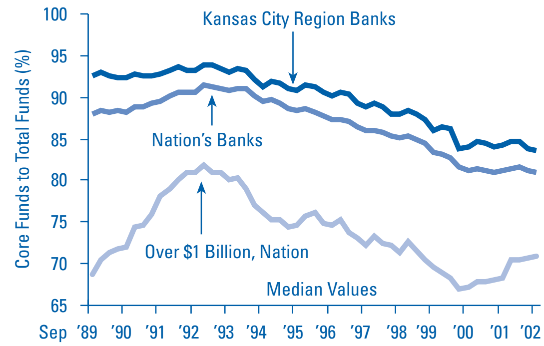
The shift toward greater use of noncore funds throughout the 1990s adversely affected community banks' cost of funds. Generally, large time deposits and other noncore funds, such as advances from the Federal Home Loan Bank System, are more costly than core deposits, such as checking and money market accounts. Community banks that increased reliance on noncore funds during the past ten years experienced steadily increasing interest costs compared with banks that maintained relatively high levels of core funding (see Chart 2).

Not surprisingly, the overall rising cost of funds among the Region's community banks, coupled with intense pricing competition on the asset side of the balance sheet, led to steady erosion in community banks' net interest margins (NIMs). The aggregate NIM declined from 4.55 percent at September 1992 to 4.24 percent ten years later. Net interest margin pressures, combined with strong loan demand, prompted many community bankers to heighten credit exposure. The aggregate loan-to-asset ratio of the Region's community banks increased from 53.7 percent to 65.5 percent during the

[8] A detailed discussion of rural depopulation trends appears in *Kansas City Regional Perspectives*, first quarter 2000.

Chart 1

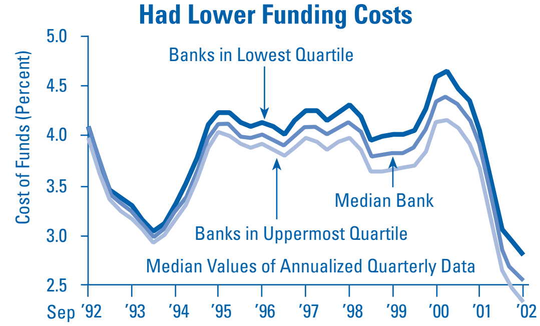
Core Funding Has Stabilized after Years of Decline



Note: Excludes credit card and specialty banks. Not merger adjusted.
Source: Bank Call Reports

Chart 2

Kansas City Region Banks That Maintained Core Funds Had Lower Funding Costs



Note: Banks are grouped into quartiles by the proportion of September 2002 core funding ratio to September 1992 core funding ratio.
Source: Bank Call Reports, Kansas City Region banks in continual existence September 1991 through September 2002, excluding credit card banks and other small specialized banks

Table 3

The Kansas City Region Has a Greater Proportion of Community Banks and Rural Banks than the Rest of the Nation

Kansas City Region % of Total Banks		Rest of Nation % of Total Banks
91.3	Banks with assets of $250 million or less	76.5
1.5	Banks with assets exceeding $1 billion	6.3
65.5	Banks headquartered in rural counties	39.4

Note: "Community banks" are defined as insured institutions that hold $250 million or less in assets, excluding de novo and specialty institutions. Thrifts are excluded from this table.

Rural counties are nonmetropolitan statistical area counties that have urban populations under 20,000.

Source: September 2002 Bank Call Reports same period. As loans typically carry more credit risk than other assets, this trend suggests that community bankers are increasing their tolerance for risk. Even so, higher loan concentrations did not prevent margin erosion during the 1990s.

Recent Deposit Inflows Do Not Signal a Reversal of Funding Pressures

Historically, funds flow out of the banking industry and into the equity and bond markets during times of economic prosperity and flow back into insured deposits during economic downturns. This trend has held true recently as a dramatic outflow of funds from banks occurred during the 1990s economic expansion, and funds returned to insured deposits during the recent recession. Household assets deposited in checking, savings, and time deposit accounts increased 9.3 percent in the five quarters ending September 30, 2002. Household assets deposited in money market mutual funds declined slightly during that period.

Although funds are returning to the banking system, much of the inflow is concentrated in the nation's largest banks. The annualized core deposit growth rate for the nation's 100 largest banks in existence during the past six years was 9.0 percent in the two years ending September 30, 2002, up from 1.1 percent in the four years ending September 30, 2000 (see Table 4). The Region's community banks in existence during the past six years reported a more moderate increase in growth rates, from 4.4 percent (October 1996 through September 2000) to 6.0 percent (October 2000 through September 2002). This core deposit flow allowed community banks to slow the growth of noncore funds significantly. *Note, however, that despite the deposit inflows during a weak economy, growth in noncore funds continued to exceed growth in core deposits.* If economic and market stability return, community banks may face long-term funding challenges again.

The account mix of core deposit growth further emphasizes this point. Although consumers are moving funds into banks, they are placing these funds in readily accessible accounts. Much of community bank deposit growth has occurred in checking, savings, and money market accounts, while time deposit growth has declined significantly (see Table 4). Apparently, although depositors are seeking the safety of insured deposits, they are not willing to lock into long-term commitments. If the stock market rebounds and funds begin to move from banks into the equity markets, community banks will find it increasingly difficult to attract and retain core deposits.

Table 4

Community Bank Core Deposit Growth Rates Have Increased Recently

	Community Banks Kansas City Region	Top 100 Nation
Annualized Growth Rates (%)—September to September		
Total deposits		
1996 through 2000	5.47	4.51
2001 through 2002	6.02	4.35
Core deposits		
1996 through 2000	4.42	1.13
2001 through 2002	6.07	8.95
Checking and savings		
1996 through 2000	4.87	2.81
2001 through 2002	10.28	14.66
Small time deposits		
1996 through 2001	4.00	–1.34
2001 through 2002	1.48	–10.03
Total noncore funds		
1996 through 2000	20.12	10.70
2001 through 2002	6.47	–0.60
Large time deposits		
1996 through 2000	15.08	13.23
2001 through 2002	5.65	–1.41
Other noncore funds		
1996 through 2000	32.87	9.19
2001 through 2002	7.91	3.26

Note: This table refers to community banks headquartered in the Kansas City Region for the past six years. The "Top 100" category refers to the largest banks in operation during the past six years, with asset sizes ranging from $7 billion to $605 billion.

"Community banks" are defined as insured institutions that hold $250 million or less in assets, excluding denovo and specialty institutions. Thrifts are excluded from this table.

Source: Bank Call Reports, merger adjusted

Therefore, community bankers must continue to monitor the long-term funding situation to ensure that lending and investment strategies related to core deposit inflows are appropriate. Moreover, managers should revisit the accuracy of current funding measurement tools. Do these tools help management identify and segregate shifts in funds among deposit accounts (for example, from certificates of deposit to money market accounts) from new funds flowing into the bank?

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New York Regional Perspectives

Mid-Atlantic Economic and Banking Conditions

Employment Growth in Some Mid-Atlantic Cities Has Not Kept Pace with the Nation

While employment trends in the nation and the Mid-Atlantic Region improved modestly between March and October 2002, several of the Region's metropolitan statistical areas (MSAs) did not keep pace.[1] This article identifies MSAs that experienced a significantly higher rate of job contraction than the nation through October 2002 or exhibited weaker employment growth despite improvement nationwide.[2] Most of them are small cities (labor force less than 1 million) with high concentrations of manufacturing jobs. Negative employment trends in some MSAs also reflect job cuts in state and municipal governments that have been affected adversely by the national recession. If these MSAs continue to lag the nation, banking conditions there could be negatively affected. The effects of the economic weakness will vary with differences in insured institutions' business lines and risk profiles.[3] (Employment data for the Region's MSAs are provided in the Appendix.)

MSAs That Lagged National Employment Trends Are Generally Smaller and Dependent on the Manufacturing Sector

The **Rochester, New York**, economy relies more on manufacturing jobs than does the nation; manufacturing represents 18 percent of employment in Rochester compared with 13 percent for the nation. The rate of job contraction in Rochester eased between August and October 2002, similar to the national trend. However, as of October, Rochester's rate of job growth (minus

1.46 percent) remained lower than the nation's (minus 0.64 percent). The Rochester economy has been weakened by problems in technology-intensive firms, such as Global Crossing, Kodak, Xerox, and Corning, all of which announced significant layoffs during the recent recession. Similarly, the **Elmira** and **Binghamton**, New York (minus 2.22 percent) MSAs lost jobs more rapidly than the rest of the nation during this period.[4] These two MSAs rely heavily on computer hardware and telecommunications equipment manufacturing, industries that have experienced overcapacity. While the overall rate of job loss improved slightly in Binghamton between March and October, it declined in Elmira.

Consistent with employment contraction, credit quality among insured institutions headquartered in the Rochester and Binghamton/Elmira MSAs has weakened in recent years. In the case of Binghamton/Elmira, credit quality has weakened to a greater extent than the national trend (see Table 1). However, institutions headquartered in Binghamton/Elmira are less heavily concentrated in commercial real estate (CRE) and commercial and industrial (C&I) lending, typically higher-risk lending businesses. Nevertheless, the ratio of the allowance for loan and lease losses (ALLL) to noncurrent loans has declined to a greater extent than for insured institutions across the nation and may be pressured further if the local economy continues to lag the nation.

Insured institutions headquartered in the Rochester MSA have increased their concentrations in CRE and C&I loans to levels that are higher than elsewhere in the nation, with the median CRE loan concentration to capital doubling during the past four years. The past-due loan ratio for banks and thrifts headquartered in this MSA equaled the nation's as of third quarter 2002,

[1] Employment growth for the nation, excluding the Mid-Atlantic Region, reached a floor of approximately minus 1.37 percent in February 2002 and improved to minus 0.37 percent by October 2002. Job growth for the Mid-Atlantic Region bottomed in December 2001 at minus 1.12 percent and eased to minus 0.51 percent by October 2002.
[2] For comparative purposes, national employment data exclude the Mid-Atlantic Region. Employment growth is measured by the year-over-year change in the trailing three-month moving average of employment for each MSA and the nation.
[3] Banking data for the Region's MSAs represent medians.

[4] Employment data for the Binghamton and Elmira MSAs are combined.

Table 1

Risk Profiles for Insured Institutions Vary among Metro Areas That Have Lagged the Recovery

Metropolitan Area	Number of Institutions	Tier 1 Capital Ratio (%)	C&I and CRE Loans to Capital (%)	Past-Due Ratio (%)	ALLL Coverage of Noncurrent Loans (%)	ALLL to Total Loans (%)
Allentown	14	8.90	119	1.22	151	1.05
Binghamton/Elmira	15	8.11	256	2.65 ▲	140 ▼	1.17
Johnstown	10	8.55	223	2.17 ▲	153	0.90 ▼
New York City	76	8.68	310	1.12	170	1.12
Rochester	13	8.15	318 ▲	1.85	118	1.05 ▼
Washington, D.C.	58	8.80	342 ▲	0.74	361	1.19
Wilmington	21	9.87	255	1.80	166	1.43
U.S. Excluding Mid-Atlantic	6,183	8.87	297	1.87	167	1.22

Notes: Past-due loans are loans 30 days or more past due or in nonaccrual status. Noncurrent are loans 90 days or more past due or in nonaccrual status.
CRE = commercial real estate. C&I = commercial and industrial loans.
Includes metropolitan statistical areas (MSAs) with at least ten insured institutions; therefore excludes the Mayaguez, Puerto Rico, and Trenton, New Jersey, MSAs.
Analysis excludes credit card and agricultural banks, and banks in operation less than three years. Banks with total assets over $10 billion also are excluded, as operations likely extend beyond the metropolitan area in which these institutions are headquartered.

Triangle denotes an indicator that increased to a greater extent than the U.S. average during the past two years *and* that was above the U.S. average as of September 30, 2002. However, a triangle appearing in the ALLL coverage ratio columns indicates that a value has declined more than the U.S. average *and* had fallen below the U.S. average as of the end of third quarter 2002.

Binghamton/Elmira includes the Binghamton and Elmira MSAs plus the surrounding Chenango, Cortland, Steuben, and Schuyler counties.
Johnstown includes the Johnstown MSA plus Bedford County.
Rochester includes the Rochester MSA plus the surrounding Seneca, Wyoming, and Yates counties.

Source: Bank and Thrift Call Reports

but loan charge-offs have outpaced the national average during the past year. Insured institutions in Rochester, on average, have increased provision expenses to replenish loan loss reserves; however, ALLL coverage remains well below the national average.

Employment in **Johnstown** and **Allentown, Pennsylvania**, has contracted since first quarter 2002, and the rate of job decline worsened through October. Although manufacturing sectors in these MSAs continued to shrink, job losses have been widespread across industries. In Johnstown, for example, losses in manufacturing have been compounded by layoffs in the retail trade and transportation and public utilities sectors. In Allentown, job declines have also occurred in the retail trade and services sectors.

Insured institutions headquartered in the Johnstown MSA have reported increases in loan delinquencies, consistent with the decline in employment conditions. The comparatively high median past-due loan ratio among banks and thrifts in this MSA is mitigated somewhat by a lower concentration of CRE and C&I loans to capital. One-half of insured institutions in the Johnstown MSA focus on residential mortgage lending. Insured institutions headquartered in the Allentown MSA had not reported deterioration in credit quality, on average, through third quarter 2002. Nonetheless, banks and thrifts in this MSA reported a lower median ALLL coverage level, potentially increasing their vulnerability to continued weakening in the local economy. However, modest commercial loan concentrations among insured institutions in Allentown likely would mitigate any weakening in asset quality.

Employment in many cities in **Puerto Rico** has weakened because of a confluence of factors. First, the manufacturing-led recession in the U.S. mainland has contributed to job cuts in the island's manufacturing sector. Second, the phase-out of Section 936 tax incentives provided to U.S.-based companies operating in Puerto Rico[5] has contributed to the departure of some manufacturers, primarily labor-intensive industries such as food and apparel, to neighboring countries with lower labor costs. Finally, softness in the tourism industry and competition from other destinations has filtered throughout the island's economy. Manufacturing jobs in **Mayaguez** contracted significantly during much of 2002. Manufacturing represents approximately 18 percent of this MSA's employment, second to the government sector. The rate of job loss in the Mayaguez MSA deteriorated more quickly than in any other MSA in the Mid-Atlantic Region from March 2002 to October

[5] The 936 tax credit, which provided tax incentives to U.S.-based companies operating in Puerto Rico, expires over a ten-year period ending in 2005. The Puerto Rican government has enacted several incentives to help replace Section 936.

2002. Consistent with employment declines, credit quality has weakened among insured institutions headquartered in Puerto Rico. The median past-due ratio has increased on par with the national trend and may increase further if employment weakness continues.

Manufacturing is not the only sector responsible for job losses in lagging areas. Employment losses in the **Wilmington, Delaware**, MSA occurred in the financial services and state government sectors as well. This MSA's financial services sector employs more people than the manufacturing sector, and many of those jobs are more highly compensated. Employment in financial services weakened steadily from September 2001 through October 2002. Although employment declines decelerated slightly nationwide between August and October 2002, jobs were lost at an increasing rate in the Wilmington MSA. Insured institutions headquartered there reported an increase in the past-due ratio through third quarter 2002, similar to the national trend.

The situation in **Trenton**, **New Jersey**'s capital shows the serious fiscal problems many states face as a result of the recent recession. During first quarter 2002, as the nation was losing jobs, Trenton reported slightly positive job growth. The state's growing budget imbalance, however, resulted in the layoff of more than 3,500 government employees in July 2002. Job losses also have occurred in the city's financial services and broader services sectors. The rate of job loss in Trenton between March and October 2002 was second in the Mid-Atlantic Region only to that of Mayaguez. Most insured institutions headquartered in the Trenton MSA reported past-due loan ratios below the national average through third quarter 2002. However, employment conditions weakened later in Trenton than in the rest of the nation. As credit quality typically lags economic conditions, job declines could pressure loan delinquency rates for insured institutions in the Trenton MSA.

Employment Rates in Most of the Mid-Atlantic Region's Larger Cities Kept Pace with the Nation

Employment growth in most of the Region's larger cities (labor forces greater than 1 million)[6] kept pace with the nation through October 2002. Excluding the MSAs that experienced the highest rate of job growth (**Nassau-Suffolk**, New York, at 0.15 percent) and the lowest (**New York City** at minus 1.67 percent), employment grew at very similar rates in all the Region's large cities. Moreover, except for **Washington, D.C.**, where the rate of job loss increased through October, the rate of employment growth in the Region's large cities has paralleled that of the nation.

While employment in the New York City MSA continued to contract more rapidly than that of the nation, the rate of job loss has improved.[7] Employment declined 3.1 percent during first quarter 2002, compared with 1.7 percent during third quarter 2002. Employment trends in New York City's retail sector and business services sector also improved during 2002. In October 2002, the retail sector posted the first net gain in hiring since September 2001. However, job losses in the business services, manufacturing, transportation, and financial services sectors have been significant. The MSA is particularly vulnerable to further cutbacks or reduced compensation in the securities industry. While this industry represented approximately 5 percent of the jobs in Manhattan, it accounted for almost 21 percent of total salaries and wages because of its high compensation levels.[8] Like other cities in the Region, New York City faces a large fiscal imbalance that has prompted cuts in government employment. To help balance the budget, the city government approved an 18.5 percent property tax increase in November 2002, which could have broad and perhaps negative implications for the local economy.

Loan quality remained favorable among insured institutions headquartered in the New York City MSA, on average, through third quarter 2002. Loan delinquency rates have remained well below national averages across loan types, although the median residential loan delinquency rate increased during 2002. Residential loan quality may be pressured because of the property tax increase and a potential contraction in city government employment. Tax increases also likely will pressure commercial property cash flows. Exposure to CRE and C&I loans, typically higher-risk loan types, has increased among insured institutions headquartered in the New York City

[6] The Region's metropolitan areas with a labor force greater than 1 million people are New York City, Washington, D.C., Philadelphia, Nassau-Suffolk, New York, Baltimore, Pittsburgh, and Newark.

[7] The New York City MSA includes the five New York City boroughs as well as Putnam, Rockland, and Westchester counties.

[8] Office of the State Deputy Comptroller for the City of New York, "Review of the Four-Year Financial Plan for the City of New York," December 2002.

Large Bank Profitability Has Declined with Shrinking Market-Sensitive Revenues

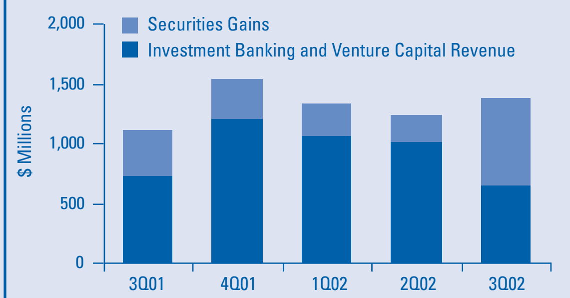
Large banks (those with total assets over $10 billion) headquartered in the Mid-Atlantic Region reported a decline in the median return on assets, from 1.41 percent in second quarter 2002 to 1.30 percent in the third quarter. The median net interest margin was flat over the period as asset yields declined with funding costs. Provisions moderated for most of the Region's large banks in third quarter 2002. However, money center banks reported increased provisions on average during the quarter in response to continued weakness in corporate credit quality. Noninterest income declined moderately in third quarter 2002, largely because of declines in revenue from investment banking business lines, such as underwriting fees and brokerage, and losses in venture capital activities. Conversely, securities gains increased during this period, aided by declining market interest rates (see Chart 1).

The malaise on Wall Street has hurt many market-sensitive business lines, including asset management activities, underwritings, initial public offerings, and mergers and acquisitions (see Chart 2). According to the ***Securities Industry Association***, asset management fees declined 3.5 percent through the first nine months of 2002 compared with a year ago. This decline, should it continue in the fourth quarter, would be the second consecutive annual decrease in management fees after a decade of double-digit increases. Total underwriting dollar volume (including debt and equity) in 2002 was up slightly (1.8 percent) from 2001, after increasing almost 37 percent the previous year.[9]

[9] www.sia.com, January 8, 2003. Data represent amounts for New York Stock Exchange members.

Chart 1

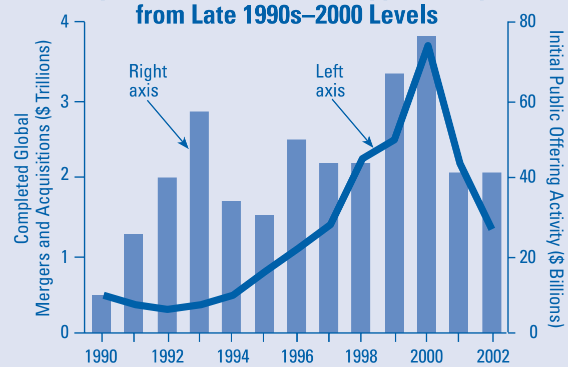
Decline in Investment Banking and Venture Capital Revenues Has Been Offset by Securities Gains in Third Quarter 2002



Note: Includes institutions with total assets greater than $10 billion, excluding credit card banks.
Source: Bank and Thrift Call Reports

Chart 2

Initial Public Offering (IPO) and Merger and Acquisition Activity Has Dropped Sharply from Late 1990s–2000 Levels



Source: Thomson Financial Services, Securities Industry Association

MSA on par with the national trend, as have ALLL coverage levels.

Employment trends in the Washington, D.C., MSA (which includes parts of suburban **Maryland**, Northern **Virginia**, and two counties in **West Virginia**) began on a strong note in 2002 but weakened between March and October. Job losses have occurred in the business services, transportation, communications, and manufacturing sectors in the broader metropolitan area, particularly in parts of Northern Virginia. Job cuts in the airline, telecommunications, and technology sectors have affected the Northern Virginia economy adversely, especially in the Dulles corridor. Like the Trenton MSA, the District of Columbia's local government faces budgetary challenges that have led to job declines in the government sector.

Credit quality among insured institutions headquartered in the Washington, D.C., MSA remained favorable at September 30, 2002, compared with national trends. The median past-due loan ratio was lower across loan categories; the past-due CRE loan ratio was only a fraction of the national average. However, CRE loan exposure among insured institutions headquartered in this MSA increased during the latter part

Appendix Table 1

Employment Trends in Some (Mostly Smaller) Cities Have Not Kept Pace with the National Trends						
	Employment Growth			Employment Trends		
Metropolitan Area	March 2002 (%)	August 2002 (%)	October 2002 (%)	Difference Between March–October Growth Rates (%)	Difference Between August–October Growth Rates (%)	Long-Term Growth Rate (1992–2000) (%)
Allentown	–0.95	–1.44	–1.45	–0.50	–0.01	1.80
Binghamton/Elmira	–2.39	–2.08	–2.22	0.17	–0.14	0.83
Johnstown	–1.38	–1.78	–1.94	–0.56	–0.15	0.88
Mayaguez	0.44	–1.93	–2.51	–2.95	–0.58	0.80
New York	–3.12	–2.04	–1.67	1.46	0.37	1.78
Rochester	–1.83	–1.83	–1.46	0.37	0.37	0.96
Trenton	0.21	–1.51	–1.79	–2.00	–0.28	1.73
Wilmington	–0.94	–0.08	–0.70	0.24	–0.62	2.71
Washington, D.C.	0.26	–0.41	–0.59	–0.85	–0.17	2.52
Albany	0.36	0.37	0.40	0.04	0.03	1.25
Altoona	–1.29	–0.60	0.11	1.40	0.71	1.34
Atlantic City	0.77	1.07	0.76	–0.01	–0.31	1.48
Baltimore	0.15	–1.00	–0.54	–0.69	0.45	1.86
Bergen-Passaic	–1.15	–1.39	–1.14	0.01	0.25	1.51
Buffalo	–0.70	–0.34	–0.38	0.32	–0.03	0.65
Caguas	–0.79	–2.22	–1.03	–0.24	1.20	3.70
Dover	N/A	0.96	0.42	N/A	–0.54	N/A
Dutchess County	–0.65	–0.54	0.11	0.77	0.65	1.21
Erie	–0.80	0.60	0.57	1.37	–0.03	1.11
Glens Falls	–1.43	–0.55	0.00	1.43	0.55	1.21
Harrisburg	–0.16	–0.26	–0.25	–0.09	0.02	1.63
Jersey City	0.63	0.63	0.61	–0.02	–0.02	1.72
Lancaster	0.88	0.91	0.86	–0.02	–0.05	1.98
Middlesex	0.37	0.10	–0.02	–0.40	–0.12	2.76
Monmouth-Ocean	1.17	0.60	0.88	–0.28	0.29	2.66
Nassau-Suffolk	0.54	0.15	0.15	–0.40	–0.01	2.08
Newark	–1.26	–1.00	–0.83	0.43	0.17	1.61
Newburgh	–0.08	0.47	0.75	0.83	0.28	2.08
Philadelphia	–0.59	–1.15	–1.03	–0.44	0.12	1.55
Pittsburgh	–1.11	–0.94	–0.65	0.46	0.29	1.26
Ponce	0.17	2.92	1.95	1.78	–0.97	1.96
Reading	0.08	0.59	0.47	0.39	–0.12	1.45
San Juan	–0.60	–0.05	1.18	1.78	1.23	2.57
Scranton	–1.06	–1.12	–0.76	0.30	0.35	1.08
Sharon	–1.54	–1.38	–1.05	0.49	0.33	2.00
State College	0.33	0.69	0.47	0.14	–0.22	1.69
Syracuse	–0.31	–0.74	–0.27	0.03	0.47	0.76
Utica	–0.35	–0.42	–0.17	0.18	0.25	1.22
Vineland	–0.06	–1.44	–0.56	–0.50	0.89	0.88
Williamsport	–0.43	–0.72	–0.30	0.13	0.42	1.05
York	–2.28	–1.08	–1.29	0.99	–0.21	1.59
U.S. Excluding Mid-Atlantic	–1.31	–1.00	–0.64	0.67	0.35	2.54

Note: N/A = not available.

Data are year-over-year change in trailing three-month moving average of employment growth.

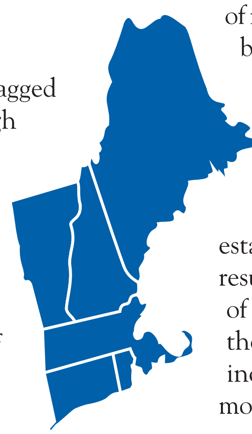
Long-term trend is compound annual growth rate between 1992 and 2000.

Sources: Bureau of Labor Statistics; Haver Analytics of the economic expansion, driven in part by strong real estate development. At 266 percent, the median percentage of CRE loans to capital significantly exceeded the national level of 186 percent as of September 30, 2002, and CRE market conditions in the area have softened. A higher ALLL-to-noncurrent loan ratio than the national average may mitigate some of the increased risk exposure. However, as credit quality indicators typically lag the business cycle, emerging weakness in several of the MSA's key industries could affect insured institution asset quality in the near term.

Mid-Atlantic Staff

New England Economic and Banking Conditions

The New England Economy Continued to Lag the Nation Late Last Year



New England job and income growth lagged that of the nation in late 2002, although state unemployment rates remained at or below the national average. **Massachusetts** (which accounts for half of New England's economic activity) remained the greatest drag on the area's overall job growth; however, stagnant labor markets characterized most of the New England states last fall. Strong productivity growth modestly boosted real per capita income during the first half of 2002, despite lackluster labor markets. Still, a meaningful rebound in economic growth in New England depends on a national economic expansion and, in particular, a resumption of steady gains in business investment. Continued improvement in the U.S. equities market would also support income growth and consumer spending across New England.

Insured Institutions Remain Healthy

Insured institutions headquartered in New England reported healthy financial conditions during the first nine months of 2002 (see Table 1, next page). Net interest margins rebounded, particularly in smaller institutions (total assets less than $1 billion) and remained relatively steady in larger institutions (total assets more than $1 billion) during the past two years. Steady levels of noninterest income and low loan loss provisions, aided by few asset quality problems, helped profitability.

Smaller insured institutions report strong growth in traditionally higher-risk loan types (commercial real estate, construction, and multifamily). Larger institutions report strong commercial real estate and construction loan growth as well. As a result, higher-risk loans made up just over 38 percent of total loans as of September 30, 2002, rising from the recent low point of 28 percent in 1994. This increase occurred as insured institutions shrank mortgage-backed loan portfolios that historically have experienced low loss rates. Despite the decline in mortgage-backed loans as a percentage of total loans, the volume of long-term assets has increased following heavy refinancing of adjustable rate loans into lower-rate, long-term, fixed-rate products. The median ratio of long-term assets as a percentage of earning assets increased to almost 33.5 percent as of September 30, 2002, from its recent low point of approximately 13 percent in 1990.

As funding costs increase, insured institutions will hold large concentrations of long-term, fixed-rate products. These assets have no repricing option and likely will show low prepayment rates, increasing institutions' exposure to interest rate risk. Earnings may suffer as a result. Also, if the recovery stalls or the economy suffers another downturn, defaults may rise in the higher-risk portfolios, adversely affecting earnings.

Table 1

New England Insured Institutions, Particularly Large Banks, Continue to Report Healthy Conditions

	New England Region			< $1 billion			> $1 billion		
	Sept. 02	Sept. 01	Sept. 00	Sept. 02	Sept. 01	Sept. 00	Sept. 02	Sept. 01	Sept. 00
Return on Assets (ROA) (YTD)	1.11	1.11	1.09	0.98	0.94	1.05	1.19	1.20	1.11
Median ROA	0.88	0.81	0.91	0.84	0.77	0.90	1.08	1.08	1.04
Net Interest Margin (YTD)	3.80	3.75	3.82	3.94	3.77	3.90	3.71	3.73	3.78
Past-Due Ratio	1.12	1.27	1.22	1.22	1.38	1.33	1.05	1.19	1.15
Core Deposits/Assets	65.62	65.13	65.63	69.66	69.30	70.15	63.22	62.64	63.02
Noncore Funding/Assets	23.07	23.13	23.38	18.78	18.88	18.10	25.61	25.67	26.43
Loans/Assets	57.85	60.75	62.32	62.74	65.06	66.44	54.95	58.18	59.94
C & I Loans/Loans	12.94	13.08	13.28	7.32	7.13	6.75	16.75	17.04	17.47
Consumer Loans/Loans	10.26	10.07	9.92	4.20	4.63	5.03	14.37	13.71	13.06
Single Family RE & MBS/Assets	45.81	46.50	46.38	46.24	47.60	48.31	45.54	45.83	45.26
Total Loan Growth (Year-over-Year)	5.17	5.71	10.85	6.19	8.23	11.55	4.49	4.10	10.41
Tier 1 Leverage Ratio	8.30	8.59	8.55	9.92	10.01	10.26	7.30	7.72	7.55

YTD = year to date. C&I = commercial and industrial.
RE = real estate. MBS = mortgage backed securities.
All figures are percentages.
Note: All data exclude credit card institutions, Fleet, and State Street.
Source: Bank and Thrift Call Reports, reported on a merger-adjusted basis

The Risk of Declining Home Prices Is Modest

Nationally, strong home price appreciation has continued despite a recession. The same is true in Massachusetts (particularly in greater **Boston**, including **Cape Cod**), as well as in other areas of New England, such as southeastern **New Hampshire**, **Providence**, **Portland (Maine)**, and **Stamford (Connecticut)**. Since home sales and price growth typically slow during a recession, some concern exists that housing price "bubbles" may have formed in certain markets across the nation and in New England.[1] In response to this concern, this article looks at where New England home prices may be headed and presents evidence that a near-term collapse in home prices, such as occurred in the early 1990s, appears unlikely.

[1] For a discussion of home price issues, see "In Focus This Quarter," *Regional Outlook*, first quarter 2002.

Certain New England Markets May Be Exhibiting Unsustainable Rates of Home Price Appreciation

What Are Home Price Bubbles?

There is no precise definition of a "bubble" in the economics and finance literature. Typically, the term refers to episodes when market prices rise well above *market fundamentals*, or the factors that support prices in the long run. Thus, the rapid rate of home price appreciation observed in many New England markets in recent years does not, in itself, indicate a bubble.

Economists use statistical models to try to identify market bubbles before they burst. Typically, these models estimate the relationship over time between market fundamentals (such as population, incomes, interest rates) and changes in some measure of home prices. Once the model is estimated, the current value of home prices can be compared with the value predicted by the model to identify markets where prices may have risen beyond what the fundamentals can support.

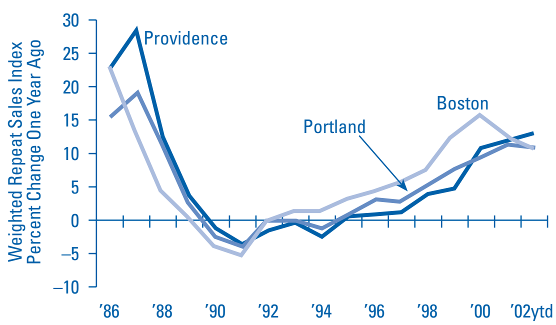
Three New England Markets May Be Susceptible to Price Corrections

Three recently published statistical analyses suggest that home price increases have gone beyond the levels that market fundamentals would suggest in Boston, Providence, and Portland.[2] Note that, even though the results of these analyses appear to be a fairly reliable indicator of overheating in home prices, their ability to forecast future price trends is limited. This is due to the fact that underlying economic fundamentals and housing supply dynamics also are key determinants of future home prices.[3]

Chart 1 shows the ***Office of Federal Housing Enterprise Oversight's*** home price index for these markets through third quarter 2002.[4] Although home prices continued to appreciate at an accelerating rate in Providence, the rate of growth has begun to decelerate in Boston. While current rates of price appreciation likely may be unsustainable, the critical question for home owners and lenders in these markets is whether housing prices will begin to decline.

Chart 1

Of Those Markets Possibly Showing Unsustainable Price Trends, Only Boston Has Begun to See Slower Price Growth



Note: YTD = year to date.
Source: OFHEO

Despite the Weak Economy and Recent Significant Price Appreciation, New England Home Prices Are Not Likely to Decline Significantly

Unlike the early 1990s, several conditions are present today that should help prevent a substantial drop in home prices. These conditions include a relatively healthier economy, limited new supply, favorable demographic trends, and greater pent-up demand for housing.

Economic Conditions Are Stronger Today than in the Early 1990s

Economic conditions today, despite the recent recession, are not as dire as during the early 1990s. Fewer potential excesses in housing markets developed during the most recent expansion, and this recession has been much milder than that experienced more than a decade ago.

During the 1980s, twin booms in commercial and residential real estate led the economic cycle, especially in southern New England, allowing real estate imbalances to develop which spilled into the general economy. More recently, however, residential and commercial real estate markets followed the boost in personal incomes caused by a strong information technology sector and significant gains in the equity markets. As a result, there was less time for price and supply imbalances to form and for speculative behavior to become entrenched. In addition, the cyclical effects of the early 1990s recession were compounded by downsizing in the defense industry and a collapse in the area's dominant minicomputer industry-structural drags on growth that are absent today.

[2] Three models have produced the following results:
1. "The Single Family Housing Monitor, Second Quarter 2002," Economy.com, September 2002, identifies Providence as "overpriced," with Boston and Portland "highly overpriced."
2. These same markets were identified by Local Market Monitor as (respectively) 30 percent, 36 percent, and 15 percent "overvalued" in Chris Horymski, "Where Is Your Home's Value Headed?" *SmartMoney Magazine*, November 15, 2002.
3. Michael D. Youngblood, "Is There a Bubble in Housing? New Evidence From 123 Housing Markets," *RiskView, LoanPerformance*, Vol. VIII, No. 4, suggests that Boston was exhibiting a price bubble in 2001 (this finding likely held true in 2002 as well, given subsequent fundamental trends).

[3] The original specification of the model estimated by LoanPerformance (Stephen Malpezzi, "A Simple Error Correction Model of House Prices," *Journal of Housing Economics*, No. 8, 1999) had an adjusted R2 (goodness of fit) of 61 percent, while that for the Economy.com model had an adjusted R2 of 95 percent. On the question of forecast accuracy, Malpezzi used multiple variations of his disequilibrium model in 1999 to predict subsequent price changes, but was able, at best, to account for only 35 percent of the variation in price change.

[4] The index records the price trend, based on resale or refinance, of a set of properties where past transactions are available. It is limited to conventional single-family purchase and refinance transactions that fall within the current conforming loan limit ($322,700 in 2003).

New Construction and Supply Have Been Restrained Relative to the 1980s

Housing supply has been fairly restrained during the past decade, a much different scenario from that of the 1980s (see Chart 2). In addition, it currently does not appear that existing rental units are being converted on a large scale to owner-occupied condominiums in the greater Boston market. These conversions helped to suppress home prices in the early 1990s, even as new building activity had waned.

Population Trends Are Stronger Today than in the Early 1990s

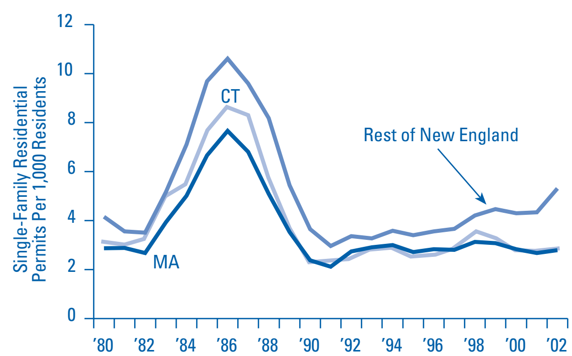
The severity of the early 1990s recession in New England prompted an outflow of residents from some areas while dampening population growth in others. This demographic drag increased the inventory of homes for sale and reduced the number of potential buyers. Chart 3 shows the relationship between population and home price trends in Boston and Providence. The chart also may help explain why home price growth in Providence continued to accelerate recently, despite the weak economy. Continued population growth, thanks to a relatively easy commute to Boston-area jobs and lower home prices compared with similar properties closer to Boston, may be supporting housing demand and home price appreciation in the Providence area. Portland has also maintained steady population growth in recent years, supporting housing demand and price appreciation in that market.

Pent-Up Demand May Mitigate the Magnitude of Any Price Declines

Housing affordability recently has declined in many New England markets. The rapid rise in home prices during the late 1990s may have priced some buyers out of the market. If prices eased somewhat, these buyers could reenter the market, helping to avert the sort of precipitous price decline seen in the early 1990s. Chart 4 shows trends in housing affordability during the past five years for several New England markets. In markets where affordability has dropped dramatically, such as Boston, pent-up demand may be more pronounced than in markets such as Providence, where affordability has changed little despite the recent runup in prices.

Chart 2

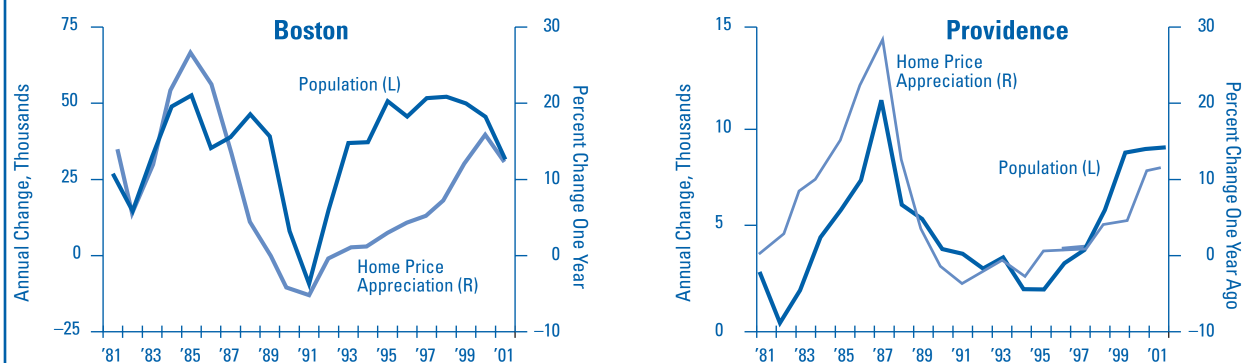
Unlike the 1980s, Housing Supply Has Been Restrained, Which Should Help to Support Prices



Source: Census Bureau

Chart 3

Population Outflows Aggravated Home Price Declines in the Early 1990s, while Recent Population Growth Is Supporting Price Gains in Providence



Source: OFHEO and Economy.com

What Are the Implications for Insured Institutions?

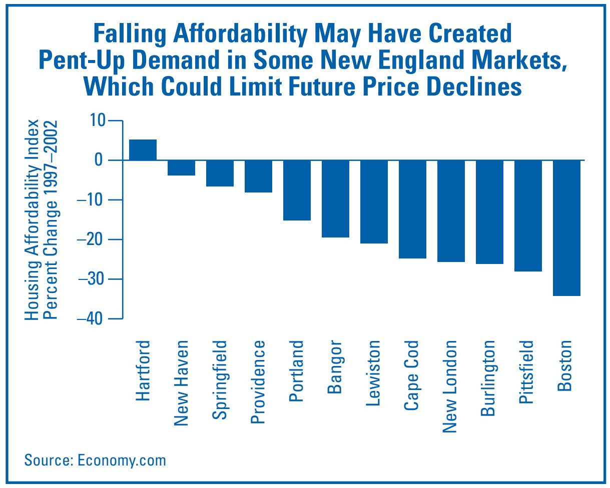
As of September 30, 2002, insured institutions in New England continued to report low aggregate delinquency and loss rates on residential mortgages and home equity lines of credit (in line with national trends). However, if home prices begin to falter in combination with continued weakness in the economy and a persistent rise in unemployment rates, residential real estate credit quality could deteriorate.

Mortgage lending also may be more challenging today because of innovations in this business line since the last bicoastal real estate crisis in the early 1990s. These new practices include widespread adoption of automated appraisal systems, subprime lending, and higher leverage on purchase mortgages.[5]

Residential lenders should be aware of the altered risk environment today compared to a decade ago, especially since many of these innovations have not weathered a severe real estate downturn. However, despite these changes, it appears likely that mortgage lending will retain a lower *relative* credit risk than credit card, non-real estate secured personal, and commercial lending.

Norman Williams, Regional Economist
Cameron Tabor, Senior Financial Analyst

Chart 4

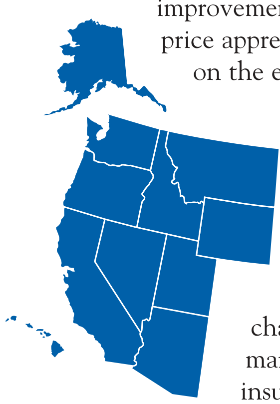


[5] See "In Focus This Quarter," *Regional Outlook*, first quarter 2002.

San Francisco Regional Perspectives

Continued Economic Sluggishness, Shifts in Residential Mortgage Exposures, and Changes in Underwriting Practices Could Challenge the Region's Mortgage Lenders

Repeated refinancing waves during 2001 and 2002 eased the effects of the recession on consumers in many of the Region's local economies. Low interest rates and escalating home values in the Region during the past several years enabled borrowers to refinance and, by some estimates, cash out over $80 billion in home equity.[1] This money has been used to pay off loans, purchase consumer goods, and make home improvements. Going forward, slowing home price appreciation may have negative effects on the economy as refinancing and cash-out opportunities dry up. This article identifies the residential markets that could be vulnerable to price pressures as a result of adverse trends in employment, migration, or affordability. It also examines changes in the residential lending market that might increase risks to insured institutions.



Employment Downturns Could Prompt Out-Migration in Some Markets

Sluggishness in the high-tech and civilian aerospace sectors continued to affect nonfarm employment adversely in several metropolitan statistical areas (MSAs) throughout the Region. The most notable year-over-year declines as of November 2002 occurred in the **San Jose**, **Seattle**, **San Francisco**, **Provo**, **Salt Lake City**, **Spokane**, **Boise**, and **Portland** MSAs.

The Region's employment trends could affect migration and housing prices adversely. A ***Census Bureau*** study suggests that 31 percent of households that relocated across county lines between 1999 and 2000 did so for job-related reasons.[2] During the early 1990s recession, when job availability in **California** declined, people moved out of the state.[3] **Nevada**, **Oregon**, **Washington**, **Arizona**, and **Utah** were destinations for net migration out of California between 1990 and 1994.[4,5] As a result, home prices fell in California (primarily in Southern California) and home values increased in the surrounding states, most notably in Utah (see Chart 1).

Domestic out-migration is already evident from some areas of the Region that suffered significant job losses following the 2001–02 recession. During 2002, United Van Lines identified net outbound household relocations for Utah, Washington, and California.[6] Net out-migration has also occurred in the Bay Area and Seattle as a result of the technology industry problems and, more recently, Boeing layoffs in Seattle.[7,8]

The Confluence of Weak Employment and Affordability Could Pressure Home Prices

In addition to job losses and out-migration, prolonged periods of low affordability (a situation in which home price appreciation outpaces personal income growth) can affect housing prices. Because personal income is a key driver of home prices, "prolonged and rapid increases in the price to income ratio may be a sign

[1] "The Economic Contribution of the Mortgage Refinancing Boom," a joint research project of Economy.com and the Homeownership Alliance, December 2002, p. 7 (http://www.economy.com/store/samples/refinancing1202.pdf).

[2] Jason Schachter, *Why People Move: Exploring the March 2000 Current Population Survey*, Census Bureau Special Study, May 2001, p. 3.

[3] Stuart Gabriel, Joe Mattey, and William Wascher, "The Demise of California Reconsidered: Interstate Migration over the Economic Cycle," Federal Reserve Bank of San Francisco *Economic Review*, Number 2, 1995, p. 30.

[4] Hans P. Johnson and Richard Lovelady, *Migration Between California and Other States: 1985 to 1994*, a joint research project of the California State Library and the California Department of Finance, November 1995, p. 33.

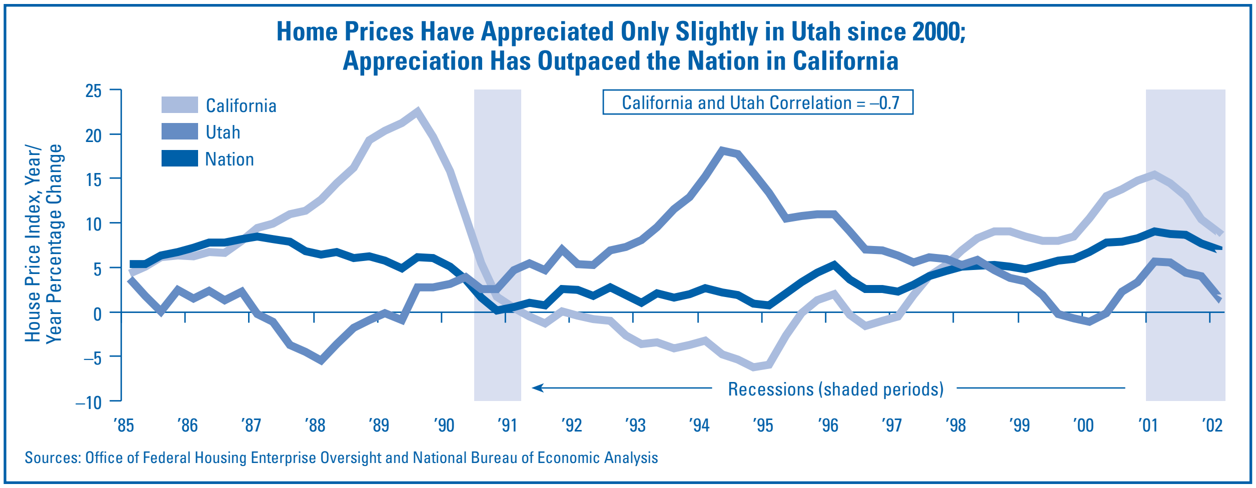
[5] *Utah Data Guide*, Utah State Data Center, Governor's Office of Planning and Budget, Demographic and Economic Analysis, Autumn 2001, p. 9, (http://www.governor.state.ut.us/dea/publications/dataguide/01udg10.pdf).

[6] "Southern States Gaining Appeal, North Sees More Leaving, According to Latest United Van Lines Study," United Van Lines Press Release, January 7, 2003.

[7] Amanda Bronstad, "Moving—Southward Migration: Bay Area Troubles Sending Workers In L.A.'s Direction," *Los Angeles Business Journal*, July 23, 2001.

[8] Bradley Meacham and Dave Woodfill, "Seattle Sees More People Moving Out of City Than In," *Seattle Times*, January 7, 2003.

Chart 1



of an overshooting cycle or a bubble,"[9] as they may signal that speculative rather than fundamental factors are driving house prices. Over the long term, market forces are expected to correct any imbalances.

Several studies have compared personal income levels with home prices and identified various areas in the San Francisco Region that may be vulnerable to housing price declines. Research studies published by ***PMI*** and ***LoanPerformance*** suggest that the confluence of employment and affordability issues in the **Oakland**, **Phoenix**, Portland, Salt Lake City, **San Diego**, San Francisco, San Jose, **Santa Barbara**, and Seattle markets could increase their vulnerability to home price declines (see Table 1).[10,11] Of these markets, ***SmartMoney*** also identified the San Diego and Oakland housing markets as being overvalued by at least 29 percent.[12] In addition, data from ***Economy.com*** reveal that the affordability index in the Santa Barbara, San Francisco, San Diego, and San Jose MSAs was nearly half the national average as of third quarter 2002. In addition to concerns about affordability, rising interest rates could increase new homebuyers' mortgage costs as well as the cost of variable rate mortgages and further pressure home prices.

Foreclosures Have Risen in Some Areas, but Insured Institutions Continue to Report Low Mortgage Delinquency Ratios

Low interest rates and home price gains generally mitigated the effects of the recent recession. However, high and rising foreclosure rates and above-average personal bankruptcy rates in Utah, Nevada, and **Idaho** through third quarter 2002 suggest that some homeowners are having difficulty meeting mortgage debt payments (see Chart 2, next page). In addition, foreclosure rates in Oregon, Washington, and **Montana** exceed levels reported during the early 1990s. Foreclosure rates for California have declined during the past year; however, an increase in the number of Notice of Default filings in several Bay Area counties suggests that a growing number of households in the area are experiencing financial difficulties.[13]

Despite the rise in foreclosures, insured institutions headquartered in 13 of the Region's 19 major MSAs reported year-over-year flat or declining median single-family mortgage delinquency rates.[14] Of the six major markets

[9] Office of Federal Housing Enterprise Oversight, *House Price Index, Fourth Quarter 2000*, March 1, 2001, pp. 7-8.
[10] "Economic & Real Estate Trends," PMI Mortgage Insurance Co., September 2002 (http://www.pmigroup.com/media/pmi_eret02v3s.pdf).
[11] Michael D. Youngblood, "Is There a Bubble in Housing? New Evidence from 123 Housing Markets," *The Market Pulse*, Vol. VIII, Issue 4, 2002 (Loan Performance Corporation).
[12] Chris Taylor, "Your Home's Value: Will It Rise or Fall?" Smartmoney.com, November 15, 2002 (http://www.smartmoney.com/mag/index.cfm?story=dec02-homes).

[13] "California Foreclosures Decline," *DataQuick Real Estate News*, October 30, 2002 (http://www.dqnews.com/RRFor1002.shtm).
[14] Based on a comparison of MSAs in which more than five insured institutions with total assets of less than $5 billion were headquartered. Insured institutions chartered as industrial loan companies, those with consumer loan-to-Tier 1 capital ratios exceeding 200 percent, and those with single-family mortgage-to-Tier 1 capital plus loan loss reserve ratios of less than 25 percent were excluded to minimize the effects of insured institutions with broad lending markets or very small mortgage portfolios. The analysis also excluded insured institutions less than three years old, as these institutions often do not hold seasoned loan portfolios.

Table 1

Nine Housing Markets in the Region May Be Vulnerable to a Home Price Decline Because of Economic Issues

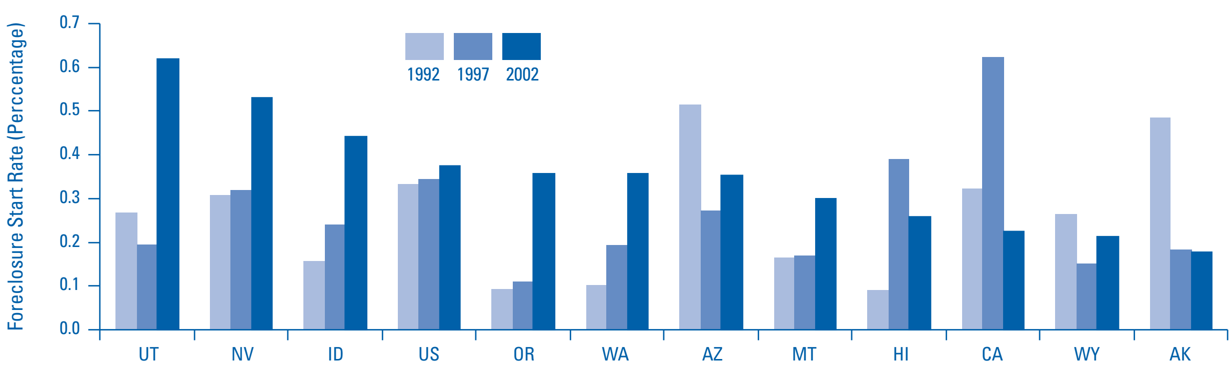
Metropolitan Statistical Area (MSA)	PMI Study Sept. 02	Loan-Performance Nonparametric Test 2002	SmartMoney Home Price (*percent overvalued*) Nov. 02	Economy.com Housing Affordability (*index*) 3Q02	House Price (*compound annual growth rate*) 3Q97/3Q02	Nonfarm Employment (*year/year % change*) Nov. 02	Unemployment Rate Nov. 02	Unemployment Rate (*annual % change*) Nov. 02
Oakland	High risk	Bubble	29%	83	12.5%	–0.1%	5.9%	0.8%
Phoenix	High risk		10%	151	6.4%	0.4%	5.2%	0.1%
Portland	High risk	Bubble	23%	110	4.1%	–0.7%	7.0%	–0.4%
Salt Lake City	High risk		12%	135	2.9%	–1.8%	4.9%	0.3%
San Diego		Bubble	41%	60	12.4%	1.8%	4.1%	0.4%
San Francisco	High risk	Bubble	17%	59	12.3%	–2.2%	5.2%	0.1%
San Jose	High risk	Bubble	0%	62	12.1%	–2.9%	7.8%	0.9%
Santa Barbara	N/A	Bubble	17%	55	12.8%	–0.3%	4.6%	0.6%
Seattle	High risk		19%	78	7.5%	–2.5%	6.2%	–0.1%
Nation				111	6.7%	–0.1%	5.7%	0.4%

Notes: The Economy.com Affordability Index gauges, for each MSA, what percentage of a mortgage a household earning a median income and buying a median-priced home can afford. Some studies did not include all the MSAs in the Region. The unemployment rate was not seasonally adjusted.

Sources: PMI Mortgage Insurance Co.; LoanPerformance; SmartMoney.com; Economy.com; Office of Federal Housing Enterprise Oversight; and Bureau of Labor Statistics

Chart 2

Foreclosure Rates Are High in Utah, Nevada, and Idaho



Note: Data reflect four-quarter moving averages through third quarter of each year.
Source: Mortgage Bankers Association of America via Haver Analytics

with rising mortgage delinquency rates, median past-due ratios exceeded 1 percent only in the Provo and San Jose MSAs. Furthermore, insured institutions headquartered in the San Francisco Region generally reported healthy earnings, relatively high capital, and manageable proportions of problem assets through third quarter 2002.[15]

[15] As of September 30, 2002, 89 percent of the Region's insured institutions were profitable, up from 82 percent in third quarter 1992. Similarly, the median Tier 1 leverage capital ratio reported in the Region was 9.1 percent, up appreciably from 8.1 percent a decade earlier. The third quarter 2002 median past-due loan ratio declined year-over-year from 1.49 percent to 1.28 percent and was down substantially from a median ratio of 3.25 percent in 1992.

Structural Changes in the Residential Lending Market Could Challenge Insured Institution Risk Management

Shifts in mortgage portfolio composition, changes in underwriting processes and standards, and heightened exposures to construction lending could pose new challenges in some markets.

Changes in Mortgage Portfolio Composition Could Affect Future Delinquency Trends

Residential property markets are of prime importance to lenders that specialize in single-family mortgages, specifically the Region's 94 savings institutions. Commercial banks are generally less exposed to residential mortgages and hold smaller concentrations now than a decade ago. Nevertheless, changes in local residential real estate values remain important to banks, given the current composition of bank residential mortgage exposures. Home equity loans and lines of credit constitute a larger share of community bank[16] exposures now than ten years ago, while standard residential mortgages comprise a smaller proportion of direct mortgage exposures.

Home equity-based loans may challenge lenders because these loans are often secured by junior liens on homes or carry adjustable interest rates. A decline in home value can quickly erode the collateral protection of a junior lien, and increases in interest rates can strain the ability of certain households to remain current on their debts. Commercial banks headquartered in the Santa Barbara, Provo, Oakland, **Santa Rosa**, **Stockton**, and San Francisco MSAs reported relatively high home equity credit-to-Tier 1 capital and reserve ratios as of third quarter 2002 (see Chart 3).

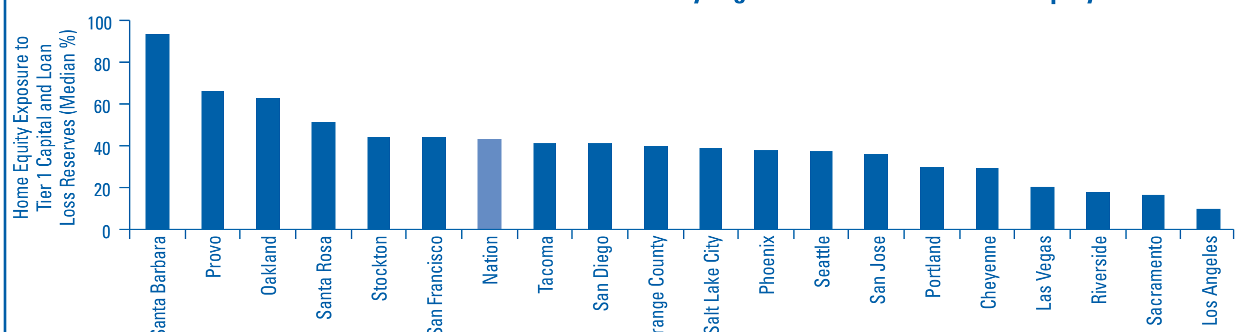
Changes in Underwriting Standards and Processes Could Introduce New Risks

Mortgage loan underwriting has changed somewhat during the past decade. Subprime lending has gained in popularity, and the underwriting process in general has become more automated. According to ***Inside B&C Lending***, subprime mortgages represent about 8 percent of all mortgage debt nationally, and the outstanding volume of subprime mortgages grew 8 percent during the first nine months of 2002.[17] The introduction of credit scoring and automated valuation models (AVMs) also has changed the way many residential lenders evaluate a borrower's creditworthiness. The benefits of automation include speed and cost of execution and the removal of potential human biases. However, on the downside, the property is often not inspected and the model may not select appropriate comparable transactions. In addition, scoring models and AVMs have not been tested through a full real estate cycle.

Federal Housing Finance Board surveys suggest that lenders in certain markets have also eased collateral protection requirements. During 2001, the loan-to-purchase price (LTPP) ratio of at least one-quarter of purchase-money mortgages[18] that originated in the **Honolulu**, Phoenix, **Tucson**, **Las Vegas**, **Fresno**, and Salt Lake City MSAs exceeded 90 percent

Chart 3

Insured Institutions in Northern California Hold Relatively High Concentrations of Home Equity Loans



Note: Medians are based on insured commercial banks with less than $5 billion in total assets that are not industrial loan companies and that do not have consumer loan-to-Tier 1 capital ratios exceeding 200 percent. Only metropolitan statistical areas (MSAs) with more than five qualifying insured banks are shown. "Nation" includes similar types of insured banks headquartered in MSAs outside the San Francisco Region.
Source: Bank and Thrift Call Reports (September 30, 2002)

[16] Community banks are defined in this article as insured commercial banks that hold less than $5 billion in total assets. Industrial loan companies and specialty consumer lenders often meet this definition but hold large concentrations of out-of-area loans. Therefore, they are excluded from this analysis.

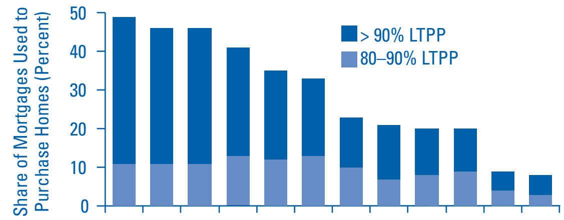
[17] "Record Loan Volume Fuels Strong Servicing Growth Through Third Q," *Inside B&C Lending*, Vol. 7, Issue 24, December 2, 2002.

[18] Purchase-money mortgages include conventional loans used to finance the purchase of a single-family residence.

(see Chart 4), up substantially from the early 1990s. Nationally, roughly 21 percent of mortgages had similarly high LTPP ratios, more than double the ratio reported in the late 1980s and early 1990s. According to the ***Federal Housing Finance Board***, commercial banks, rather than thrifts or mortgage companies, originated a disproportionately high share of these mortgages during 2002. Private mortgage insurance may mitigate losses in the event of foreclosure. However, higher LTPP ratios suggest that default rates on single-family mortgages could increase should job declines, migration trends, or rising interest rates adversely affect borrower cash flows or property values.

Chart 4

Collateral Margins Are Often Narrow in Hawaii, Arizona, and Nevada



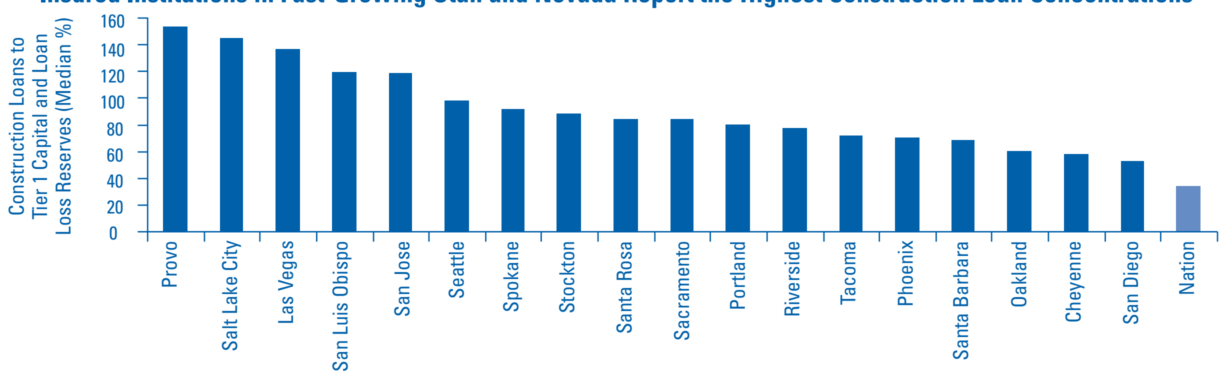
LTPP = loan-to-purchase-price ratio.
Note: "*" denotes consolidated metropolitan statistical area. Figures are based on terms for purchase money mortgages originated during 2001.
Source: Federal Housing Financing Board

Residential Construction Loans Are Also Vulnerable to Declining Home Prices

Construction expenditure data and anecdotal evidence suggest that construction and development (C&D) loan exposures are composed, in part, of single-family development loans.[19] Community institutions headquartered in the Provo, Salt Lake City, Las Vegas, **San Luis Obispo**, and San Jose MSAs hold relatively high concentrations of C&D loans (see Chart 5). Median C&D loan delinquency ratios remained low among institutions headquartered in these areas as of third quarter 2002. However, high concentrations are a concern because institutions with elevated C&D loan exposures were more likely to fail during the banking crisis of the late 1980s and early 1990s.[20] Deterioration in the construction loan portfolio during that period was attributed to softening market conditions and weak underwriting, especially among insured institutions headquartered in California. Since that time, underwriting standards have reportedly tightened.[21] However, 29 percent of Federal Deposit Insurance Corporation examiners responding to a recently conducted underwriting survey stated that institutions

Chart 5

Insured Institutions in Fast-Growing Utah and Nevada Report the Highest Construction Loan Concentrations



Note: Medians are based on insured institutions with less than $5 billion in total assets that are not industrial loan companies and that do not have consumer loan-to-Tier 1 capital ratios exceeding 200 percent. "Nation" includes similar types of insured banks headquartered in MSAs outside the San Francisco Region.
Source: Bank and Thrift Call Reports (September 30, 2002)

[19] The actual proportion of C&D credits used to finance residential construction is unknown because of Call Report limitations. Only Thrift Financial Report filers must distinguish between residential and commercial construction loans. Examiners do report that the size of most community banks precludes them from participating in larger-scale office, industrial, and retail projects.

[20] 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*, Chapter 3, Washington, DC: Federal Deposit Insurance Corporation, 1997.

[21] Steve Burton, "Recent Trends in Construction Loan Underwriting," *Bank Trends*, Federal Deposit Insurance Corporation, July 1999.

"frequently" or "commonly" made residential C&D loans on a speculative basis.[22]

Challenges to Mortgage Loan Quality May Be Greatest in a Few Key Markets

Weak employment and low affordability increase the vulnerability of the San Francisco Bay Area and, to a lesser degree, the Seattle and Portland MSAs to slowing home price appreciation. In addition, the Provo, Salt Lake City, Las Vegas, Phoenix, and Boise MSAs recently have experienced relatively high foreclosure rates and personal bankruptcy activity. Insured institutions in most of these five markets hold high levels of C&D loans and also appear to hold elevated exposures to high loan-to-purchase price mortgages. A confluence of these risks could pressure the quality of mortgage portfolios going forward, particularly if job markets remain weak and interest rates rise.

San Francisco Staff

[22] Federal Deposit Insurance Corporation, *Report on Underwriting Practices*, September 2002 (http://www.fdic.gov/bank/analytical/report/2002sept/uw0209.pdf).

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