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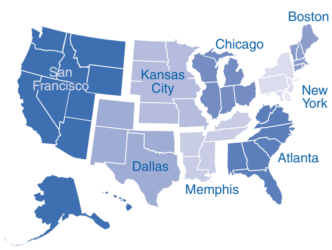

DIVISION OF
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A Message to Our Readers

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

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

In Focus This Quarter

Regional Perspectives

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Slowing Economy Reduces Demand for U.S. Office Space

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

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

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

Overview

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

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

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

Vacancy Rates Have Risen Quickly from Cyclical Lows

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

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

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

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

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

Table 1

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

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

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

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

Office Demand Drops

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

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

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

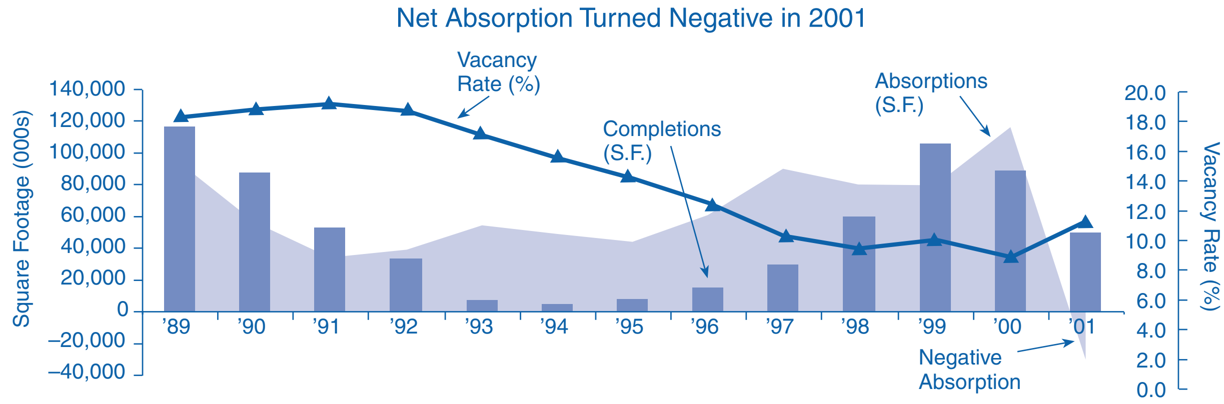
[4] Louis, Arthur M. July 24, 2001. "Empty Offices, Economic Downturn, Overconstruction Leave Commercial Landlords with More Space on their Hands." *San Francisco Chronicle.*

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

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

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

CHART 1



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

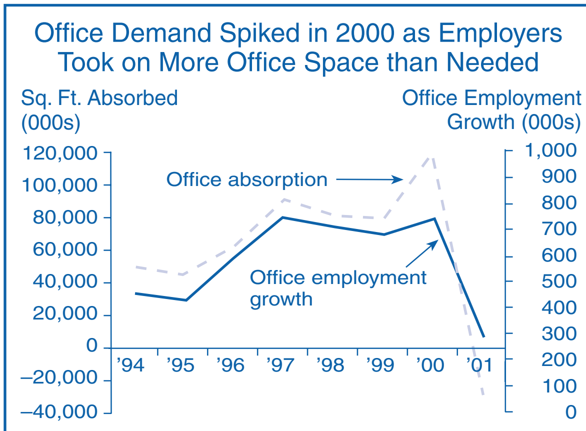
insurance, and real estate (FIRE) and services sectors combined was more than 3 percent in every month from January 1993 through June 2000. Since the middle of 2000, job growth in these sectors has fallen steadily to a year-over-year rate of less than 1.5 percent in June 2001. A spring 2001 survey conducted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

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

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

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

CHART 2



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

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

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

Meanwhile, Construction Continues

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

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

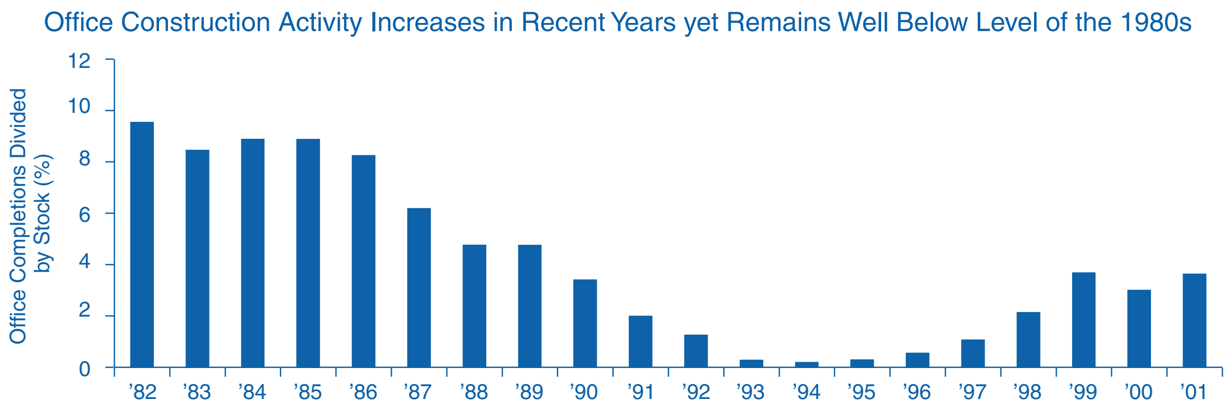
Many metropolitan areas currently experiencing high levels of construction activity also are seeing the largest increases in office vacancies. For example, cities that are positioned toward the upper right quadrant of Chart 4 are characterized by higher vacancy rate increases and more new office space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

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

Softening Extends to Other Commercial Real Estate

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

CHART 3

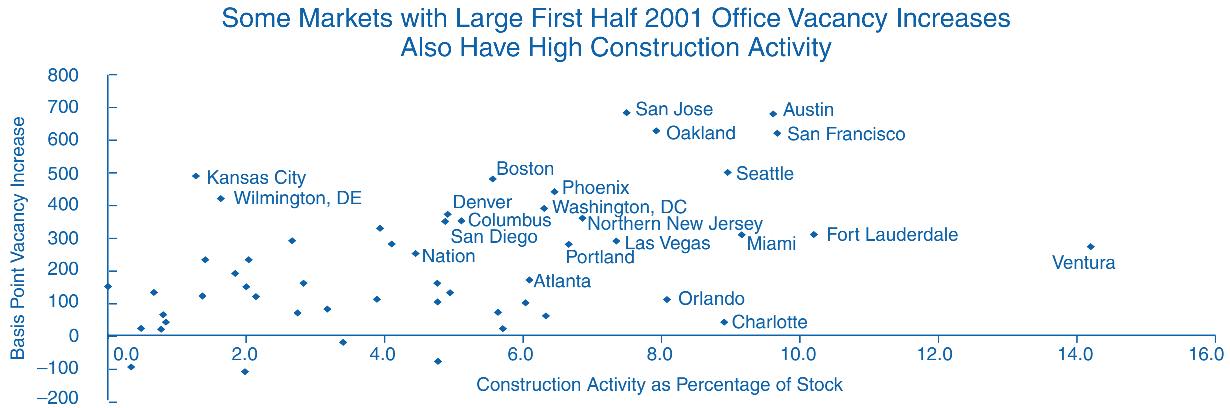


Notes: Construction activity is completions per year divided by prior year-end stock. 2001 is projected.
Source: Torto Wheaton Research

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

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

CHART 4



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

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

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

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

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

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

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

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

[14] Kozel, Peter P. June 18, 2001. "U.S. Commercial Property Markets in a Slowing Economy: Implications for CMBS Credit Performance." *Standard and Poor's Structured Finance.*
[15] Data provided to Haver Analytics by U.S. Bureau of the Census.
[16] Ibid.

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

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

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

Implications for Insured Institutions

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

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

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

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

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

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

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

[20] Sally Gordon, op. cit.

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

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

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

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

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

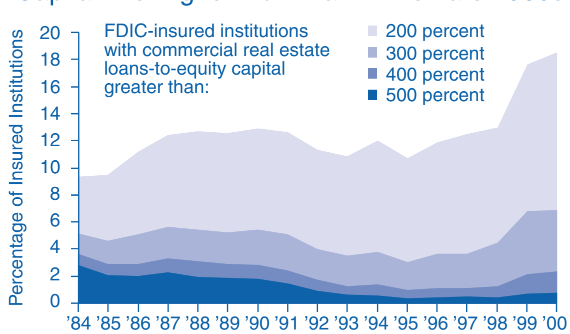
see *History of the Eighties*[26]). As shown in Chart 5, the percentage of insured institutions with commercial real estate loan concentrations between 200 and 400 percent of capital is higher now than it was in the late 1980s. However, there are relatively fewer institutions at the highest concentration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

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

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

CHART 5

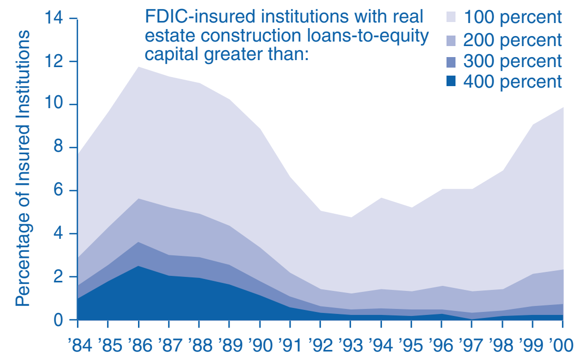
Concentrations of Commercial Real Estate Loans between 200 and 400 Percent of Capital Are Higher Now than in the Late 1980s



Sources: Bank Call Reports, Thrift Financial Reports (Research Information System, FDIC)

CHART 6

Concentrations of Construction Loans Have Moved Higher in Recent Years



Sources: Bank Call Reports, Thrift Financial Reports (Research Information System, FDIC)

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

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

Conclusion

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

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Senior Financial Analyst

[26] Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s,* Chapters 9 and 10. 1997. Washington, DC: FDIC. http://www.fdic.gov/bank/historical/history/index.html.
[27] Smith, Ray A. August 1, 2001. "Property Held by Public Firms Drops." *The Wall Street Journal*.

Table 2

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

Table 2 (continued)

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

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

Atlanta Regional Perspectives

The Atlanta Regional Outlook, second quarter 2001, examined economic and competitive factors that could affect bank performance in metropolitan areas; however, some nonmetropolitan counties may share similar risk factors. The Atlanta Region's rapid growth over the past decade and the increasingly important issue of urban sprawl have blurred the distinctions between many metropolitan and nonmetropolitan counties. To focus on areas where competitive pressures may be high, we considered nonmetropolitan markets where ten or more insured institutions compete. Of the 424 nonmetropolitan counties in the Atlanta Region, only 25 have ten or more insured institutions with offices accepting deposits within the county. Of these 25, all but 3 are adjacent to metropolitan areas.

We developed an economic classification for nonmetropolitan counties by modifying a methodology used by the United States Department of Agriculture (USDA). The USDA's ***Rural-Urban Continuum*** defines counties bordering a metropolitan area with at least 2 percent of the workforce commuting to that metropolitan area as *Adjacent*. Otherwise, the counties are identified as *Not-Adjacent*. We further classified Adjacent counties into three groups: *Dependent*, *Independent*, and *Mixed*.

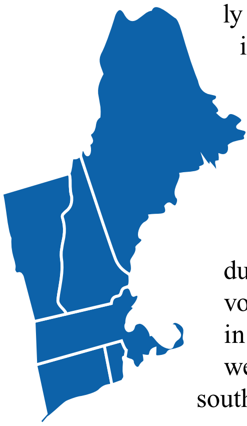
Dependent counties are adjacent counties whose economies are tied closely to the bordering metropolitan area. Independent counties are those that remain heavily dependent on a particular local industry. Mixed counties generally appear to be in a transitional stage because they continue to be affected by traditional industries, yet there may be an increasing spillover effect from bordering metropolitan areas.

Some patterns in banking market structure emerge using our classification of nonmetropolitan counties that are home to at least ten insured institutions. The number of institutions and offices in all market types except Independent grew during the latter half of the 1990s. Although all market types were dominated by superregional or regional banking companies, Dependent and Not-Adjacent counties were comparatively less concentrated; consequently, the degree of competition may be higher in these areas. In addition, nearly one-third of the insured institutions operating in Independent counties are headquartered locally, compared with 25 percent among the other county types. Finally, Dependent and Not-Adjacent counties, which displayed the highest overall levels of per capita income, also hold the highest levels of deposits per capita.

Insured institution performance and the overall risk profile can vary significantly by geographic location and local economic structure. Community banks[1] headquartered in the 25 counties in our analysis generally exhibit a different risk profile and underperform other nonmetropolitan banks. At year-end 2000, Atlanta Region community banks operating in highly competitive nonmetropolitan counties held less capital and larger loan portfolios—with a greater concentration in real estate loans, particularly in the traditionally higher-risk construction and development loans—and relied more on borrowed funds because of lower core deposit levels than other nonmetropolitan areas with fewer market participants. These characteristics have been apparent during much of the recent economic expansion. The risk profile of these community banks more closely resembles that of an urban bank than does that of the typical nonmetropolitan community bank. Also, while the banking markets exhibit more favorable growth potential than those of other nonmetropolitan counties, they may be less desirable to large insured institutions if the level of competition constrains customer profitability.

[1] Community banks include all Call Report filers, commercial banks, and state savings banks with assets of $1 billion or less.

Boston Regional Perspectives



Following the nation, New England's economic growth slowed through midyear 2001. As of June, nonfarm employment in the Region was up 1.5 percent from year-ago levels, a sizable deceleration from the prior year's pace. Initial unemployment claims between January and June significantly exceeded year-earlier levels. Rising unemployment and an increase in personal bankruptcy filings also resulted from the slowing economy by midyear. Despite continued strong appreciation in home prices, existing home sales were flat or down slightly during the first quarter. New permit volume has been easing since 1998 in the Region, and much of the weakness has been centered in southern New England. The Region's economy, along with the nation's, hinges on the continued strength of consumer spending.

Fraudulent activity poses an ongoing and significant risk to financial institutions. Fraud manifests itself in many forms; however, the vast majority of fraud is carried out by a firm's own employees. Effective measures should be in place to protect a firm's assets and minimize potential losses arising from internal fraud, which can lead to loss and, in extreme cases, failure. Several studies of the reasons for bank failures suggest that insider fraud was a significant contributing factor to the failure of anywhere from 11 percent to 33 percent of failed institutions. In light of the fact that nearly 3,000 banks and thrifts have failed in the past 20 years, these findings underscore the importance of managing fraud risk. Historical patterns suggest that evidence of fraud increases following a downturn in general economic conditions, which reveals situations that may be masked during good economic times. In fact, Suspicious Activity Report filings related to crimes of an internal nature—including bribery, embezzlement, misuse of position, and mysterious disappearance—have begun to rise after remaining fairly stable during the past three years.

Fidelity insurance coverage is a necessary safeguard against fraud loss. Boards of directors are responsible for ensuring that effective measures are in place to minimize potential losses arising from internal fraud. Fraud cannot be entirely eliminated; however, strong internal controls and comprehensive audit programs are the most effective means of both deterring and detecting internal fraud. As fraud represents a source of significant or even catastrophic loss to any institution, residual risk should be shifted to other parties through appropriate levels of fidelity insurance coverage. Coverage is especially important in small institutions that may not have the resources to devote to the more sophisticated fraud programs that larger institutions are capable of administering.

Fidelity insurance coverage levels among insured institutions may be worth reviewing in light of deteriorating economic conditions. The median level of fidelity coverage has remained fairly constant across all asset sizes since the late 1980s. While there has been a noticeable rise in financial institution bond (FIB) levels, aggregate fidelity coverage has remained fairly flat. The increased fidelity coverage provided by Clause A of the FIB has been largely offset by elimination of coverage under excess employee dishonesty bonds. The increased coverage for losses covered by nonfidelity clauses of the FIB is a positive trend. However, it is somewhat surprising that fidelity coverage has been flat, given the fact that a significant percentage of bank failures have been attributed directly to insider fraud and abuse.

Savings banks typically carry lower levels of fidelity coverage than do their commercial counterparts. Data obtained from the ***Surety Association of America*** and the ***Association of Certified Fraud Investigators*** suggest that the risk of fraud and abuse in savings institutions, from a fidelity perspective, is not significantly dissimilar to that of commercial organizations. As savings institutions make up 70 percent of all banks in the Boston Region, this observation is worthy of consideration.

Effective fraud deterrence and detection policies are the first lines of defense for minimizing exposure to fraud. Fidelity insurance plays an important backup role in preserving the solvency of an insured institution that is victimized by a significant fraud event. Ensuring that all these aspects of an effective fraud risk management program are in place is an important function of the board of directors and senior management, and becomes particularly important during periods of economic uncertainty.

Chicago Regional Perspectives

Recent economic crosscurrents triggered noticeably slower growth and uncertainty about the future for households and major industries in the Region.

Labor markets weaken and households face pressure. Employment growth in the Region turned modestly negative in second quarter 2001 as a growing number of layoffs occurred in the manufacturing sector and smaller employment gains occurred in most others. Manufacturers trimmed the length of the workweek and, thus, average weekly earnings for many workers. Households also faced higher energy prices and the average 401(k) retirement account balance failed to rise in 2000. All these developments contributed to a decline in consumer confidence.

Real estate sector presents a mixed picture. Residential resales and permits for new construction remain high in the Region. In contrast, conditions in commercial real estate (CRE) markets changed fairly abruptly. Weaker conditions were widespread in suburban office markets, while vacancy rates jumped for downtown office space in Indianapolis and Columbus.

Inventory correction is a key to the economy's near-term health. Production cutbacks are occurring in many industries because inventories are high relative to the pace of sales. The rise in inventory-to-sales ratios is most pronounced among producers of durable goods, which have a relatively large presence in the Region. A correction seems well under way in the light-vehicle sector, where domestic auto stocks fell considerably after year-end 2000 and production turned up in the second quarter. In contrast, recent inventory-to-sales ratios were high for primary and fabricated metals and other important sectors despite production cutbacks.

How crosscurrents will play out is unclear. Positive developments in the first half of 2001 include lower interest rates, tax rebates, stable residential markets, and reduction of the inventory imbalance for motor vehicles. On the other hand, activity in the manufacturing and CRE sectors is likely to remain a drag on the economy until current imbalances are resolved.

Sluggish economy pressures banks' asset quality and interest-rate risk management. Although some deterioration occurred in first quarter 2001, overall asset quality reported for the Region's banks and thrifts appears favorable, while aggregate capital levels are high by historical standards.

Economic weakness may affect insured institution asset quality adversely, however, particularly at institutions that have exhibited aggressive risk selection. Slower economic growth has also contributed to sharp reductions in interest rates, which may improve profitability for some insured institutions but present interest-rate risk management challenges for others.

Asset quality has deteriorated somewhat at large banks and thrifts. Large institutions in the Region, much like their counterparts nationwide, have experienced some asset quality weakening. The Region's large banks and thrifts reported a past-due and nonaccrual (PDNA) ratio of 2.42 percent on March 31, 2001, up 53 basis points from a year earlier and the highest in 12 quarters. The 2000 ***Shared National Credit Review*** program showed a second significant increase in classified and criticized credits, albeit from a very low base. Indications from the 2001 review are that this trend is continuing.

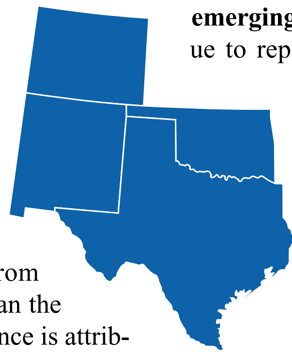
Concentrations in traditionally higher-risk assets have increased among community institutions. Increasing volumes of traditionally higher-risk loans and higher loan-to-asset levels may have heightened the credit risk for the Region's community banks. For example, 32 percent of institutions reported CRE exposure in excess of 200 percent of Tier 1 capital in early 2001, up from 19 percent in 1990. Loan delinquency levels have risen recently, yet remain well below levels of a decade ago. However, insured institutions with concentrations in CRE, commercial and industrial, or agricultural loans represent a significant share of those institutions with higher PDNA ratios.

In addition to rising credit exposure during the past decade, institutions faced an increasingly competitive environment, particularly for traditional funding sources. Competition on both sides of the balance sheet has led to significantly lower net interest margins despite increased credit exposure. Even so, aggregate profitability has held up well, thanks to a low level of problem loans, correspondingly low provision expenses, and the cultivation of noninterest income. The recent economic slowdown may weaken these positive trends.

Dallas Regional Perspectives

A slowing economy adds more uncertainty to the Dallas Region's agricultural sector. Prolonged price weakness, rising expenses, and weather-related issues have dampened profitability for most agricultural producers. However, government payments and strong levels of off-farm income have averted more serious problems for agricultural producers and their lenders. Signs of a slowing economy and prospects for a new farm bill could weaken these supports for the industry.

The effects of a decline in government payments may not be felt as acutely in the Dallas Region. Government payments and net farm income for 2001 are forecast to be considerably lower than in 2000. However, Congress recently approved an additional $5.5 billion of emergency aid for the 2001 crop year. While this allocation indicates a certain level of concern on behalf of Congress, it is substantially less than the $9.7 billion funded last year.[1]



During 1999, 39 percent of the Dallas Region's net farm income was derived from government payments, significantly less than the 50 percent average nationwide. This difference is attributable to the strong presence of the livestock sector, which does not receive government payments. Specifically, 69 percent of the Region's agricultural cash receipts are derived from livestock products, compared with 51 percent for the nation.[2] Livestock prices have performed well during the past two years, and this sector's current strength has protected the Region's agricultural industry somewhat from the effects of declining government payments this year.

Off-farm income helps to stabilize the economy. Another stabilizing effect on the general farm economy is the amount of off-farm income available to cover shortfalls in farming operations. The recent economic expansion and tightening labor markets have created new opportunities for nonfarm employment. Off-farm income in Texas and Oklahoma averaged almost $80,000 per farm household at year-end 1999—an increase of 116 percent since 1991, and 38 percent greater than the national average.[3]

In addition, commercial farms[4] saw their share of total household income derived from off-farm sources rise to 69 percent, an increase of 11 percentage points from 1991 to 1999. This increase helped mitigate problems that could have resulted from depressed commodity prices and sluggish exports. An economic slowdown would diminish the overall prospects for off-farm employment and income, increasingly used to supplement total farm household income.

Problems in the agricultural economy have not manifested in bank portfolios, but some weakness is emerging. In the aggregate, agricultural banks continue to report strong balance sheets and steady profits despite depressed agricultural conditions. However, the bottom 5 percent of the Dallas Region's agricultural banks reported a negative average return on assets (ROA), continuing a downward trend that began in 1997. The difference between the average pretax ROA for the Region's agricultural banks as a group and the "worst" performing members of this group is widening at an accelerating pace.

The 2002 farm bill is an unknown quantity. While it is unclear at this time what direction the new farm bill will take, most congressional leaders agree that ad hoc disaster payments are not a long-term solution for farm policy. Many members of Congress support keeping a market-oriented farm bill that also contains provisions to support farm income. Taking this a step further, the administration's position, as stated by U.S. Secretary of Agriculture ***Ann Veneman,*** emphasizes that any safety net for farmers and ranchers should be consistent with an evolving and dynamic global marketplace.[5] However, many industry analysts view ongoing attempts to move U.S. producers toward a free market approach as problematic because of the subsidies offered by other countries in the global agricultural marketplace.

[1] Jackson, Ben. May 14, 2001. "Farm Group Sees Shortfall In Budget Aid." *American Banker*.

[2] USDA, U.S., and State Income Data 1999. http://www.ers.usda.gov/data/farmincome/finfidmu.htm.

[3] USDA, Household Income Data 1999. http://www.ers.usda.gov/Briefing/FarmIncome/

[4] Farms reporting annual sales of $50,000 to $250,000.

[5] Remarks of Secretary of Agriculture Ann M. Veneman at the Sparks Companies 9th Annual Food and Agriculture Policy Conference, Washington, DC, April 17, 2001.

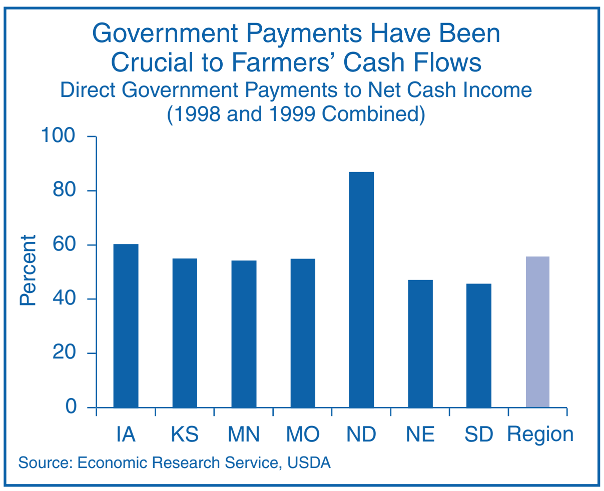
Kansas City Regional Perspectives

Heavy reliance on government payments makes uncertainty about these payments a key concern. Despite a prolonged period of low commodity prices, the Region's farm banks continue to report sound asset quality, in large part because of increasing government support to farmers. Much of this support has been ad hoc emergency and loan deficiency payments, which represented slightly less than two-thirds of the $22.9 billion in total payments last year. However, going forward, farmers are unsure about the timing and amount of these payments at a critical time—when they are deciding what to plant. Moreover, the farm bill expires in 2002, and it is not clear what direction farm support policy will take under new farm legislation.

The Region's farmers are highly dependent on government payments, although this dependence varies across the Region (see Chart 1). Generally, farm banks with the highest concentrations in farm lending and whose borrowers show the most reliance on government payments would likely exhibit the greatest exposure to changes in the level of government payments.

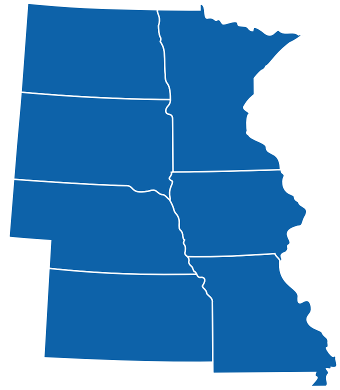
Assessing insured institutions' level of exposure to the agricultural sector is one way to evaluate the vulnerability of farm banks to declining government payments. Looking at a state's dependence on government support and farm banks' concentration in farm lending, **North Dakota** stands out in the Region. North Dakota's farmers are the most dependent on federal payments, and farm banks in that state tend to be relatively highly concentrated in farm lending.

CHART 1



The other states present a mixed picture. Although **Iowa** exhibits a relatively high dependence on government payments, its banks tend to be less concentrated in farm lending. Conversely, **Nebraska** and **South Dakota** farm banks tend to be more concentrated in agricultural lending, but these states' farmers appear to be less reliant on government payments.

However, the fact remains that all states in the Region are home to farmers who are highly reliant on government payments and to farm banks with relatively high concentrations in agricultural lending. As a result, the entire Region appears to be vulnerable, to some degree, to a significant reduction in government payments.



Large government payments have contributed to stable land values despite declining farm revenues. Despite large declines in farm operating net cash income during the past few years, farmland prices are holding steady or rising across the Region. In the aggregate, the value of cropland rose 3.6 percent and the value of pastureland rose 4.3 percent between year-end 1996 and year-end 1999, according to the most recent data available.

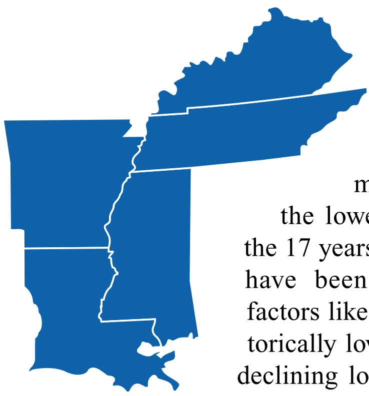
Nonfarm influences, such as urbanization and nonfarm residential and recreational use, are contributing to these sustained prices. However, a relatively high level of government payments appears to exert the greatest influence. Farmland, like other business property, derives its value from the ability to generate cash flow. Therefore, because government payments represent a portion of farmers' cash flow, they influence farmland value.

A reduction in government support could cause rising delinquencies and declining collateral protection. An analysis of the influence of government payments on land prices suggests that such payments accounted for as much as 52 percent of the Region-wide value of farmland in 1999, up considerably from 14 percent in 1996. As a result, even a small reduction in government payments to farmers could affect farmland values negatively and could result in escalating default rates on farm loans. Moreover, collateral protection could be eroded if current payments and the expectation of continued payments are supporting farmland values.

Memphis Regional Perspectives

Economic conditions in the Region and the nation have slowed considerably in recent quarters, and the outlook remains uncertain. While banks and thrifts in the Region remain relatively well positioned to meet the challenges posed by changing economic conditions, this transition is affecting earnings performance and credit quality at insured financial institutions.

Earnings fell sharply in first quarter 2001, and further economic slowing could contribute to additional earnings erosion. Community banks (those with less than $1 billion in total assets) reported a median return on assets of 1.03 percent, down from 1.17 percent one year ago because of increased provision expenses and declining margins. Net interest margins, a vital component of community bank earnings, fell to a median 4.09 percent, the lowest level reported in the 17 years for which such data have been collected. Several factors likely contributed to historically low margins, including declining loan volumes, balance sheet optionality, and limited repricing of deposits.



Margins should benefit significantly from the considerable steepening of the yield curve during the first half of 2001, but this improvement could be offset by declining loan levels and increasing levels of nonearning assets if economic conditions deteriorate. Furthermore, additional weakening could contribute to higher provision expenses. While many banks and thrifts recently tightened lending standards in response to changing conditions, credit quality deterioration may occur in loans originated during a stronger economic period and under less stringent underwriting standards. Many banks and thrifts in the Region already report higher loan delinquencies than one year ago, with the increase centered in consumer and construction lending.

A growing consumer debt burden and numerous layoffs in recent quarters may lead to higher consumer delinquencies and loan losses. Recent job losses, most notably in the stressed manufacturing sector, raise concern about the ability of some consumers to meet debt service payments, which at a national level have climbed as a share of disposable income to the highest level since 1987. The Region's insured financial institutions, particularly those in rural areas, appear more at risk to deterioration in consumer loan quality than institutions in other parts of the nation because of higher exposure levels and potentially weaker consumer finances. Without a quick economic recovery, consumer credit quality in the Region may deteriorate further. A significant number of layoff announcements continued into second quarter 2001 and many previously announced layoffs have only recently occurred, suggesting that the number of unemployed is likely to rise. As unemployment benefits, severance packages, and savings are exhausted, consumer loan delinquencies may climb.

Banks and thrifts in some of the Region's metropolitan areas may be vulnerable to potential residential real estate market imbalances. At least half of the banks and thrifts headquartered in the **Memphis, Fayetteville-Springdale,** and **Lexington** metropolitan areas report construction and development loan concentrations equivalent to 100 percent of leverage capital. Many banks in **Little Rock** and **Nashville** also report relatively high exposure. Among these five markets, Memphis banks appear most vulnerable because of substantially higher concentration levels, a preponderance of speculative rather than presold development, and an oversupply of existing homes.

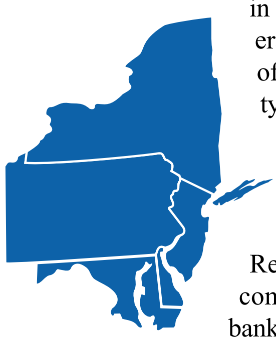
Risk managers face challenges with the economy in transition. Strong economic conditions throughout most of the 1990s provided creditors with greater comfort and flexibility in the application of underwriting standards without incurring substantial additional risk. However, the current economic slowing raises the level of incremental risk associated with each credit decision. Regardless of whether the recent slowing is a merely a temporary inventory adjustment or part of a more pronounced cycle, it does require front-line risk managers to adjust to a less forgiving economic climate.

New York Regional Perspectives

The economic tide has risen since the beginning of the 1990s; however, the Region's counties have not benefited equally. "Vibrant counties," those that ranked in the top third of economic performance over the past five years,[1] tend to be located in the suburban and exurban rings around the Region's major cities. These counties track the I-95 corridor between **New York City** and **Washington, DC,** and extend up to the Hudson River valley to **Albany.** During the latter half of the 1990s, vibrant counties experienced higher population and employment growth rates and had a more diversified job base, relative to the nation, than the Region's less vibrant counties. Many of the Region's vibrant counties also benefited from strong growth and higher-paying jobs in the construction, finance, insurance, and real estate industries. Conversely, the share of jobs in the stressed manufacturing sector in the Region's less vibrant counties, although declining, is roughly twice that in vibrant counties.

Banks in vibrant economies report higher margins but greater credit risk.

The Region's insured institutions have benefited from the rising economic tide, reporting strong loan growth and favorable credit quality. The Region's banks also have higher average capital ratios than a decade ago. Nevertheless, local economic conditions have contributed to differences in performance and credit risk profiles among the Region's banks. After declining throughout much of the late 1990s, net interest margins (NIMs) reported by the Region's banks have improved. However, banks in the Region's vibrant counties reported NIMs increasing to a greater degree than did banks in less vibrant counties. A moderate increase in the percentage of commercial loans, which are typically higher-yielding loans, and stronger core deposit growth have contributed to this difference in NIMs. Moreover, while institutions Region-wide face increased competition for core funding, banks in the Region's less vibrant economies face the added challenge of unfavorable population and personal income growth trends. Additionally, banks in less vibrant counties hold loan portfolios characterized by a longer maturity, which reflects a greater proportion of residential loans. This portfolio composition also may have contributed to NIM compression when the yield curve was relatively flat in the late 1990s.



Despite slightly higher past-due ratios reported by banks in less vibrant counties, insured institutions in the Region's vibrant economies might be more vulnerable to losses. According to a ***Federal Deposit Insurance Corporation*** study of the 1980s banking crisis, bank failures that occurred a decade ago generally were concentrated in the Region's markets that had experienced rapid growth, particularly speculative commercial real estate (CRE) development.[2] The Region does not currently exhibit the economic imbalances it experienced a decade ago; however, a softening economy could lead to a weakening in credit quality. Moreover, should margin pressure increase, banks in less vibrant economies holding lower-yielding portfolios may be tempted to shift into traditionally higher-yielding, higher-risk assets or expand their geographic lending area, which could heighten credit risk profiles.

Economic slowdown affects office markets.

Recent evidence suggests that some of the Region's office markets may be experiencing the effects of the economic slowdown. According to recent reports,[3] many of the Region's major office markets, including New York City, northern **New Jersey, Long Island, Philadelphia,** Washington, DC, **Westchester,** and **Wilmington** experienced negative absorption, increased vacancy rates, and declining rents in the first half of 2001. Despite recent increases, vacancy rates in many of the Region's office markets remain below the national average.

CRE credit quality reported by the Region's banks has remained favorable; however, delinquency ratios have slightly increased since mid-2000. Softer economic conditions could pressure vacancy and rental rates, thereby affecting the repayment capacity on loans that assume a continuation of the high rental rates achieved at the height of the recent economic expansion.

[1] The Region's 178 counties were ranked by the degree of change in employment, population, income, and single-family home prices between 1996 and 2000 and industrial diversity relative to the nation.

[2] Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s.* 1997. Washington, DC: FDIC.

[3] Torto Wheaton.

San Francisco Regional Perspectives

The Region's employment growth outpaced the nation's, but decelerated through second quarter 2001. Weakness in the manufacturing and high-tech sectors contributed to the slower growth. Should the national economy continue to slow, job creation could also be affected adversely in the high-tech manufacturing, lumber, and tourism industries, three sectors that have contributed significantly to the gross state products of many states in the San Francisco Region. Continuing weakness in these key industries could contribute to additional deterioration in commercial and industrial (C&I) loan quality among the Region's insured institutions.

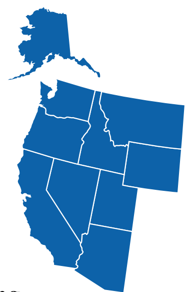
High-tech manufacturing, particularly semiconductor production, has slowed owing to worldwide cutbacks in capital expenditures. Many semiconductor manufacturers announced disappointing results and layoffs during the first half of 2001. The semiconductor industry represents a significant component of the high-tech manufacturing sector in **Oregon, Idaho, Arizona,** and northern **California.**

Increasing imports and declining overseas demand have contributed to weakness in the timber industry. In addition, rising energy prices could pressure lumber producers and processors further, which could adversely affect the economies of **Washington,** Oregon, and Idaho.

Continued economic slowing could also affect travel-related industries that are critical to the economies of Hawaii and Nevada. Visitor counts have already declined in **Hawaii,** and the **Las Vegas** hospitality industry could feel the effects of reduced corporate spending, higher energy prices, and increased gaming competition.

Commercial and industrial delinquency and loss rates have increased in recent periods at many of the Region's insured institutions, particularly large banks. Between year-end 1999 and March 31, 2001, delinquent commercial and industrial (C&I) loan ratios increased, particularly among large institutions. Year-end 2000 C&I loss ratios also rose at many of the Region's established commercial lenders, and gross C&I losses represented an increasing share of total loan losses. Overall, commercial loan delinquency and loss rates remain low by historical standards; however, rising levels are of concern, given that C&I lending contributes significantly to many institutions' loan portfolios and incomes.

During the late 1990s, increased competition for C&I loans contributed to easing underwriting standards, which could adversely affect credit quality going forward. Several trends have contributed to the intensity of C&I loan competition. Credit-scoring models improved the cost-effectiveness of small business lending for larger institutions, prompting many smaller institutions operating without these models to grant underwriting concessions. Community banks also have faced increased C&I loan competition from thrifts and newly chartered banks. Flagging core deposit demand in the late 1990s contributed to higher funding costs and profit pressures industry-wide, prompting savings institutions and new banks to compete directly with commercial banks by offering higher-yielding commercial loan products.



Some of the drivers of increased competition are not yet recession-tested. For instance, credit-scoring models, developed primarily since the last recession, have not been tested through a full credit cycle. Likewise, new banks and thrifts that have increased C&I lending activity recently might not have experience in managing, monitoring, and controlling an increased level of C&I credit risk during a slowing economy.

During a period of brisk competition and aggressive loan growth, some insured institutions have increased C&I loan concentrations and pared staffing resources. The relative size of small business loans has grown, most notably among metropolitan insured institutions with less than $100 million in total assets. Given that C&I loan portfolios often experience higher loss rates than other loan categories, an increase in the average size of a small business transaction could weaken loss reserves at small institutions more quickly. Finally, sustained C&I loan growth throughout the Region has stimulated demand for qualified commercial loan officers. At the same time, however, some bankers are reporting a shortage of seasoned commercial lenders, and the level of serviced assets per full-time equivalent employee ratios are on the rise.

Should the economy continue to slow, the effects of increasing competition could combine with weakness in the high-tech manufacturing, lumber, and tourism sectors to erode insured institution C&I credit quality.

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