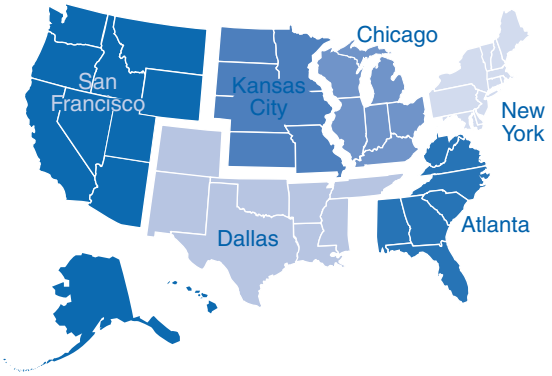
FDIC Outlook

FALL 2003

In Focus This Quarter



The reluctance of businesses to hire and invest in new equipment has been a significant drag on the economy's progress since the 2001 recession ended. The banking industry, though, has continued to do well and credit quality continues to improve despite a climate of subpar economic growth. However, as signs have pointed to accelerating U.S. economic activity during the third quarter of 2003, long-term interest rates have risen sharply. The recent increase in interest rates may raise certain concerns for some insured institutions, including reduced refinancing demand; asset-extension risk; reduced valuation of mortgage-backed securities and other securities holdings; and more difficulty generating low cost, core deposits, as households seek greater yields than those offered by bank deposits. *See page 3.*

By Risk Analysis Staff

Regional Perspectives

Atlanta—Weak conditions persist among many segments of the commercial real estate sector in most major Southeastern markets. However, because property valuations have not declined, loan quality at insured institutions has weakened only modestly. *See page 11.*

Chicago—Information technology advancements have improved access to banking services in the Chicago Region and across the nation. Layered security can mitigate vulnerabilities arising from increasingly complex computer systems. *See page 17.*

Dallas—The Region's rural economy is showing signs of life despite a prolonged slump in the agricultural and manufacturing sectors, but recovery is not assured. *See page 21.*

Kansas City—Continuing weakness in the aircraft manufacturing sector could begin to have an adverse effect on insured institutions headquartered in the Wichita metropolitan statistical area when extensions to unemployment benefits expire. *See page 25.*

New York—Despite ongoing job losses, the Region's insured institutions are performing well, and asset quality remains favorable. Earnings could suffer from a continued weak economy or from interest rate risk inherent in increasing concentrations of long-term assets. *See page 30.*

San Francisco—Declining tax revenue could prompt layoffs in the state and local government sector, contribute to municipal bond downgrades, and constrain the volume of municipal deposits, potentially pressuring the asset quality and liquidity of insured institutions. *See page 33.*

By Regional Operations Staff

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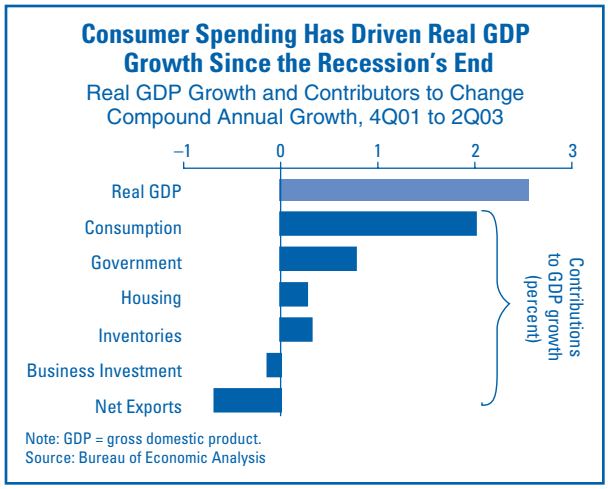
At the Crossroads: Banks See Interest Rates Rise as Economy Shows Signs of Improvement

Economic Growth in the Current Expansion Has Been Unbalanced

Since the end of the recession in November 2001, the U.S. economy has expanded at a subpar pace. Real gross domestic product (GDP) expanded by nearly 3 percent during 2002 and at an annualized rate of roughly 2 percent through June 2003. Thus far, this pace has been insufficient to generate net employment gains. While the 2001 inventory correction and accompanying cyclical slump are well behind us, certain longer-term, secular features (such as strong labor productivity growth) are combining with slack global demand and global pricing pressures to limit the strength and breadth of the ensuing economic expansion.

Household demand has been the major source of real GDP growth since the end of the recession. Consumer spending accounted for 2 percentage points of the overall 2.5 percent average annualized gain in real GDP between December 2001 and June 2003. Over the same period, the net contribution of all other sectors was only 0.5 percentage points of real GDP growth. The contributions from government spending, new residential investment, and inventory accumulation were nearly offset by expansion of the trade deficit and a modest net contraction in business investment for plant, equipment, and software, as illustrated in Chart 1.

Chart 1



The drag on growth from net exports is in part a long-term structural issue but also may reflect unusually slow worldwide economic growth. Weak foreign demand has limited any improvement that might otherwise have resulted from the 7 percent drop in the trade-weighted value of the U.S. dollar since December 2001. Real imports rose by about 10 percent in 2002, while real exports grew by roughly 4 percent. During the first half of 2003, real imports continued to inch ahead, while real exports fell by about 1 percent. Since real export growth appears unlikely to accelerate over the near term, it will be critical that domestic spending on capital equipment and inventories gains traction in order to provide a more well-rounded, stronger expansion—one that is less likely than the present one to be derailed by any unforeseen shocks. A stronger business contribution is especially necessary given the recent high degree of dependence on the consumer. Household spending for goods and services grew throughout the recession for the first time on record, while the dip in new residential investment was extremely mild. Consequently, pent-up demand from the household sector, which traditionally boosts demand and production growth immediately after a recession, may not provide as much momentum in this expansion.

While the consumer sector has carried growth in recent quarters, the opposite is true of business spending and investment. The reluctance of businesses to hire additional employees and invest in new equipment has been a significant drag on the economy's progress since the recession ended. Some have attributed this reluctance to sluggish sales growth; however, while not robust, sales for all U.S. nonfinancial corporate businesses grew at a 4 percent annualized pace in both fourth quarter 2002 and first quarter 2003. By way of comparison, sales for these firms grew at an average annual pace of about 6 percent between 1995 and the beginning of the recession in early 2001.

Other explanations include excess worldwide production capacity in many sectors, such as motor vehicles and parts, commercial aerospace, telecommunications, textiles, chemicals, and agricultural commodities, as well as increasing globalization of economic activity—both of which have impinged on pricing power in certain domestic industries that either sell

internationally or produce goods and services exposed to import competition. While it is not readily apparent to what extent nonfinancial corporate business sales gains have been constrained by price discounting, the trend in the unit price of real nonfinancial corporate GDP may offer some insight into the weak state of business pricing power in the current environment (see Chart 2).[1]

In addition to global supply and pricing pressures, strong and enduring labor productivity gains resulting from the late 1990s surge in business investment may be limiting the need for additional business investment and hiring in the near term. Finally, it has been suggested that some U.S. firms may have been more focused recently on balance sheet restructuring, corporate governance and control issues, accounting and financial reporting accuracy, and the correction of other imbalances from the 1990s than on expanding their markets and operations. Over the next year, most of these distractions should fade, although weak global demand could continue to weigh on growth until other major economies begin to grow at rates approaching their potential.

The Jobless Expansion Is Weighing on Economic Growth

To an even greater extent than was the case after the 1990–91 recession, the period since November 2001 can be called a "jobless recovery." Weak job growth in the wake of the last two recessions may reflect that they were short and mild compared with previous recessions, which were typically "V-shaped" and had a more pronounced upturn of employment soon after the recessions' ends. Even so, against the benchmark provided by the early 1990s jobless recovery, the recent trend in U.S. payroll employment may be cause for some concern. As Chart 3 shows, nonfarm payrolls in July 2003 were 2 percent lower than in early 2001. By way of comparison, 1.5 years after the peak preceding the early 1990s recession, nonfarm payrolls were already well on their way to recovery and were less than 1 percent below the prior high.

[1] This metric is the difference between nominal and inflation-adjusted (real) sales (GDP) of nonfinancial corporate businesses. It is essentially the price component of business sales.

Chart 2

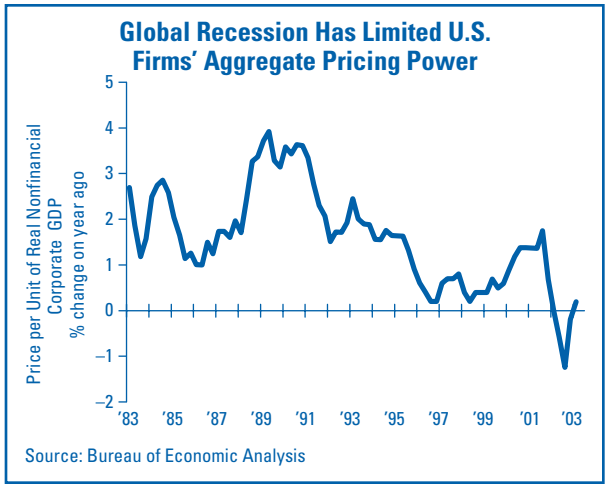
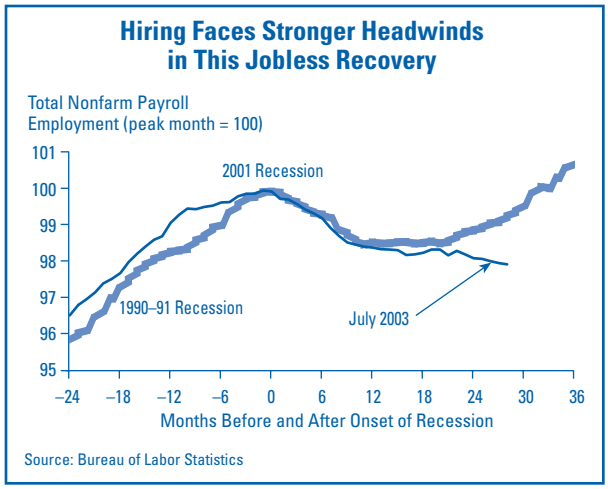


Chart 3



Why has this divergence occurred? An obvious answer is the manufacturing sector's reluctance to hire additional workers. The world continues to experience subpar economic growth, replete with excess capacity and disinflationary, or outright deflationary, pressures. These pressures are likely limiting firms' collective pricing power, especially in manufacturing. As would be expected, firms operating in an environment where the price of their product is declining face two options to bolster earnings. The first—making up for a lower unit price by increasing sales volume—has proved quite difficult given the weak state of global demand in recent years. This leaves the second option—cutting costs and enhancing efficiency by bolstering productivity. Manufacturing firms are more exposed than many services firms to pricing pressure, either because their markets are global in nature or because they are subject to a high degree of import competition. In addition,

labor productivity gains have been greatest in the manufacturing sector, although this may reflect in part a better ability to measure output per hour in these industries than in services.

Payroll reductions and a hesitancy to respond to any upturn in demand with new hiring are two approaches manufacturers are taking to control costs. The U.S. economy shed 2.7 million jobs on net between the February 2001 peak and July 2003, with 90 percent, or 2.4 million jobs, coming from manufacturing. Further, half the reduction in factory payrolls occurred after the end of the recession in November 2001. During that time, nonmanufacturing payrolls inched up by roughly 183,000 positions, due mostly to strength in education and health services and, to a lesser extent, local government.

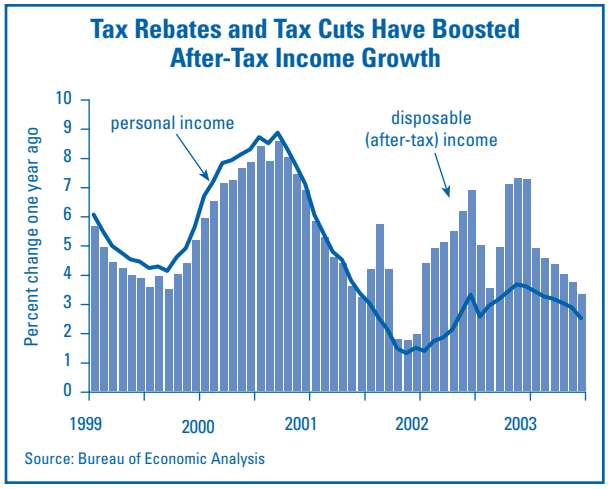
Weak Job Growth Has Been Offset, So Far, by Fiscal and Monetary Policy

Proactive and sizeable fiscal and monetary stimulus helped consumer spending carry economic growth through both the recent recession and the subsequent period of moderate growth and lackluster labor market conditions. While wage and salary growth decelerated sharply through the 2001 recession and remained sluggish subsequently, overall income continued to grow at a somewhat sturdier pace. This was due in part to anti-recession income transfer programs, such as unemployment insurance.

Additionally, gains in after-tax income have generally exceeded those for personal income since summer 2001, reflecting reduced income tax rates enacted in 2001[2] (see Chart 4). In addition, the 2003 Jobs and Growth Tax Relief Reconciliation Act is expected to boost year-ago after-tax income growth beginning in July 2003. This stimulus will last through mid-2004, at which time, absent further tax cuts, year-over-year income growth will return to its underlying trend and more closely reflect changes in net employment.

Monetary policy also has been quite accommodative, contributing to lower short-term and mortgage interest rates through mid-2003. Lower short-term rates helped to reduce the cost of variable-rate consumer credit. They also enabled some households to reduce their

Chart 4

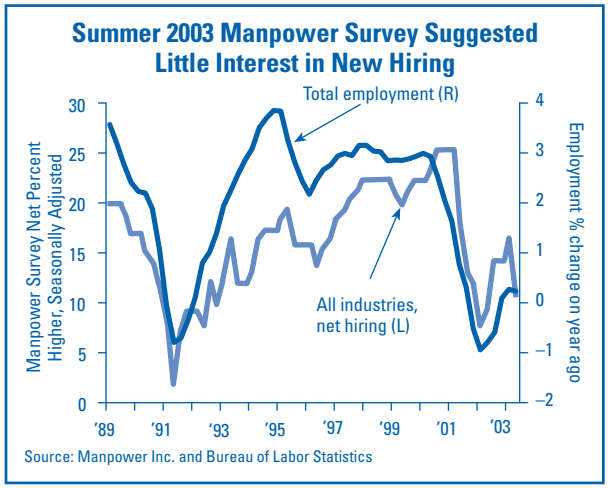


debt service burdens not only by refinancing outstanding mortgage debt but also by rolling higher-cost debt into lower-cost, fixed-rate, tax-favored mortgage debt. In addition, favorable mortgage rates spurred a significant surge in cash-out refinancing volume during the past two years.[3] Momentum from that surge will provide support to consumer liquidity through at least the end of 2003 even though a rise in mortgage rates after mid-June quickly began to dampen refinancing demand.

What Is the Outlook for Renewed Hiring?

As of mid-2003, there was little evidence that businesses planned any significant return to hiring. Accord-

Chart 5



[2] The after-tax income growth stimulus from the tax rebate checks issued that year appear in the graph briefly just after midyear.

[3] See In Focus article in the Summer 2003 FDIC Outlook.

ing to ***Manpower Inc.,*** which conducts quarterly surveys of the hiring intentions of more than 15,000 employers in 473 cities, the outlook for near-term job gains turned down in the first half of 2003.[4] Chart 5 shows the recent trend in this survey's measure of net hiring strength, which attempts to gauge the share of businesses that plan to increase hiring in the next three months. In addition, the chart provides the year-ago change in U.S. nonfarm employment. The results of the third quarter 2003 Manpower survey suggest that employment probably will not expand significantly over the remainder of the summer.

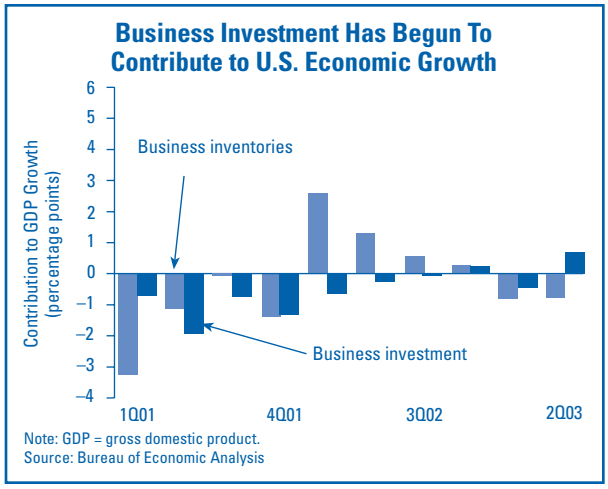
A monthly survey of hiring intentions by the ***National Federation of Independent Business*** also showed little hiring interest by small firms in June, while the employment sub-index from the ***Institute for Supply Management's*** July survey of manufacturing offered a similarly glum assessment for renewed factory sector hiring.

Business Inventories and Investment Also Are Weighing on Growth

Businesses' inventory liquidation was a significant drag on growth during the 2001 recession. However, as liquidation turned to positive accumulation in 2002, this component of business spending became a considerable boon to GDP growth (see lighter-shaded bars on Chart 6). Now that inventories are better aligned with the pace of sales, no additional stimulus from inventory accumulation is anticipated until aggregate demand growth shows a noticeable and sustained pick-up. In fact, during the first half of 2003, inventory liquidation reduced net economic growth at the margin.

Business fixed investment in equipment, software, and buildings contracted more than usual in the recession and has been, at best, an insignificant factor in the recovery (see Chart 6). Equipment and software spending, which makes up about 85 percent of total business fixed investment, has now grown in four of the last five quarters. However, offsetting this spending have been outlays on commercial buildings, which fell for ten consecutive quarters before rising modestly in the second quarter of 2003. The net effect has been that

Chart 6



business investment (the darker-shaded bars in Chart 6) has contributed little to overall economic growth until recently.[5]

In second quarter 2003, overall business spending rose and contributed nearly 1 percentage point to real GDP growth because of strength in the equipment and software segment and an increase in spending for structures after six quarters of decline. In fact, investment in structures leveled out in first-half 2003, albeit at a pace about 25 percent slower than in late 2000. Thus, it should no longer weigh heavily on overall business investment, although high vacancy rates and the potential for continued subdued employment growth likely will keep this category from contributing much to economic growth for some time.

The recent trend in equipment and software outlays has been somewhat mixed, depending on the type of investment. Spending for information processing equipment and software rose at a double-digit pace in four of the six quarters ending June 2003. Growth in this component, which accounts for about 60 percent of total investment in equipment and software, helped offset continued weakness in spending for industrial and transportation equipment.

Current capacity utilization among U.S. manufacturers is below 73 percent, which might suggest that years of production growth will be needed before the utilization rate returns to 80 percent, a rate typically supportive of

[4] Employers declare their intentions to increase, decrease, or maintain the size of their present workforce for the upcoming three-month period. The survey was designed with the assistance of the Survey Research Center of the University of Michigan. In Chart 5, the current seasonal adjustments are by Manpower, Inc. Haver Analytics, Inc. calculated the historical seasonally adjusted series.

[5] In the national income and product accounts, commercial buildings include offices, factories and warehouses, hotels and motels, and retail facilities.

a healthy pace of new investment. The amount of excess capacity varies considerably among domestic manufacturers, however—as low as 63 percent among high-tech firms but 74 percent among other manufacturers as a group. The decline in investment spending over the past three years has contributed to slower growth in the U.S. capital stock, or its total productive capacity. This development, plus rising demand for manufacturers' output, should help ease excess capacity, thus bringing closer the time when need for new investment arises.

Along this line, manufacturers' new orders for nondefense, nonaircraft capital goods started rising in late 2002. Production of such equipment is typically indicative of broader investment trends, so developments through midyear 2003 suggested a potential strengthening of business investment going forward. In addition, some firms are experiencing an upturn in orders for defense-related goods that will spur further investment. Various national and regional surveys of manufacturing firms reinforce the idea that conditions are improving, and that demand for capital goods will rise in coming quarters.[6]

Banking Industry Continues to Thrive Despite Unbalanced Economic Growth

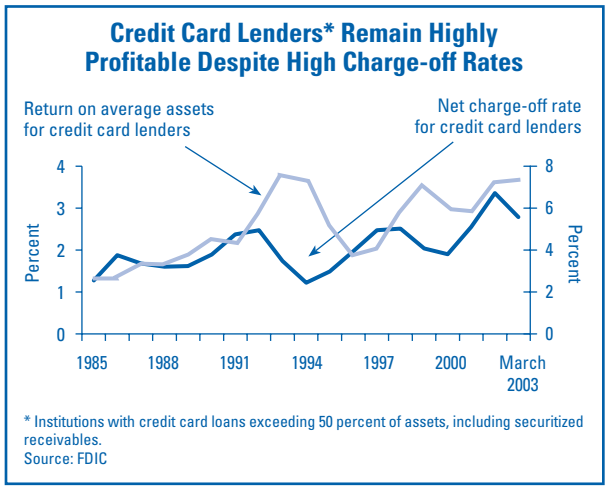
During first quarter 2003, net charge-offs at FDIC-insured institutions totaled $10.4 billion, $1.2 billion (10.6 percent) below the level of first quarter 2002. This is the second quarter in a row that industry charge-offs have been lower than a year earlier, following two-and-a-half years of rising charge-offs. Significant declines in net charge-offs from credit cards and commercial and industrial (C&I) loans, which dropped 18.5 percent and 10.7 percent, respectively, drove the overall improvement.[7]

Noncurrent loans—loans past due at least 90 days plus those on nonaccrual status—also have improved since third quarter 2002. Aggregate noncurrent C&I loans fell by $1.3 billion (4.7 percent) during first quarter 2003, the second consecutive quarterly decline. Developments at large commercial banks with assets of $1 billion or more, the group most severely affected by troubled corporate borrowers during the recent recession, have driven the overall improvement. The group of 413 large commercial banks accounts for just 5 percent of total insured institutions but held 87 percent of C&I loans in first quarter 2003.

After reaching a peak of $1.05 trillion in fourth quarter 2000, C&I loans outstanding at all commercial banks dropped to $907 billion by first quarter 2003. About $57 billion of the decline occurred in the year ending first quarter 2003. Shrinking C&I portfolios reflect both lower demand, given lackluster business investment, and generally tighter lending standards on the part of the banks.[8]

Despite weak commercial real estate (CRE) fundamentals in some markets, there has been only a minimal effect on bank CRE portfolios. A repeat of the large-scale losses in commercial bank CRE portfolios in the last cycle does not appear likely. Still, the nation's commercial banks registered increases in noncurrent CRE loan portfolios of $530 million, or 7 percent, during first quarter 2003, and charge-offs are trending upward. As a share of total CRE loans at commercial banks, however, the noncurrent portion is still a low 0.95 percent. This is a moderate increase from 0.90 percent at year-end 2002 and 0.94 percent at year-end 2001.

Chart 7



[6] For example, the *Empire State Manufacturing Survey* by the New York Federal Reserve Bank and the national manufacturing diffusion index from the Institute of Supply Management.

[7] The 18.5 percent drop in credit card charge-offs was influenced by the sale of a large subprime credit card portfolio in first quarter 2002, which produced a spike in charge-offs at that time.

[8] According to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, the net percentage of domestic banks reporting tightening standards for commercial and industrial (C&I) loans has been positive in every survey conducted since August 1998. See http://www.federalreserve.gov/boarddocs/SnLoanSurvey

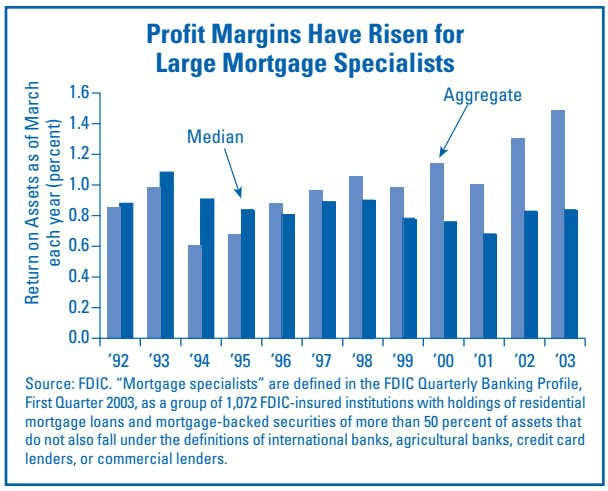
Charged-off CRE loans have increased steadily from a low of $38 million in 1997 to $1.17 billion in 2002 but, as a percentage of CRE loans outstanding, increased from 0.01 percent in 1997 to just 0.14 percent at year-end 2002. Thus, CRE delinquencies and charge-offs as a percentage of total CRE loans remained near historic lows during the past two years.

Commercial banks and thrifts have benefited from strong consumer loan demand. This is evidenced by growth in consumer loans over the four years ending March 31, 2003, which averaged 6 percent—up from an average of 3.3 percent in the prior four-year period. Even with this growth, banks and thrifts continue to report modest levels of noncurrent consumer credits. For first quarter 2003, the ratio of noncurrent consumer loans to total consumer loans was 1.35 percent. Although this average ratio was similar to the levels recorded during the two years immediately following the 1991 recession, it was below the peak of 1.50 percent seen during that recession.

The banking industry also has enhanced its profits through credit card lending activities. Institutions classified as credit card lenders reported an annualized return on assets (ROA) of 3.66 percent for first quarter 2003, the highest since first quarter 1994, when the figure was 3.81 percent. Despite the recent strength in credit card profits, annualized net charge-offs rates remained higher in first quarter 2003 than in much of the 1990s. Annualized net charge-offs to total loans for credit card lenders reached 5.57 percent in first quarter 2003, well above the 4.97 percent in first quarter 1992—a year or so after the end of the prior recession. Meanwhile, noncurrent credit card loans declined in first quarter 2003 by $919 million (or 14.3 percent). The higher profit margins of credit card lenders, whose businesses are benefiting from improved credit-scoring technologies relative to the early 1990s, have helped compensate them for the higher credit risks of such unsecured lending (see Chart 7).

The total outstanding debt of U.S. households increased by $768 billion in 2002. Mortgage debt accounted for 87 percent of this amount. For FDIC-insured institutions, mortgage-related lending accounted for some 64 percent of net loan growth during 2002 and 70 percent of asset growth in first quarter 2003. During the year ending March 2003, first and junior liens outstanding at insured institutions rose 15 percent. In addition, the industry has experienced double-digit growth in home equity lines of credit.

Chart 8



Source: FDIC. "Mortgage specialists" are defined in the FDIC Quarterly Banking Profile, First Quarter 2003, as a group of 1,072 FDIC-insured institutions with holdings of residential mortgage loans and mortgage-backed securities of more than 50 percent of assets that do not also fall under the definitions of international banks, agricultural banks, credit card lenders, or commercial lenders.

Home equity lines of credit held by insured institutions as of March 2003 totaled $277 billion, up 39 percent from a year ago.

Meanwhile, mortgage-backed securities (MBS) offered attractive investments for commercial banks and thrifts. The banking industry's holdings of MBS grew by 20 percent to nearly $1 trillion between the first quarters of 2002 and 2003, far surpassing previous year-ago growth in first quarter holdings. As discussed later, these assets likely declined in value late in second quarter 2003, as mortgage interest rates climbed dramatically.

Despite a rising concentration in mortgage-related assets, mortgage debt historically has shown lower levels of credit exposure than other loan types. In addition, low interest rates have kept the household debt service burden at a reasonable 14 percent of disposable income, despite recent large increases in household indebtedness. To the extent that most of this recent debt accumulation has taken the form of fixed-rate mortgage borrowing, household debt service burdens may not rise appreciably with higher interest rates over the business cycle. Further, any sustained rise in interest rates likely would imply that the recent fiscal and monetary stimuli have been successful in spurring economic growth, so advancing employment and aggregate income would be expected to improve debt service capacity.

Commercial banks and thrifts have profited from the boom in mortgage originations. Insured institutions identified as mortgage lenders reported a record-breaking ROA of 1.49 percent in first quarter 2003;

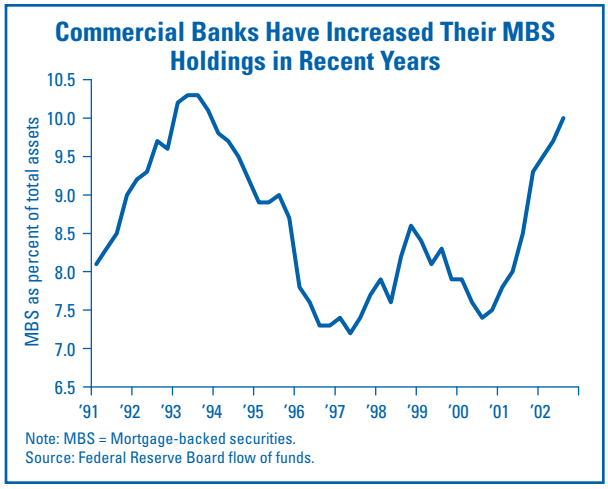
however, this trend appears to be driven by large institutions originating mortgage loans and holding MBS assets, as the median profitability in this segment, though also improved, remains within its historical range (see Chart 8). Further, to the extent that the recent peak in aggregate profitability reflects gains from the sale of MBS and other securities through the early part of this year, the recent rise in interest rates and subsequent decline in the value of securities may detract from earnings in subsequent quarters. Finally, even though net charge-offs for mortgage lenders also increased modestly, to 0.19 percent from 0.16 percent in the prior year, these low loss rates speak to the relatively low credit risk of residential mortgages.

While stronger economic growth likely will result in a continued improvement in credit quality, it also appears likely to bring higher interest rates, which will raise the cost of credit to borrowers and the cost of funds to banks and thrifts. Long-term interest rates have risen sharply in the third quarter of 2003, even as the federal funds target rate was cut an additional quarter percent to 1.0 percent in late June.

Despite the recent rise in intermediate- and longer-term interest rates, C&I loan growth may strengthen as the economy improves. Consumer loans likely will continue to grow, though possibly more slowly than in the past few years, in light of consumer debt levels and a lack of pent-up demand. Rising mortgage rates may dampen mortgage refinancing opportunities but prompt households to increase their use of home equity lines. Commercial real estate loan growth is expected to remain anemic and lag the economic rebound, given significant amounts of unused space available.

At the height of the bull market in equities, core deposits increased by only 3 percent between first quarter 1999 and first quarter 2000. Over the next three years, core deposit growth more than doubled, rising 7 percent in 2000, 8 percent in 2001, and nearly 10 percent in the year ended first quarter 2003; however, a stronger stock market in 2003, coupled with better returns in other investment opportunities, may begin to reduce the safe-harbor appeal of bank deposits. This situation, coupled with record low deposit rates, may lead to modest core deposit growth at most insured institutions going forward.

Chart 9



If banks choose to supplement any shortfall in core deposit growth through borrowed funds, to the extent these funds are *not* priced off short rates, funding costs will begin to increase at the margin. This rise in funding costs may occur more rapidly than asset prices adjust upward, especially if asset prices *are* tied to a short-term rate, such as prime, which likely will remain fixed at least through early 2004.

Despite the boost and earnings brought about by the widespread refinancing of mortgage debt and record home sales in recent years, interest rate risk issues for many mortgage lenders may be elevated. Specifically, record long-term, fixed-rate mortgage origination volume during the historically low rate environment that persisted up to summer 2003 may have generated extension risk for many mortgage portfolio holders. This can result in net interest margins being squeezed as lenders hold low-yielding, long-lived, mortgage-related assets while funding costs reprice upward along with market interest rates.

Also, banks that are active mortgage loan securitizers may see declines in this form of funding as new loan originations and refinancings begin to slow down. As long-term rates increase, many banks will see their unrealized securities gains shrink and perhaps begin to experience unrealized losses, further straining liquidity. The banking industry as a whole has seen significant increases in MBS holdings over the last couple of years (see Chart 9). Banks with high proportions of MBS and intermediate and long-term agency and treasury securities will be most at risk for future unrealized losses.

Banks' Strong Performance Should Continue, Though Higher Interest Rates May Raise Some Concerns

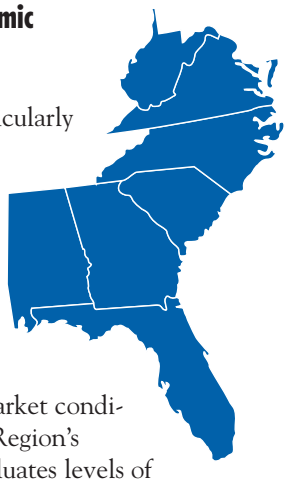
The reluctance of businesses to hire new employees and invest in new equipment has been a significant drag on the economy's progress since the recession ended. Possible explanations include sluggish sales growth in a weak global economy and reduced pricing power due to excess global capacity, which pressures margins and result in heightened cost control efforts. Other explanations include strong and enduring labor productivity gains resulting from the late 1990s surge in business investment, which may be limiting the need for business investment and hiring in the near term. Finally, it has been suggested that some U.S. firms during the past year may have been more focused on balance sheet restructuring, corporate governance and control issues, accounting and financial reporting accuracy, and the correction of other imbalances from the 1990s than on expanding their markets and operations. Over the next year, most of these distractions should fade, although weak global demand could continue to weigh on growth until other major economies begin to grow at rates approaching their potential.

The banking industry continues to do well and credit quality continues to improve despite this climate of subpar economic growth. The recent rise in interest rates, however, may raise certain concerns for the industry, particularly for mortgage lenders. These challenges will take the form of slower growth in residential real estate loans, particularly refinance transactions; asset extension risk, which may tie up capital that could otherwise be deployed at higher interest rates; increased unrealized losses in MBS and other securities holdings; and a reduced ability to generate low-cost, core deposits, as rising interest rates spur households to seek greater yields than those offered by bank deposits.

Risk Analysis Staff

Atlanta Regional Perspectives

A Recovery in Some Atlanta Region Commercial Real Estate Markets Remains Constrained by Weak Economic Growth



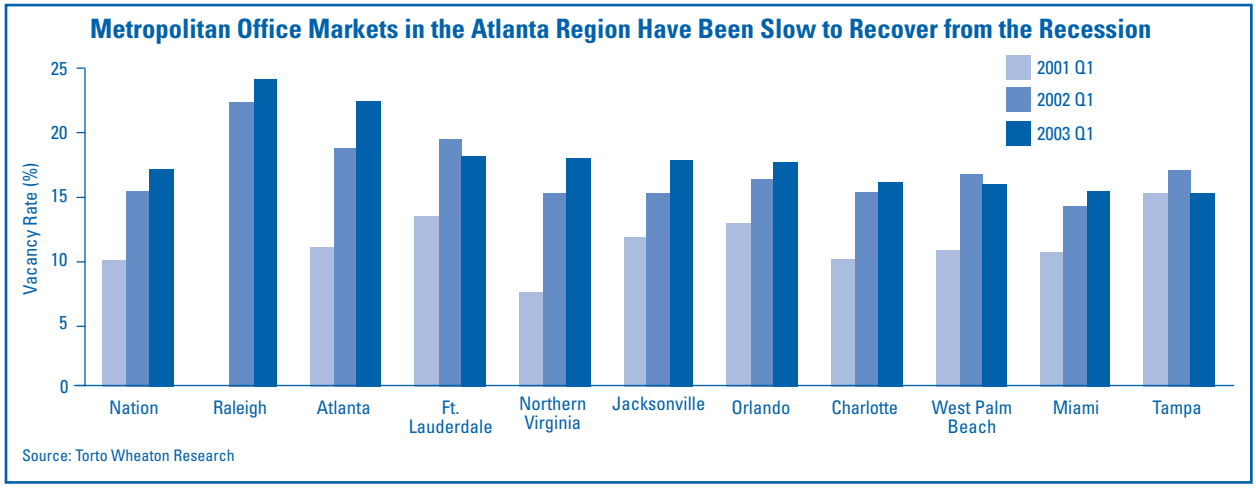
The recent recession was particularly problematic for commercial real estate (CRE) markets in the Atlanta Region. The subsequent "jobless" recovery has contributed to low absorption rates that have prevented some markets from rebounding. This article examines CRE market conditions by property type in the Region's major metropolitan areas, evaluates levels of community bank exposure to CRE lending, and identifies areas where prolonged weak economic growth and market downturns have resulted in CRE asset quality deterioration.

Office Markets Have Been Hit Hard by the Recent Recession

The recent recession adversely affected office real estate markets in the Atlanta Region. Unlike past economic downturns, net absorption rates turned negative in many areas as layoffs disproportionately affected salaried office workers. Simultaneously, new space remained in the construction pipeline because of developers' prior expectations of continued economic growth. Subsequently, market conditions in many instances deteriorated rapidly as vacancy rates rose significantly (see Chart 1). Some metropolitan areas that previously had been characterized as tight markets suddenly faced the prospect of double-digit vacancy rates. Until recently, low interest rates had helped support market values; however, as leases expire and rent appreciation remains weak owing to continued fragile economic growth, these markets may come under pressure. During first quarter 2003, office market values declined nationwide.[1] Widespread deterioration in fundamentals continued to occur in the Region's major metropolitan statistical areas (MSAs) as office employment growth remained lackluster in the face of further layoffs, and as space offered for sublease continued to inflate vacancy rates.

Office markets in metropolitan areas that are home to large concentrations of high-tech employment **(Atlanta, Raleigh, Northern Virginia)** generally experienced the greatest deterioration. The Raleigh and Atlanta MSAs reported the Region's highest office vacancy rates in first quarter 2003, while rates in Atlanta and Northern Virginia have more than doubled during the past few years. Some submarket vacancy rates in Raleigh and Northern Virginia recently have spiralled to above 30 percent.[2] Though submarket vacancies in Atlanta have yet to reach that

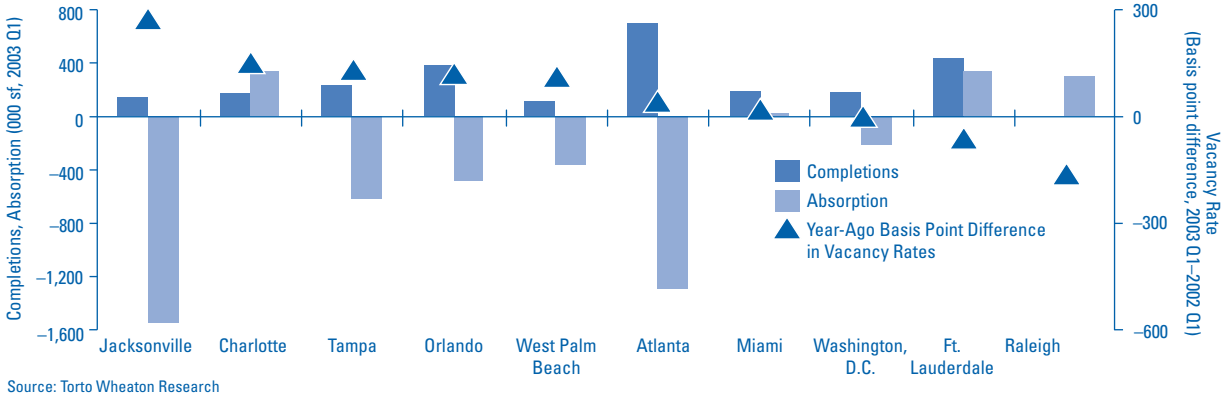
Chart 1



[1] Dean Starkman, "Property Values Finally Decline With Office Space Falling 1.7%," *Wall Street Journal,* May 28, 2003.
[2] Northern Virginia submarkets: Herndon and Sterling. Raleigh submarkets: Cary, Glenwood/Creedmoor, Northeast Wake County.

Chart 2

Industrial Markets Have Continued to Deteriorate in Most of the Region's Major Metropolitan Statistical Areas



Source: Torto Wheaton Research

level, some local developers speculate that the downturn in the local office market may be the worst in nearly three decades.[3] In contrast, vacancy rates in office markets characterized by significant back office operations and call centers, such as **Tampa,** have declined during the year ending first quarter 2003.

Industrial Real Estate Market Conditions Continued to Weaken in Early 2003

Industrial real estate market conditions in the Atlanta Region began to deteriorate with the onset of the recent recession as employment in manufacturing, wholesale trade, and high-tech industries started to erode. Average vacancy rates in all major regional markets have increased significantly. This trend was particularly evident in Atlanta, as net absorption rates turned negative even as new completions continued. Job losses in the nation's manufacturing sector did moderate in late 2002; however, by early 2003, the sector, particularly among high-tech industries, weakened again. As a result, the Region's industrial markets experienced negative net absorption (see Chart 2) at levels rivaling those at the beginning of the recent recession. Nonetheless, vacancy rate increases were not as great as during the onset of the recent recession, as completions were much lower.[4] Continued job losses in manufacturing likely will forestall a rapid recovery in the Region's industrial real estate markets.

Retail Real Estate Has Outperformed Other Commercial Real Estate Types in Several Atlanta Region Markets

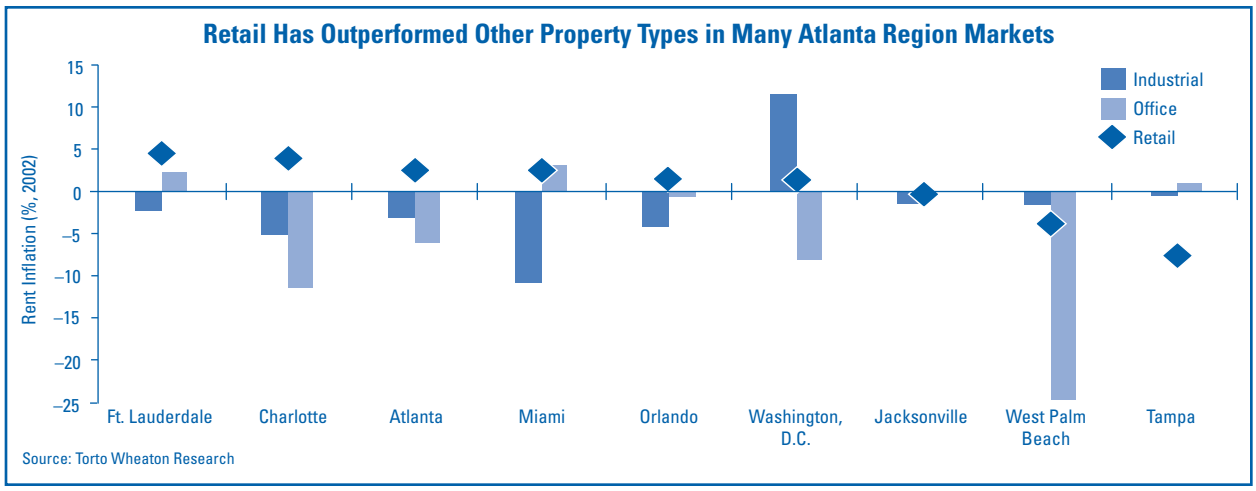
Retail real estate generally has outperformed other market types during and following the recent recession. Typically, during an economic downturn, retail real estate is pressured by declines in consumption as incomes fall and consumers attempt to reduce debt. In the recent downturn, however, consumer spending remained strong and debt levels increased, supporting growth in the retail real estate market. However, prolonged weak job growth, the potential for a retrenchment in consumer spending, and the risk of a "double-dip" recession may increase the vulnerability of this market type going forward.

Following the recent recession, rent appreciation in the **Orlando** and **Miami** MSAs declined significantly as domestic and international visitor spending cooled retail markets. Subsequently, however, rents have appreciated strongly in most of the Region's retail real estate markets (see Chart 3). Rental rates in the **Jacksonville**, **West Palm Beach**, and **Tampa** MSAs have deviated from this pattern during the past year, a trend that in part may be due to continued market space expansion. Since 1999, total retail stock in the Tampa metro area has increased more than 10 percent, nearly twice the growth rate of major markets nationally. Year-to-date third quarter 2002 new space construction in the Jacksonville metro area was up more than 120 percent from the previous year. Such supply increases prompted one investment bank earlier this year to

[3] Jarred Schenke, "Developer: Atlanta Office Recession May Rival '73–'75," *Atlanta Business Chronicle,* March 21, 2003.

[4] Average vacancy rates in the **Washington, DC, Fort Lauderdale,** and Raleigh MSAs declined modestly in first quarter 2003 from a year earlier.

Chart 3

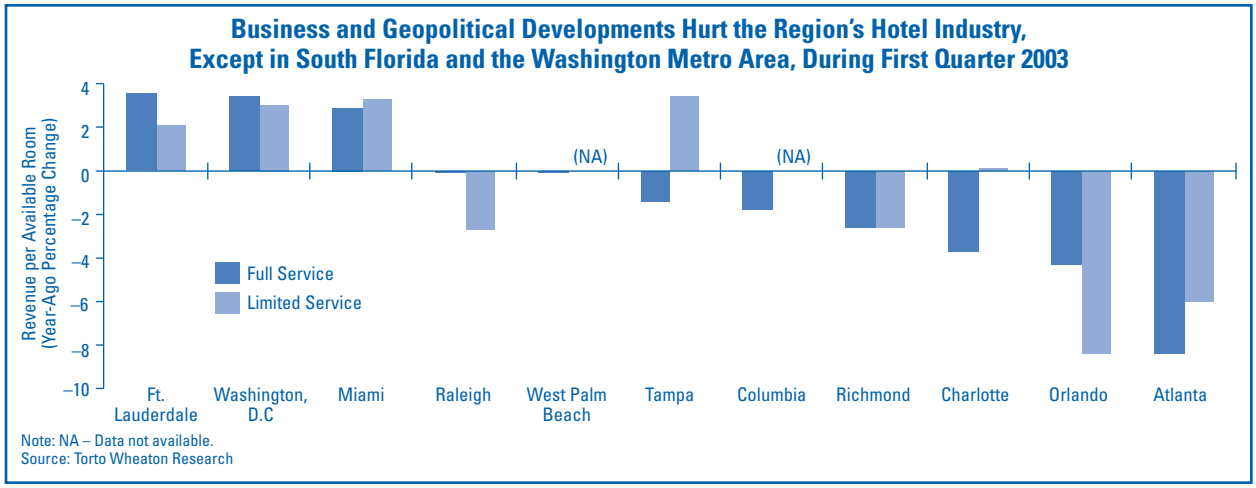


characterize this MSA as having the greatest vulnerability to oversupply in the state.[5]

Hotel Markets Continued to Struggle in Early 2003

The recent recession had a chilling effect on the Atlanta Region hotel industry, as tourism and convention business declined significantly. Double-digit year-ago declines occurred in revenue per available room (RevPAR) in all major markets except **Columbia,** by fourth quarter 2001 as occupancy and room rates fell substantially. This trend was particularly evident in the **Orlando** and Atlanta MSAs, where the tourism and convention businesses are essential components of the local economy. By late 2002, the tourism industry was showing signs of an emerging recovery, allowing RevPAR to rebound from the lows of the previous year. However, in early 2003 the looming military campaign in Iraq and apparent weakening economic growth dealt another round of setbacks to the tourism industry. As Chart 4 shows, RevPAR declined from a year earlier in all major markets except Fort Lauderdale, Washington, DC, and Miami for full- and limited-service hotels during first quarter 2003. The events of early 2003 highlight the vulnerability of the hotel real estate market to economic and geopolitical uncertainties that could continue to pressure any further near-term recovery. Many analysts consider the hotel sector the property class most likely to experience defaults.[6] Limited-service properties operated by independent owners appear more vulnerable to default

Chart 4



[5] Gregory Richards, "Is City Building Its Way into a Retail Space Glut?" *Florida Times-Union,* April 4, 2003.
[6] "CRE Losses Likely to Be Modest in this Cycle," *Citigroup Smith Barney: Equity Research Banks,* June 3, 2003.

than full-service properties and chains operated by large corporate owners.[7]

Weak Economic Growth, Continued Construction, and an Increase in Home Ownership Have Pressured Multifamily Markets

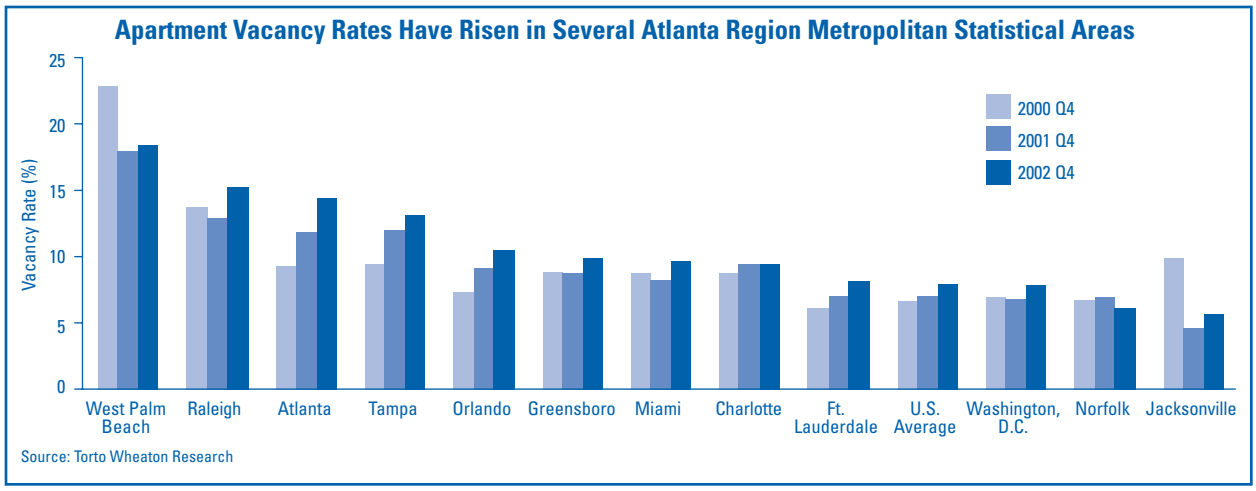
The "jobless" recovery and record levels of home ownership brought about by low interest rates have contributed to rising apartment vacancies (see Chart 5), while new construction continues to inflate multifamily stock in the Atlanta Region. Rental vacancies have increased across the Region during the past two years, while rent inflation remains below the U.S. average in all areas except the Miami and Washington, DC, MSAs. Nominal rents declined during the year ending fourth quarter 2002 in the **Charlotte, Greensboro,** and Atlanta metro areas. Persistent low rent inflation across the Region could constrain cash flows for property owners and, as a result, adversely affect their credit quality.

CRE Lenders Have Performed Well, but Caution Is Warranted

CRE lenders in the Region have performed fairly well throughout this cycle. Profitability has remained solid while capital levels and reserves have held steady.[8] Despite this positive performance, modest signs of asset quality weakness have emerged. Total noncurrent loans have risen in each of the past two 12-month periods ending March 31, 2003, driven primarily by deterioration in commercial and industrial, construction and development, and 1- to 4-family loans. Noncurrent nonresidential loan levels also have increased moderately. Nevertheless, 34 percent of CRE lenders reported an increase in noncurrent CRE loan levels at March 31, 2003, compared to only 28 percent a year earlier.

In the Atlanta Region, community institutions are the primary funding source of nonresidential real estate loans.[9] In fact, median CRE exposure among community banks in major CRE markets was 21 percent as of March 31, 2003, 6 percentage points higher than the median CRE exposure among mid-tier banks in these same markets.[10] However, community banks headquartered in areas such as Atlanta, Raleigh, and Miami, where office vacancy rates have risen by at least 7 percentage points during the past year, have reported a significant divergence in asset performance. Community banks based in the Atlanta MSA reported a noticeable increase of 52 basis points (to 0.94 percent) in noncurrent CRE loans during the 12-month period ending March 31, 2003. This compares to 0.73 percent among all CRE lenders across the Region. The exposure of the Atlanta MSA to industries that have been hard hit during the past 18 months, such as technology, telecom, and tourism, increases the vulnerability of institutions headquartered there to rising office vacancy rates. In addition, a study conducted by ***Smith Barney*** suggests that community banks based in the Atlanta

Chart 5



[7] Peter Henderson, "Hotel Industry Sees Downturn Moving Deals," *Reuters*, June 5, 2003; Barbara DeLollis, "Hotels Upgrade Freebies to Fill Empty Rooms; Meals, Sweepstakes Offered," *USA Today,* July 8, 2003.

[8] For purposes of this analysis, CRE lenders hold at least 25 percent of assets in nonresidential real estate loans.

[9] Community banks hold assets less than $1 billion and exclude de novos and specialty institutions.

[10] Major CRE markets in the Atlanta Region are Atlanta, Charlotte, Fort Lauderdale, Jacksonville, Miami, Orlando, Raleigh, Tampa, and West Palm Beach.

area are niche lenders to limited-service hotels.[11] Given the pressure on the travel industry, hotels are considered the weakest property class in the study. A significant exposure to this industry segment may contribute to further credit quality weakness. Because Call Report data do not allow for separation of loans by property type, it is difficult to discern the level of bank and thrift industry exposure to the hotel sector.

By contrast, despite noticeable increases in office vacancy rates, community banks headquartered in the Raleigh and Miami MSAs have reported improving CRE asset quality. The ratio of noncurrent nonresidential loans held by community banks in each of these MSAs declined during the 12 months ending March 31, 2003, to roughly 0.22 percent. Nonresidential loans in both areas have surged during the past two years. CRE loans as a percentage of total loans have risen approximately 28 percentage points, to 48 percent among banks based in the Raleigh MSA. This ratio increased almost 12 percentage points among banks based in the Miami MSA, to roughly 51 percent. Regionally, CRE loan portfolios grew just under 7 percentage points during this period to 44 percent of total loans.

According to Torto Wheaton Research, forecasts calling for steady increases in office employment during each of the next six years may be fueling growth in CRE loan levels.[12] However, at year-end March 31, 2003, a robust pace of loan growth may have masked higher past-due loan amounts. Management of insured institutions should be aware that deterioration in asset quality often lags the business cycle, so lenders should monitor concentration levels carefully in the near term. Job creation is expected to remain stagnant until business investment and economic growth accelerate. As a result, capital levels may be vulnerable among community banks headquartered in areas with significantly higher vacancy rates and CRE exposures, such as the Atlanta, Raleigh, and Miami MSAs. Continued economic weakness could contribute to an increase in office foreclosures and higher charge-offs among local institutions.

Conclusion

Thus far, the Region has experienced no significant deterioration in CRE property values. Falling capitalization rates and robust investor demand have supported prices. Low interest rates and cost-cutting measures also have allowed many owners to break even at lower occupancy rates. In cases where cash flow has been negative, anecdotal reports indicate that owners have been able to sell the property for more than the debt outstanding. The ability of property owners to sell in order to repay debt may diminish should property values weaken. Property valuations could soften if fundamentals continue to erode. Property cash flow, particularly in the office sector, will be reduced as expiring leases reprice downward. Also, technology may lower the demand for office space and lead to lower rental rates. Computer servers have greater capacity but are physically smaller and require less square footage than they did even five years ago. Electronic storage costs continue to fall, allowing firms to migrate from

Perspectives from the FDIC Regional Director

In the past few years, examinations of banks with concentrations of commercial real estate (CRE) have generally reflected sound risk management practices and overall satisfactory conditions. Nevertheless, the macro trends cited in the accompanying article, particularly with regard to the office market, prompted the Division of Supervision and Consumer Protection to initiate a CRE credit risk analysis pilot program in January 2003. The purpose of the pilot was to gather significantly more CRE lending data than are available from call reports and briefly to assess risk management in Atlanta-area banks with large CRE concentrations. Preliminary results indicate that Federal Deposit Insurance Corporation-supervised banks continue to avoid high concentrations in the types of CRE loans identified as primarily susceptible to declining market conditions (i.e., office, industrial, retail, hotel, and multifamily). As a general rule, the banks included in the program were focused on the development and construction of residential properties, a market that remains relatively strong. Further, banks are well aware of CRE lending risks and are managing those risks in a satisfactory manner. As analysis of the pilot program data is completed, additional information will be presented. It is also likely that, as part of our ongoing supervisory efforts, the program will be expanded to other geographic areas that exhibit considerable stress in CRE markets.

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Regional Director
Atlanta, Georgia

[11] "CRE Exposure for the Banking Industry," *Smith Barney: Bank Weekly,* March 4, 2003.
[12] *TWR Office Outlook,* Spring 2003.

paper document retention systems, which lessens the need for file room. Improvements in telecommunications have allowed many firms to outsource work to remote locations, reducing their need for space. The recent productivity gains from computing technologies, if sustained, will likely reduce the demand for office employment. These factors imply that occupancy rates may be lower going forward. Lower occupancy rates suggest that rental growth rates will be much slower in the next expansionary cycle than the last. A reduction in cash flow from these structural and cyclical forces—reduced occupancy rates and slower rent growth—would offset low capitalization rates and likely lead to lower valuations. In the current cycle, rising property values have contributed to generally strong CRE loan performance among insured institutions. Therefore, going forward, market participants should monitor property valuations for signs that any of the key fundamentals are weakening.

Atlanta Staff

Chicago Regional Perspectives

Improved Security Is Vital as Information Technology Grows More Complex

Perhaps no area of banking has changed as significantly during the past ten years as information technology (IT). For instance, insured institutions increasingly have made banking services and data available to customers through automatic teller machines (ATMs) and transactional websites. The complexity of maintaining a secure IT environment undoubtedly will increase as banks continue to enhance technological capabilities and delivery channels.

At the same time, attacks on IT systems are increasing. Every day, new vulnerabilities, labeled with such arcane names as denial of service attacks, buffer overflow attacks, and session hijacking, are reported nationwide.[1] Experts estimate that the number of attacks in 2003 will be twice that in 2002. The results of a recent ***Computer Security Institute/Federal Bureau of Investigation*** (CSI/FBI) survey showed that the vast majority of companies polled had experienced some type of attack in the past 12 months, many resulting in substantial financial losses.[2]

The growing complexity of the IT environment and the potential for substantial monetary losses increase the importance of IT security. Vulnerability to security breaches has been heightened as a weak economy during the last few years may have pressured IT budgets. In an effort to cut costs, the outsourcing component of IT budgets may grow the most; however, the decision to outsource brings with it particular concerns.[3] In addition, merger activity raises many IT issues, as complex networks must be coordinated or combined.

IT Security Breaches Present Substantial Risks for Insured Institutions

The potential damage from security breaches is not only monetary. Although the potential for massive fraud exists if adequate controls are not in place, the impact from lost data or a tarnished reputation is hard to overestimate. While difficult to quantify, an insured institution's reputation is critical to many customers, who expect their confidential financial information to be secure. There are several sources of regulatory guidance for insured institutions on safeguarding consumer data and best practices for IT security.[4]

The increased use of Internet-connected systems poses substantial vulnerability for bank-owned systems and data. In fact, the CSI/FBI survey reports that Internet connections are becoming an increasingly frequent point of attack. The Federal Deposit Insurance Corporation (FDIC) has cautioned banks that maintain computer networks connected to the Internet to be aware that such connections may pose risks to their information assets and to ensure that their staff or service providers perform regular reviews of security.

Technology Facilitates Retail Delivery of Banking Services and Bolsters Bank Productivity

During the past decade, many relatively new technologies have become increasingly common, even among smaller, community institutions. Banks are opening their networks to provide enhanced services to customers through telephone banking, ATMs, and transactional websites. The importance of these electronic distribution mechanisms is underscored by some institutions' business plans, which rely heavily on the anticipated benefits of increased customer convenience.

Internally, technological advances have changed the dynamics within many insured institutions. For example, some banks are using wireless technologies, and the use of customer relationship management (CRM) soft-

[1] Denial of service attacks flood a computer network with data in order to deny access to legitimate users. For financial institutions with a heavy on-line presence, these types of attacks can be the most costly.
[2] 2003 CSI/FBI Computer Crime and Security Survey, (www.gocsi.com/forms/fbi/pdf.html).
[3] "Must-Dos Will Keep IT Budgets Growing," *American Banker,* December 17, 2002. See FIL-81-2000, Risk Management of Technology Outsourcing, for regulatory guidance (www.fdic.gov/news/news/financial/2000/fil0081.html).

[4] Appendix B to Part 364 of the FDIC's Rules and Regulations establishes guidelines to help ensure that financial institutions appropriately safeguard customer data. It calls for insured institutions to develop and implement an information security program that involves the board of directors, assesses risk, and manages and controls risk associated with protecting customer information. Appendix B lists many security measures, some of which are discussed later in this article.

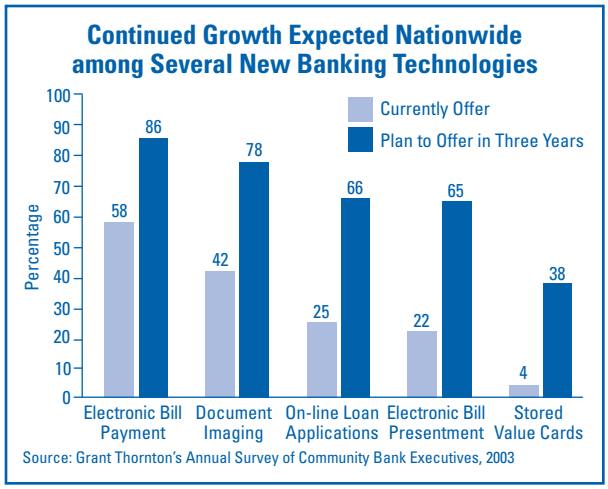
ware is growing.[5] Wireless technologies have facilitated network connectivity within some institutions and among branches. CRM software holds the promise of helping banks navigate their complex relationships with customers, with the goal of maximizing the profitability of these relationships.

New Technologies Pose New Challenges

Many technologies—such as smart cards, electronic bill presentment, and the migration of traditional banking into the on-line realm—are poised to alter further how banks do business (see Chart 1). More insured institutions are moving toward nonproprietary (often very low cost) software, such as Linux, as alternatives to costly proprietary operating systems. Banks may also adopt more advanced authentication schemes, which help prove a user's identity on a computer network. Although many bank customers can now access account information with an ATM card and a password, biometric technologies, such as retinal or fingerprint scanners, may eventually become the norm. Some institutions may be considering the benefits of more established technologies, such as moving toward on-line check imaging. Others are considering ways to reconfigure current systems in order to implement real-time processing.

The use of shared application services may grow in the near term as banks "rent" software services or processing time, rather than buy expensive in-house systems.

Chart 1



[5] FIL 8-2002, February 1, 2002, Guidance on Managing Risks Associated with Wireless Networks and Wireless Customer Access, www.fdic.gov/news/news/financial/2002/fil0208.html; and "Small Banks Seen Ready to Give CRM Another Look," *American Banker,* February 4, 2003.

More customers are now paying bills on-line; soon these customers may receive bills on-line as well, and banks may play a critical role in developing this capability.

Against this backdrop of rapid technological change, with its accompanying risks, this article explores a key concept associated with maintaining a secure IT environment—layered security.[6]

"Defense in Depth" Is Key to Successful IT Security

Perfect security does not exist, and no one solution exists for all IT security needs. Persistent and skilled perpetrators can eventually compromise any security system. Therefore, bank management should not rely on one security mechanism. "Layered" security, while not a new concept, remains highly effective. By layering IT security, insured institutions can increase the likelihood that should one security mechanism fail, another will prevent a breach. IT specialists typically refer to this concept as "defense in depth." As one chief technology officer said, "It's like an onion. The more layers a hacker has to peel through, the longer it takes and more frustrating it becomes to reach the center."[7]

The concept of layered network security may be new to some community banks that have migrated only recently to more complex computer networks or become more reliant on Internet-connected systems. While each institution must ultimately assess the level of layered security it needs, the following components, if incorporated into an overall IT security strategy, can help minimize disruptions to, or compromises of, a bank's technology infrastructure.

Segregation of networks: Maintaining appropriate segregation among computer networks is vital. For instance, data traffic originating from one (perhaps sensitive and confidential) network segment need not be broadcast to all servers or workstations on the local area network. IT managers may segment the network by installing intelligent switches rather than network hubs. Similarly, not all information that resides on

[6] The concept of layered controls is referenced in the Information Security Booklet of the Federal Financial Institutions Examination Council's *Information Technology Examination Handbook,* December 2002, page 13. The handbook can be downloaded from www.FFIEC.gov.

[7] "Layering Security to Protect Bank Networks," *Bank Technology News,* April 4, 2003.

network devices may require the same level of access by all users. Further segmenting network information by employing the "least privilege" concept, whereby employees are given access on a "need to know" or "need to do" basis, is also important.

Firewalls: A firewall is a set of components—hardware and software—that resides between two or more systems to block unauthorized traffic. Firewalls are useful in segregating networks and are the minimum security for institutions that maintain a connection to the Internet. Firewalls are essentially fences around, and sometimes within, a network. Generally, a firewall protects against unauthenticated logins to the internal network. Often, banks use firewalls between internal networks and an Internet connection. Firewalls may also create demilitarized zones, a computer host or small network inserted as a "neutral zone" between a bank's private network and the outside public network.[8]

External monitoring: A layered security process requires institutions to consider external measures, which enable an institution to see its network from an outsider's perspective. This approach allows monitoring of potential issues such as website defacements, hijacking of sessions or transactions, the need for software patch revisions, and open ports on a firewall and network.

Continuous vulnerability assessments: All security organizations recognize running vulnerability scans of an IT infrastructure as a best security practice. Unfortunately, many companies run these scans only annually or quarterly. New vulnerabilities occur daily; the ***CERT Coordination Center*** generally publishes 50 or more a week.[9] Therefore, IT managers should consider continuous scanning, or at least at more frequent intervals than quarterly. For example, frequent scanning would have protected companies from vulnerability to the "SQLSlammer" worm; information about this vulnerability was available in July 2002, but the worm did not fully materialize until 2003.[10] Software upgrades, installation of new services, and human error also can contribute to the development of vulnerabilities. Instituting a scanning process at appropriate intervals can help minimize any resulting disruption to the IT infrastructure.

Intrusion detection: An intrusion detection system (IDS) represents another layer of security—a "burglar alarm" that informs IT management when someone may be attacking the network. An IDS typically scans for anomalies in network traffic or data flows that match a known pattern of misuse. IT professionals normally place an IDS in front of or behind the firewall as a network monitor, or an IDS may reside on host systems. When placed on the host system, the IDS will examine log files for evidence of misuse. An IDS will detect attempted intrusions but will not stop or prevent them.

Encryption: When transmitting sensitive data across the Internet or another untrusted medium, IT management should ensure that the information is encrypted to prevent unauthorized access. IT managers also should encrypt sensitive data any time the data reside on a database that could be accessed by an unauthorized source—internal or external.

Virus/worm protection: A virus is a piece of programming code, usually disguised as something else, that causes some unexpected and usually undesirable event. A worm is a self-replicating virus that does not alter files but resides in active memory and duplicates itself.[11] Many viruses and worms exploit known vulnerabilities in operating systems or commonly used applications. IT managers should consider using virus protection methods for data entering bank networks, as well as periodic scanning of files within the network. All hosts, both servers and workstations, should be protected, and should have frequent virus definition updates. Also, the FDIC has recommended that banks implement an effective software patch management program as one of the best ways to prevent damage by viruses or worms.[12]

Adequately trained staff and users: Placing appropriate emphasis on IT security at the senior management and board of directors level is the first step toward minimizing system breaches. By establishing effective policies and procedures, boards of directors can promote an atmosphere that addresses critical security areas and establishes appropriate guidelines and standards for all

[8] searchwebservices.techtarget.com/sDefinition/0,,sid26_gci213891,00.html, August 4, 2003.

[9] The CERT® Coordination Center (www.cert.org) is a federally funded research and development center that addresses computer security incidents and vulnerabilities, publishes security alerts, researches long-term changes in networked systems, and develops information and training to help improve computer security.

[10] The SQLSlammer worm led to the compromise of many vulnerable machines and degraded performance on affected networks.

[11] searchsecurity.techtarget.com/sDefinition/0,,sid14_gci213386,00.html, August 4, 2003.

[12] FIL 43-2003, Computer Software Patch Management, www.fdic.gov/news/news/financial/2003/fil0343.html.

employees. A well-educated staff also can help to prevent losses resulting from "social engineering attacks," which occur when users are tricked into bypassing security procedures (e.g., an employee is tricked into revealing his password).

Successful IT Security Requires Constant Vigilance

IT security is not a one-time event, but a continuous, multifaceted process. The anticipated growth in new technologies and the rapidly changing landscape of IT call for heightened vigilance, as vulnerabilities can appear quickly and compromises can be costly. A layered security approach, coupled with well-defined exception thresholds and close monitoring, are essential. Each insured institution must assess its own IT risk profile; an awareness of available network security components and existing regulatory guidance will facilitate the process.

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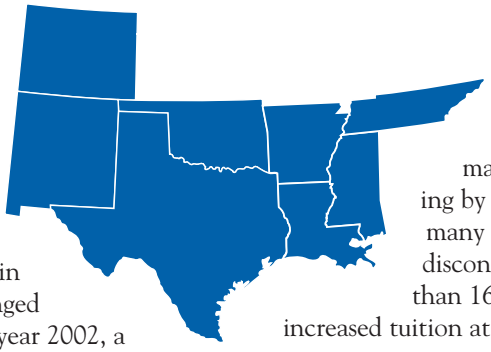
with contributions from the Chicago Region's
Division of Supervision and Consumer Protection

Dallas Regional Perspectives

Economic Recovery Appears Imminent but Fragile



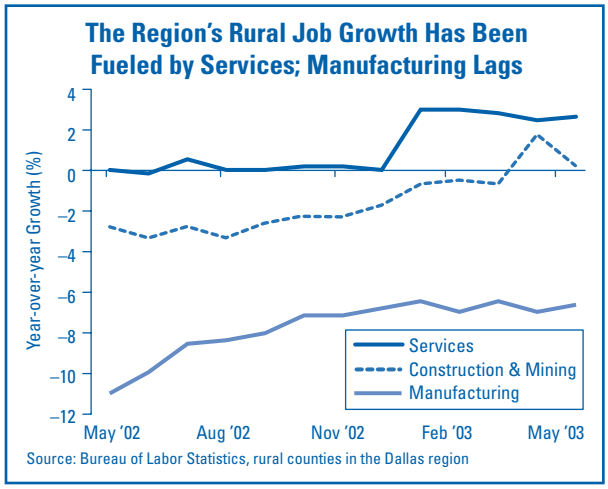
The Dallas Region's economy is beginning to improve, suggesting that recovery from the 2001 recession may be taking hold. Total nonfarm employment in the Region was essentially unchanged at midyear 2003 compared to midyear 2002, a significant improvement from the loss of 280,000 jobs in the year-earlier period. Positive employment trends are evident in the finance, insurance, and real estate sector; health and education services; state and local governments; wholesale trade; and professional business services. However, conditions in the telecommunications and high-tech industries remain weak. **Colorado, Louisiana,** and **Oklahoma** continued to lose jobs in the second quarter of 2003 on a year-ago basis in the durable goods manufacturing, telecommunications, and energy sectors.

While overall employment trends are becoming more favorable, two factors point to a fragile economic recovery in the Region. First, the manufacturing sector remains weak. Structural and cyclical weaknesses have resulted in job losses, particularly in the subsectors of industrial machinery and equipment, textiles and apparel, and lumber and wood products. On a positive note, the pace of job loss has declined, as many manufacturing plants have reached minimum staffing levels necessary to continue operating.

Second, although government hiring was a bright spot during the economic slowdown, financial stress experienced by state and local governments may constrain the Region's job growth going forward. As a result of the 2001 recession and subsequent weak U.S. recovery, tax revenues are declining in half the Region's eight states, and revenue growth in the other four states is well below the trend of the late 1990s. In fact, budget deficits are forecast for six of the Region's eight states in 2003.[1] As a result of the budget problems, states and localities have begun to aggressively scale back spending and raise taxes. For example, the Tennessee state government mandated that all agencies cut spending by 9 percent, permanently eliminated many vacant government positions, discontinued health coverage for more than 160,000 workers, and significantly increased tuition at state universities.

The fragile nature of the economic recovery is also apparent in an analysis of the Region's metro and rural areas.[2] Overall, metro areas continued to lose jobs in the first six months of 2003, though a majority of metro counties showed positive employment growth. Rural counties, on the other hand, showed aggregate employment growth of 0.6 percent in the first six months of 2003, compared to losses of 0.9 percent and 0.8 percent for all of 2002 and 2001, respectively. The divergence between metro and rural performance is not unprecedented during the early stages of recovery. Rural areas have preceded the nation out of recession several times in the past, and rural job losses occurred earlier in this cycle.[3] As shown in Chart 1, the recent growth in rural employment was led by improvement in the services

Chart 1



[1] State budget figures were reported in the National Conference of State Legislatures' *State Budget Update,* February 2003. New Mexico and Arkansas are not forecasting a budget deficit largely because of recent favorable employment trends that have limited state revenue declines, and they have been more successful in matching revenues with expenditures.

[2] For this article, rural areas are defined as counties that are not included in metropolitan statistical areas. This definition is used in calculating employment growth rates and banking performance numbers.

[3] Henderson, Jason, "Will the Rural Economy Rebound With the Rest of the Nation?" *The Main Street Economist,* January 2002.

sector and occurred despite continued weakness in manufacturing.

Despite recent employment gains, rural areas face many economic challenges in the months to come. Rural economies tend to be less diversified than their metropolitan counterparts, and often depend on a few industries. Structural shifts, such as the movement of manufacturing production overseas, have resulted in the loss of many high-paying jobs that will not return when the recovery becomes more robust. Moreover, many of the economic factors that affect the demand for rural products are typically global in nature—such as the value of the U.S. dollar, foreign incomes and preferences, and U.S. farm and trade policies—and are beyond the control of rural businesses. In addition, the Region's rural areas are linked closely to the agricultural sector, in which weakness continues to pose challenges for rural economies and rural financial institutions.

The Agricultural Sector Is Showing Signs of Improvement, but Challenges Remain

The Region's agricultural sector is vast, encompassing 473 million acres, or 61 percent of the land area. Crops are highly diversified throughout the Region; in addition to the southern staples of livestock, cotton, corn, soybeans, and wheat, the Region's farmers produce timber, sugar cane, rice, and aquaculture (catfish and shrimp). The Region produces the majority of U.S. aquaculture and rice, but the annual dollar volume is significantly less than is generated by other crops.

The agricultural industry has been affected adversely by low prices for the past seven years, primarily because of national and global overproduction (see Table 1). National net farm income peaked in 1996 at $54.8 billion but then gradually fell through 2001, when it was $45.7 billion.[4] In 2002, because of the severe drought that affected much of the Midwest and West, as well as lower levels of government subsidies, net farm income fell dramatically to $30.2 billion. Regional and national trends in farm income are similar, and 2002 regional data (which will not be available until late 2003) are expected to show a significant decline.

Table 1

Cotton Prices Remain Weak, but Cattle and Other Crop Prices Are Expected to Improve

	1996	2000	2001	2002	Est. 2003
Cotton	75.40	45.00	49.80	29.80	42.80
Cattle	65.05	69.65	72.71	67.50	77.50
Corn	3.24	1.82	1.85	1.97	2.30
Soybeans	6.72	4.63	4.54	4.25	5.50
Wheat	4.55	2.48	2.62	2.78	3.56

Note: Grain prices are for marketing year of each crop. Cotton quantities are per pound; other crop quantities are per bushel; livestock are per hundredweight. Broiler prices are set by individual contracts and are not available for analysis.

Sources: USDA World Agricultural Supply and Demand Estimates, July 2003

The ***U.S. Department of Agriculture*** (USDA) forecasts national net farm income to recover to $46.2 billion in 2003. However, a look at three products that are critical to the Region's agricultural economy suggests a mixed outlook for the Region:

Cattle: The Region produced about one-third, or $13.3 billion worth, of all U.S. beef in 2001, making livestock production a significant economic driver for many rural counties. In 2002, drought destroyed grazing lands, forcing many ranchers to sell off herds because of a shortage of feed. As a result, cattle prices declined in late 2001 and 2002, and ranchers experienced the brunt of the declines because cattle are not protected by federal farm programs. However, smaller herds have contributed to a significant increase in prices during 2003 (see Table 1), a trend that bodes well for the Region's ranchers.

Broilers (chickens): The Region's poultry industry, which is highly concentrated in **Arkansas, Mississippi,** and **Texas,** produced $5.6 billion in cash receipts in 2001 but is showing clear signs of weakness. Overall U.S. production is expected to decline significantly in 2003 (down 1.1 percent from year-ago levels), as companies are placing fewer chicks with producers in response to declining overseas demand. Such a trend could hurt producers' incomes, in both the Region and the nation, as most producers have significant fixed infrastructure costs that must be covered by production volume. In addition, producers are being affected adversely by outbreaks of avian influenza and Newcastle disease, which could cost the industry more than $100 million in 2003.[5]

[4] Farm Income data are provided by USDA Economic Research Service *Farm Income Forecast,* June 4, 2003. http://www.ers.usda.gov/briefing/farmincome/data/va_t1.htm.

[5] Simon Romero, "Virus Takes a Toll on Texas Poultry Business," *New York Times,* May 6, 2003.

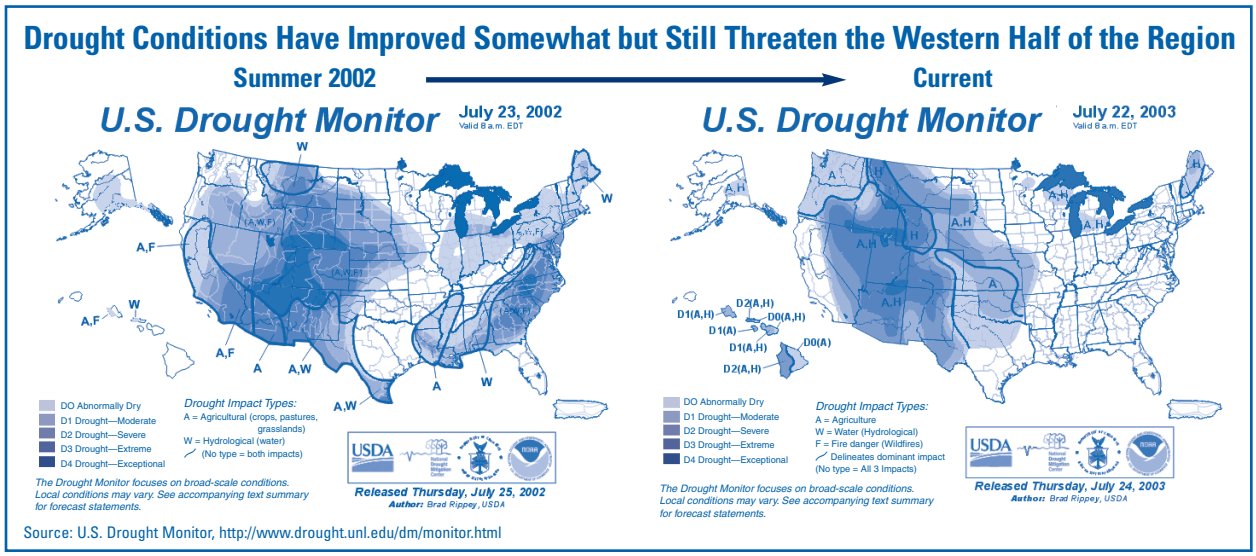
Cotton: The Region's cotton industry is significant ($2.4 billion in cash receipts in 2001, about half the U.S. total) but troubled. Cotton prices have been below the break-even point of approximately 73 cents per pound since 1996, largely because of global overproduction, a situation that was aggravated in 2002 by the global recession. Fortunately for producers, the 1996 and 2002 Farm Bills have implemented favorable subsidy schedules for cotton producers. However, these payments have also encouraged overproduction and therefore have contributed to declining prices. This year, continued overproduction, coupled with stable demand, could drive prices down about 10 cents per pound by harvest time.[6]

Overall, the expected improvement in cattle prices should bolster the Region's agricultural sector significantly, offsetting weakness in the cotton and broiler markets. Prices for other commodities, such as corn, wheat, and soybeans, are expected to improve as well (see Table 1). However, the benefits could be derailed by continued drought conditions. As shown in Map 1, which compares the summers of 2002 and 2003, drought remains significant in **New Mexico** and Colorado, and abnormally dry conditions have moved into much of Texas. On the positive side, drought conditions have abated entirely in Louisiana, Arkansas, and Mississippi. Although drought conditions usually contribute to higher crop prices because of smaller harvests, the benefits accrue only to farmers who can raise normal crop levels.

Rural Bank Performance Is Showing the Effects of the Weak Rural Economy

Overall, rural community banks continue to report relatively healthy financial ratios, but the strains of the weak rural economy are emerging.[7] Pretax earnings increased from 1.45 percent of average assets in 2001 to 1.60 percent in 2002 as low funding costs and a steepening yield curve in the first half of the year increased net interest margins.[8] However, asset quality trends have not been as favorable. Aggregate levels of past-due and nonaccrual loans reached 3.23 percent at March 31, 2003, up 18 basis points from a year earlier, and marking the highest first-quarter level since 1993. It should be noted, however, that this level of problem loans remains far less than what rural banks experienced during the agricultural crisis of the 1980s. Loan charge-off rates continue to trend slowly upward, also signifying some stress in lending portfolios. Capital levels, at 10.34 percent of total assets, continue to increase, providing protection from economic swings.

Map 1



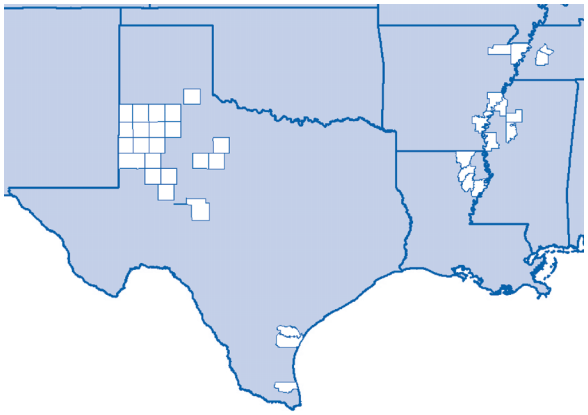
[6] Carl G. Anderson, "Cotton Market Comments," Texas A&M University. Vol. 10, No. 7, May 12, 2003.

[7] The term "community banks" includes all FDIC-insured banks and thrifts with total assets of less than $1 billion, excluding institutions that have been in existence less than three years, and specialty banks, such as credit card institutions.

[8] Pretax earnings figures are used because a large number of community banks have elected Subchapter S Corporation status, which eliminates income tax at the bank level and prevents accurate after-tax comparisons with banks that have not elected Subchapter S status.

Map 2

Dallas Region Is Home to 38 of the Top 50 Cotton Counties in the United States



Source: USDA Census of Agriculture

Additional stress is evident among community banks in cotton-producing areas. As illustrated in Map 2, the Region is home to 38 of the nation's top 50 cotton-producing counties, and the aggregate performance of community banks headquartered in these counties is considerably weaker than that of institutions elsewhere in the Region. For example, community banks based in cotton-producing counties reported pretax earnings of 1.24 percent of average assets in 2002, compared to 1.60 percent for rural community banks in the Region as a whole. In addition, almost 9 percent of banks in these counties lost money in 2002, compared with 4 percent of the Region's rural community banks overall. Although overall past-due loan levels are roughly the same, institutions based in the cotton-producing counties reported higher levels of noncurrent loans (1.54 percent of total loans) than the Region's community banks (1.27 percent) during first quarter 2003.[9] Equity capital levels for insured institutions based in the cotton-producing counties were reasonably strong at 9.97 percent of total assets but remain 37 basis points below those of all rural community banks in the Region.

Conclusion

The Region's rural economy is showing signs of life despite a prolonged slump in the agricultural and manufacturing sectors, but recovery is not assured. Higher cattle prices should boost the agricultural sector, but continued drought conditions in the western half of the Region could diminish any positive effects. The Region's manufacturing sector remains weak and may stay sluggish for an extended period even after the general economy recovers. Community bank performance reflects the economic stress evident in rural areas but is expected to improve when the agricultural and manufacturing sectors rebound.

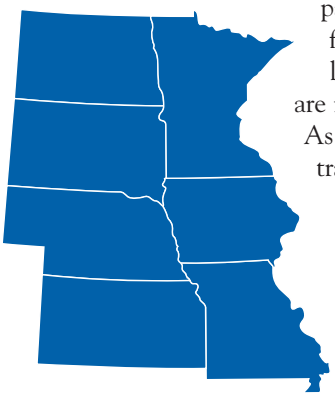
To help rural bankers face economic challenges, the Federal Deposit Insurance Corporation is actively engaged in outreach to the banking community, particularly in areas that rely significantly on the agricultural sector. These meetings, as well as ongoing Director College programs, represent an effective way to maintain a dialogue with bankers on the important risk management issues facing the industry today.

Dallas Staff

[9] Noncurrent loans are those that are past due 90 or more days or are on nonaccrual status.

Kansas City Regional Perspectives

Continued Turmoil in the Airline Industry Does Not Bode Well for Some of the Region's Communities and Insured Institutions



Airlines have experienced historically high levels of operating losses as demand remains low due to the aftermath of 9/11, the outbreak of severe acute respiratory syndrome (SARS), the conflict in Iraq, and a fragile domestic and global economy. Stress in the airline industry has spilled over into the aircraft manufacturing sector. The aviation and aerospace industries are highly important to the economies of some of the Region's states (see Table 1), and aviation and aerospace companies are among the top employers in several of the Region's communities (see inset box later in this article). However, the share of employment in these industries is greatest by far in the **Wichita** metropolitan statistical area (MSA). The sector's weak performance is expected to continue to affect the Wichita economy adversely and could contribute to some credit quality deterioration among local insured institutions.

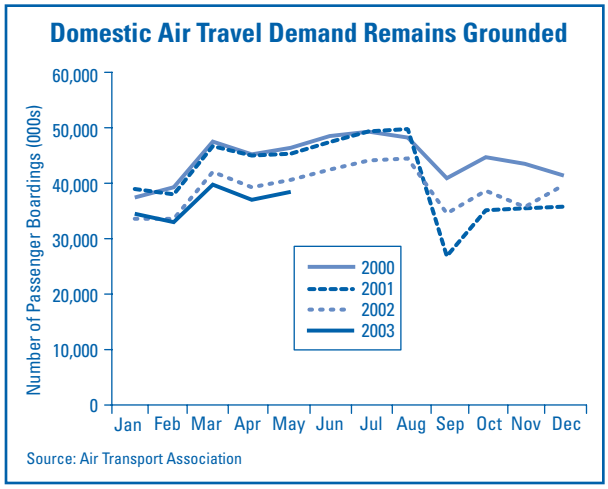
The U.S. Airline Industry Has Not Recovered to Pre-9/11 Levels

Demand for air travel, measured in passenger boardings, has declined significantly since 2000. After growing at an annualized rate of 3.4 percent between 1995 and 2000, year-over-year enplanements were flat in 2001 (due to the economic downturn and declining business travel) until 9/11 (see Chart 1).[1] Business travel represents a greater proportion of boardings and revenue passenger miles because of the frequent flights.[2] Business travelers also are more likely to pay full price, as their travel needs are more inflexible than those of leisure flyers. As a result, the scaling back in business travel exerted a disproportionately adverse effect on the airline industry's bottom line.

Although air travel rebounded from a virtual standstill in late 2001, it has not recovered to pre-9/11 levels. In fact, air travel has continued to weaken, in large part because of uncertainty about the conflict in Iraq and fears about SARS. No clear positive signals have emerged, but many air carrier analysts are optimistic that a rebound in the U.S. economy in the latter half of 2003 and subsiding fears about SARS will contribute to an uptick in air travel. Recently, airlines have drastically cut fares to stimulate demand; however, lower fares have resulted in declining operating profit margins. Nominal January fares for members of the Air Transportation Association (ATA) declined precipitously from nearly $150 in 2001 to less than $120 in 2003, the lowest level since 1987.[3] Air carriers also are scaling back the number of flights, modifying routes, and withdrawing aircraft from service to reduce supply; in addition, nearly 70,000 full-time and 20,000 part-time workers, or 13 percent of the labor force, were laid off between August 2001 and December 2002.[4]

Airlines also face rising fuel prices, the second largest operating expense after labor costs. Jet fuel prices nearly

Chart 1



[1] Member airlines are Airborne Express, Alaska, Aloha, America West, American (includes TWA), American Trans Air, Atlas Air, Continental, Delta, DHL Airways, Emery Worldwide, Evergreen International, FedEx, Hawaiian, JetBlue, Midwest Express, Northwest, Polar Air Cargo, Southwest, United, UPS Airlines, and US Airways. Source is ATA's 2002 Annual Report, http://www.ata.org.

[2] "A relatively small group of travelers (the frequent flyers who take more than 10 trips a year) account for a significant portion of air travel. While these flyers represent only eight percent of the total number of passengers flying in a given year, they make about 40 percent of the trips." www.airlines.org online handbook.

[3] Airfare is for a 1,000-mile journey, exclusive of applicable taxes. Source: *Airlines in Crisis – The Perfect Economic Storm*, Washington, DC: Air Transport Association of America, Inc., http://www.airlines.org.

[4] Ibid.

doubled from $0.56 per gallon in December 2001 to $1.02 per gallon in February 2003, before declining to approximately $0.80 per gallon. To give some perspective, after remaining below $0.60 per gallon for much of the 1990s following the Gulf War, jet fuel prices have fallen below that level for only three months since August 1999.

Despite Government Assistance, the Financial Health of Air Carriers Remains Precarious

The substantial revenue declines coupled with fuel price increases have contributed to record losses for the airline industry. The industry reported approximately $16 billion in losses in 2001 and 2002 combined, the first time losses have occurred in consecutive years.[5] Industry analysts estimate losses for 2003 between $5 billion and $8 billion.

The federal government's initial response to the problems caused by 9/11 was to enact the Air Transportation Safety and System Stabilization Act on September 22, 2001, which authorized $5 billion in direct compensation to air carriers affected by the attacks.[6] This legislation also authorized the establishment of the Air Transportation Stabilization Board (ATSB) with the authority to issue up to $10 billion in federal loan guarantees on behalf of airlines. As of May 2003, $4.6 billion in direct compensation had been distributed to 426 air carriers.[7] The ATSB approved 5 of 16 applications, resulting in $1.5 billion in air carrier loan guarantees, $900 million of which is earmarked for US Airways, Inc.[8]

Despite government aid, the airline industry has accumulated staggering debt levels during the last two years. The average debt-to-capital ratio has risen from a historical 70 to 80 percent range to 90 percent.[9] The current situation could become more severe than that following the Gulf War, when seven major carriers filed for bankruptcy or liquidated.[10] UAL Corp. ($25.2 billion, parent company of United Airlines, Inc.) and US Airways, Inc. ($7.9 billion) filed Chapter 11 bankruptcy in 2002.[11] American Airlines narrowly averted bankruptcy earlier this year through significant employee concessions. However, the airline's ability to avoid a cash flow crunch is far from certain. The same holds true for many other carriers, including Northwest Airlines.

Table 1

Kansas Ranks Second Nationally in Aerospace and Aviation Industry Employment, Far Higher than Any Other State in the Region

	Jobs per Capita		Industry Employment				
State	Number per 1,000 Workers	State's National Ranking	Number of Workers	Percentage Employed in Aircraft and Parts Manufacturing	Percentage Employed in Air Transportation	Payroll ($ millions)	Ratio of Industry Wages to State Avg. Wage (%)
Kansas	**43**	**2**	**57,103**	**83.9**	**14.0**	**2,600**	**162**
Missouri	17	15	45,706	38.7	58.2	2,000	143
Minnesota	14	20	37,553	2.1	89.5	1,900	137
Nebraska	6	39	5,618	5.3	93.4	176	123
North Dakota	6	40	1,966	30.5	66.1	64	136
South Dakota	5	47	1,846	4.1	97.5	55	120
Iowa	5	49	6,463	13.9	85.1	216	111

Source: Commission on the Future of the U.S. Aerospace Industry, 2001 Reports

[5] 2001 airline industry losses totaled $8 billion. Source: *Air Carrier Financial Statistics Quarterly,* U.S. Department of Transportation, http://www.bts.gov/press. 2002 and 2003 loss estimates collected from variety of national newsprint and financial Web magazine articles.
[6] http://www.thomas.loc.gov.
[7] U.S. Department of Transportation Web site, http://www.dot.gov/affairs/carrierpayments.html.
[8] ATSB has conditionally approved two of the remaining eleven applications for approximately $117 million and rejected the other nine applications. Sources of data are the ATSB Web site, http://www.treas.gov/offices/domestic-finance/atsb, and an America West Airlines press release dated January 18, 2003, PRNewswire-FirstCall.
[9] U.S. House Subcommittee on Aviation hearing on financial condition of the airline industry, September 24, 2002, press release, http://www.house.gov/transportation/press/press2002/release354.html.
[10] Between December 1990 and June 1992, six airlines filed Chapter 7 bankruptcy. PanAm, Midway, and MarkAir liquidated. Continental, TWA, and America West reorganized. In addition, Eastern Airlines liquidated during this period. Source: *Airlines in Crisis.*
[11] BankruptcyData.com. http://www.bankruptcydata.com/research.

The Aircraft Manufacturing Industry Is Critical to the Wichita Economy

The Wichita MSA, known as the "Air Capital of the World," is heavily concentrated in the aviation and aerospace industries. According to a report issued in October 2002 by the ***Commission on the Future of the United States Aerospace Industry***, Wichita is more dependent on the aircraft manufacturing industry than any other city in the nation, with 193 aerospace and aviation sector employees per 1,000 workers. The Seattle MSA, known for its strong ties to Boeing Corporation, is a distant second with 93 aerospace and aviation sector employees per 1,000 workers. Wichita's top-ten list of employers is a who's who of aircraft manufacturers: for example, Boeing Aircraft Wichita (rank 1, 13,650 employees), Cessna Aircraft Company (rank 2, 11,400 employees), Raytheon Aircraft Company (rank 3, 8,100 employees), and Bombardier Aerospace Learjet, Inc. (rank 6, 3,152 employees).[12]

The Fortunes of the Wichita Economy Are Closely Tied to Airline Carriers

Following the decline in passenger boardings in 2001, ATA-member airlines removed nearly 300 aircraft from service and reduced future aircraft delivery plans. Annual aircraft orders declined from more than 1,000 between 1998 and 2000 to fewer than 750 between 2001 and 2002.[13] Options on orders plummeted from nearly 2,750 aircraft in 2000 to fewer than 1,750 in 2002.[14] The sudden and steep reduction in aircraft orders has caused the "Big 4" employers to cut thousands of jobs; the effects of these cuts have hurt hundreds of other small ancillary companies in the Wichita MSA (see Table 2).

Table 2

Wichita's "Big 4" Aircraft Manufacturers Have Significantly Reduced Employment

	Wichita Employment (000s) Dec '00	Mar '03	Percentage Change
Boeing	16,800	12,500	–26
Cessna[a]	12,509	9,200	–26
Raytheon	10,000	7,100	–29
Bombardier	3,602	2,200	–39

[a] Does not include seven-week furlough of 6,000 beginning June 2003.

Sources: *Wichita Business Journal, Book of Lists 2000; Wichita Business Journal,* March 3, 2003, March 6, 2003, March 20, 2003, and June 2, 2003; Boeing Corporation at http:// www.boeing.com/employment/employment_table.html.

[12] Economy.com, Inc., *Metro 2003,* February 2003.
[13] *Airlines in Crisis.*
[14] Ibid.

Statistics from the ***Kansas Department of Human Resources*** show that the unemployment rate in Wichita in April 2003 was 6.0 percent, up from 5.6 percent one year ago, and well above the 4.4 percent reported at year-end 2001.[15] Statewide, the unemployment rate was 4.8 percent, down slightly from 5.0 percent one year ago. The number of bankruptcies increased 39 percent between year-end 1999 and 2002 and is now 10 percentage points higher than the previous peak in 1998.[16]

Despite the significant layoffs, the housing market and retail business remained strong throughout 2002. The number of single-family housing permits climbed from 2,226 in 2000 to 2,817 in 2002, a 27 percent increase.[17] Existing home sales were also strong, with sales through the first three quarters of 2002 nearly equal to the year-earlier period,[18] and existing home prices rose from $90,700 in 2000 to $97,600 in 2002.[19]

Extended unemployment benefits help explain why the Wichita economy has not slowed as much as might have been expected. The Economic Security and Recovery Act of 2001, enacted on March 9, 2002, extended the 26-week unemployment insurance program by 13 weeks. The Unemployment Compensation Amendments of 2003 enacted May 2003 extend unemployment benefits for displaced workers in the airline and related industries an additional 13 weeks.[20]

However, softening in the housing market and in consumers' personal financial conditions could be emerging. First-quarter 2003 single-family building permit activity was 15 percent below first-quarter 2002 levels, and existing home sales were flat.[21] The average marketing period for existing home sales now exceeds four months.

[15] *Kansas Labor Conditions News Releases, January 2002, June 2002, and June 2003,* Kansas Labor Market Information Services, Topeka, KS, http://laborstats.hr.state.ks.us/index.html.
[16] Ibid.
[17] U.S. Census Bureau, http://www.census.gov/const/www/permitsindex.html.
[18] *U.S. Housing Market Conditions, Housing Market Profiles, Wichita, Kansas,* Third quarter 2002, U.S. Department of Housing and Urban Development, Office of Policy Development and Research.
[19] Economy.com, Inc., *Metro 2003,* February 2003.
[20] http://www.thomas.loc.gov.
[21] *U.S. Housing Market Conditions, Regional Activity, Great Plains,* First quarter 2003, U.S. Department of Housing and Urban Development, Office of Policy Development and Research.

Aviation and Aerospace Industry Is Among the Top Employers in Several of the Region's Larger Communities

In addition to Wichita, the aviation and aerospace industry is important to the economies of **Cedar Rapids, Kansas City, Minneapolis,** and **St. Louis.** The largest of these MSAs are in **Kansas, Minnesota,** and **Missouri,** and these states rank in the top 25 nationally by share of employment in these industries (see Table 1). Kansas, because of the significant employment concentration in the aviation sector in Wichita, ranks second in the nation behind Washington.

- The Lambert–St. Louis International Airport became a major hub for American Airlines, Inc., with the airline's acquisition of Trans World Airlines, Inc. (TWA) in 2001.[22] With more than 9,000 employees, American Airlines is one of the top 15 employers in St. Louis.[23] In addition, St. Louis is home to one of Boeing's large aerospace divisions. Boeing is the second largest employer in St. Louis, employing more than 15,300 workers in 2002.[24] Increased defense spending could help bolster the St. Louis economy.

- Minneapolis-St. Paul is headquarters for Northwest Airlines, Inc., the world's fourth largest airline company.[25] Northwest Airlines was the sixth largest employer in Minneapolis-St. Paul at year-end 2001, with 18,270 employees.[26]

- Kansas City has been home to TWA's (now American Airlines) overhaul and maintenance facility since 1957.[27] The facility currently employs 2,250 workers.[28] In addition, Vanguard Airlines, Inc., headquartered in Kansas City with over 900 employees, filed Chapter 11 bankruptcy in 2002, and is now liquidating.[29]

- Cedar Rapids is the world headquarters of Rockwell Collins, Inc., an aircraft-electronics spinoff of Rockwell International, Inc.[30] Rockwell Collins is the metro area's top employer; the 7,150-person local workforce represents about 6 percent of the city's employment, far exceeding the number of workers employed by the number two employer (Cedar Rapids Community School District, with 2,775 employees).[31] Increased defense spending is expected to contribute positively to the Cedar Rapids economy.

Layoffs and wage concessions in the airline industry have had a negative effect on employment and aggregate personal income in these communities. However, even though aviation and aerospace companies are among the largest employers in these communities, the relatively high level of industrial diversity helps mitigate the adverse effects of the weak aviation sector. As a percentage of total employment, air transportation ranks sixth in the Minneapolis MSA and twelfth in St. Louis, where aircraft and parts ranks eighth.[32] The aviation and aerospace sector does not rank in the top 25 industries in the Kansas City MSA.

[22] AMR Corp (parent company of American Airlines). Data as of March 2003. http://www.amrcorp.com/facts/hub.html.
[23] *The St. Louis Business Journal*, January 2003, via Economy.com, Inc., *Metro 2003,* February 2003.
[24] Ibid.
[25] Northwest Airlines, Inc., http://www.nwa.com/corpinfo/profi/facts/.
[26] *City Business,* December 2001, via Economy.com, Inc., *Metro 2003,* February 2003.
[27] *Milestones in TWA History,* DCS TWA History, http://twdcs.org/history.html.
[28] Randolph Heaster, "Unions Say American Threatens to File for Bankruptcy, Close KC Overhaul Base," *Kansas City Star,* April 9, 2003.
[29] "Vanguard Airlines Plans Bankruptcy," *USA Today,* Kansas City, Mo. (AP), July 30, 2002, http://www.usatoday.com/money/biztravel/2002-07-30-vanguard-bk_x.html.
[30] Rockwell Collins, Inc., http://www.rockwellcollins.com.
[31] Cedar Rapids Area Chamber of Commerce, October 2002, via Economy.com, Inc., *Metro 2003,* February 2003.
[32] Source of sector employment data for Minneapolis and other communities is Economy.com, Inc., *Metro 2003,* February 2003.

The Local Banking Industry Remains Strong for Now, but Stress Is Likely

Despite the stress in the aviation industry, overall credit quality among the 36 insured institutions headquartered in the Wichita MSA has not deteriorated substantially. This can be explained in part because none of these institutions reports direct exposure to large aircraft manufacturing companies, and any commercial and industrial lending is concentrated in small-business credits. However, in a community in which one of every five workers is employed in the aircraft manufacturing industry, local bank performance is expected to reflect the stress in this sector.

In Wichita MSA institutions, the median past-due loan ratio was 1.76 percent as of March 31, 2003. In comparison, the median past-due ratio for the Kansas City Region was 2.30 percent. Delinquencies in residential loan portfolios remained relatively low at 2.12 percent, although this represents a significant increase from 0.40 percent two years ago. Again, the absence of increases in total nonperforming loans may be attributed to the extension of unemployment benefits. However, asset quality stress is becoming evident in a subgroup of institutions. The number of institutions headquartered in the Wichita MSA reporting delinquency ratios that exceed 5 percent has increased from one to seven in the past two years. In addition, the proportion of institutions with safety and soundness examinations showing Adversely Classified Assets in excess of 25 percent of Tier 1 capital has more than doubled from 22 percent to 47 percent in the same period.

However, relatively high capital and loan loss reserve levels provide a cushion for any asset quality weakness. Insured institutions headquartered in the Wichita MSA reported a median Tier 1 capital ratio of 9.09 percent as of March 31, 2003. Moreover, median ratios of loan loss reserves to total loans and nonperforming loans were high at 1.36 percent and 236.4 percent, respectively. Earnings remain solid, with a median return on assets ratio of 1.00 percent. Fewer than 6 percent of the banks were unprofitable at the end of first quarter 2003.

Wichita Consumers May Face Problems When Unemployment Benefits Expire

Air travel demand has yet to recover fully, and analysts expect airlines to continue to post losses. Should the aviation industry experience weak operating conditions into 2004, airline bankruptcies could rise, slowing any recovery for the aircraft manufacturing sector. Consumers in the Wichita MSA may find it difficult to continue their current spending levels and service their debts, particularly when unemployment insurance benefit extensions expire.

Richard D. Cofer, Jr., Senior Financial Analyst

New York Regional Perspectives

Region's Economy Has Improved Modestly; However, Its Economic Recovery May Lag the Nation's

Employment declined sharply in the Region during 2001; however, the rate of job loss has moderated and is now tracking national trends (see Chart 1).[1] Since March 2001, the beginning of the most recent recession, the Region has lost about 2 percent of its employment base, virtually the same as the nation. However, employment has declined more severely in some states, such as **New York** and **Delaware.** Job losses in **Massachusetts** reached almost 5 percent of the March 2001 level, more than double the national average.

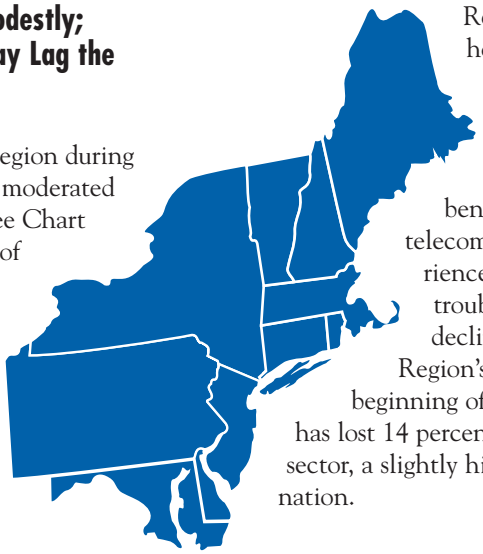
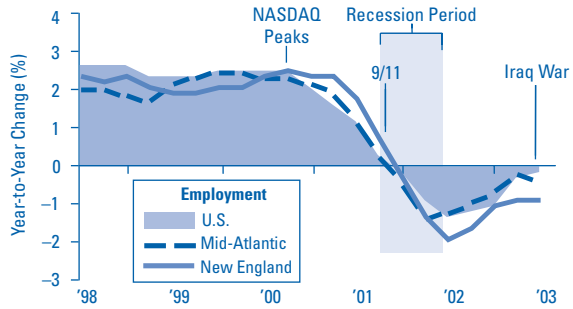


Chart 1



Note: Mid-Atlantic includes Delaware, the District of Columbia, Maryland, New Jersey, New York, and Pennsylvania. New England includes Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont.
Source: Bureau of Labor Statistics

Several of the Region's key industries have been hard hit by the economic slowdown. Compensation has declined significantly in the securities industry. Wall Street bonuses have been down sharply for two years, and layoffs since December 2000 in **New York City** alone (home to about 20 percent of the nation's employment in this sector) total about 39,000, or 19 percent of the industry's workforce. In addition, the Region's telecommunications, hotel and hospitality, advertising, and computer consulting industries remain sluggish. The greater **Boston** area, as well as parts of **New Jersey** that had benefited from the high-tech and telecom boom of the 1990s, have experienced significant layoffs in these troubled sectors. Employment declines also have occurred in the Region's manufacturing sector; since the beginning of the 2001 recession, the Region has lost 14 percent of jobs in the manufacturing sector, a slightly higher level than that of the nation.

Renewed Strength in Certain Industry Sectors Will Benefit Parts of the Region

Like that of the nation, the Region's economic outlook appears encouraging in the second half of 2003. **Washington, DC,** and suburban **Baltimore** have benefited from increased federal spending and expanded employment related to homeland security. In addition, population growth among the "echo boom" generation (children of baby boomers) in some of the Region's larger metropolitan areas has increased demand for teachers and other education professionals. An aging baby boomer generation, in turn, has stimulated demand for health care services.

A stock market rebound is critical to any sustained economic recovery in the Region. The market generates substantial compensation for Wall Street employees and affects the business services sector, including accounting, legal, and printing services. Moreover, stock market activity correlates strongly with the Region's overall employment growth; the Region's (and the nation's) employment has expanded with increases in equity markets during the past decade.[2] Evidence suggests that conditions on Wall Street may be turning around, a trend that would be expected to benefit the economies of New York City and Boston. In fact, some analysts are anticipating a pickup in equity underwriting and mergers and acquisition activity over the next 12 months, although not to the record

[1] For purposes of this article, the Region includes states in the Mid-Atlantic and New England. The Mid-Atlantic includes Delaware, Maryland, New Jersey, New York, Pennsylvania, and Washington, DC. New England includes Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont. Employment data are through first quarter 2003.

[2] The correlation coefficient between the Region's employment level and the Wilshire 5000 was 90 percent for the quarterly periods between first quarter 1990 and first quarter 2003.

level of the late 1990s.[3] According to a July 2003 report by the Securities Industry Association, profitability in the securities industry significantly improved in early 2003, and industry compensation and employment are expected to increase by year-end 2003.[4]

Despite these positive signs, the Region's employment growth in the near term may lag that of the nation. A relatively higher cost of doing business in some of the Region's larger cities has resulted in the continued out-migration of certain business sectors, such as manufacturing, to the western and southern United States and overseas. In addition, several of the Region's states and cities face serious budget constraints that could hinder a recovery further. Sharply lower tax revenue collections in **Massachusetts,** New York (particularly New York City), and New Jersey are contributing to severe budget shortfalls. State and local governments have cut costs, increased taxes, and restructured debt service in an effort to preserve service levels and maintain balanced budgets. (For more information on the Region's state budgetary problems, see ***FDIC Outlook,*** New York Regional Perspectives, Summer 2003).

Region's Insured Institutions Continue to Report Favorable Conditions Despite Economic Weakness

The Region's insured institutions have performed well during the mild recession and weak recovery by managing interest rate volatility, controlling expenses, and managing credit risk. Their earnings continued to hold up well in first quarter of 2003 despite economic softness and declining interest rates (see Table 1).

Insured institutions reported declining net interest margins (NIMs) in first quarter 2003 as yields on earning assets declined faster than funding costs. The median NIM declined 29 basis points to 3.45 percent as a percentage of average earning assets in the first quarter of 2003 compared to the first quarter of 2002. NIMs are under pressure as historically low interest rates have contributed to lower yields on certain earning assets, while interest paid on deposits may have reached an effective floor.

Noninterest income as a percentage of average assets increased 11 basis points to 0.91 percent (almost 14 percent) among the Region's savings institutions, but was more than offset by a 14 basis point drop in net interest income to 3.09 percent. A decline in noninterest income among the Region's commercial banks was attributed to an 11 percent drop in trust income as the value of assets under management declined. In addition, net interest income fell 30 basis points to 2.94 percent. Overall, insured institutions reported declines in noninterest expenses as they continued to control staffing levels and employee costs. Commercial bank operating efficiency did not improve because net interest income and noninterest income declined. However, the efficiency ratio reported by the Region's savings institutions improved to 54.41 percent from 56.65 percent a year ago as noninterest expenses declined.

Lower interest rates contributed to appreciation in many insured institutions' securities portfolios. The vast majority of institutions sold appreciated securities,

Table 1

New York Region Insured Institutions Continue to Report Healthy Conditions

	All Insured Institutions			Commercial Banks < $10 Billion			Savings Institutions < $10 Billion			Insured Institutions > $10 Billion		
	Mar '03	Mar '02	Mar '01	Mar '03	Mar '02	Mar '01	Mar '03	Mar '02	Mar '01	Mar '03	Mar '02	Mar '01
Return on Assets (ROA) (YTD)	1.22	1.12	1.10	1.11	1.17	1.15	0.98	1.00	0.88	1.27	1.13	1.12
Median ROA	0.87	0.89	0.83	1.02	1.04	1.00	0.75	0.77	0.69	1.39	1.31	1.18
Net Interest Margin (YTD)	3.45	3.74	3.27	3.53	3.74	3.72	3.35	3.45	3.27	3.45	3.78	3.18
Past-Due Ratio	2.75	2.79	2.26	2.25	2.32	2.36	1.34	1.39	1.36	3.08	3.11	2.38
Earning Asset Yield	5.33	6.08	7.66	5.37	6.12	7.79	5.62	6.43	7.48	5.28	6.02	7.66
Cost of Funding Earning Assets	1.88	2.34	4.39	1.84	2.38	4.07	2.28	2.98	4.21	1.84	2.24	4.48
Total Loan Growth (year over year)	4.14	2.66	5.64	6.82	2.43	8.00	3.63	5.54	8.66	3.69	2.27	4.73
Tier 1 Leverage Ratio	7.25	7.43	7.24	8.26	8.33	8.44	9.46	9.30	9.50	6.79	7.03	6.77

Note: YTD = year to date. All figures are percentages. All data exclude credit card institutions, de novos, and other small specialty institutions.
Source: Bank and Thrift Call Reports, reported on a merger-adjusted basis

[3] Fleet Capital. "Capital Eyes: Monthly Insights on Middle-Market Leveraged Finance," June 2003.
[4] Fernandez, Frank A, Monahan, George R, "Securities Industry Update: Turning the Corner," Securities Industry Association, July 24, 2003.

and, during first quarter 2003, 86 percent of these institutions realized gains. The gains represented 14 percent ($1.1 billion) of net income, up from 6 percent a year ago. Should interest rates remain low, insured institutions can supplement earnings, as unrealized gains on available-for-sale securities are among the highest levels in a decade. However, if interest rates rise, this source of income could dry up quickly.

The volume of long-term assets (five years or greater) continued to grow among the Region's insured institutions as mortgage refinancing activity remained strong during the past year. Commercial banks reported a 9 percent median growth rate in long-term assets, the seventh consecutive year of strong growth, as borrowers preferred longer-term, fixed-rate loans. The 27 percent median ratio of long-term assets to total assets is historically high among the Region's commercial banks. The Region's savings banks reported 40 percent of assets in the long-term category, although the growth has slowed. Savings institutions have shifted portfolio emphasis into variable-rate commercial and commercial real estate loans. These portfolios have experienced double-digit growth since 1999 and grew at a median rate of more than 10 percent last year.

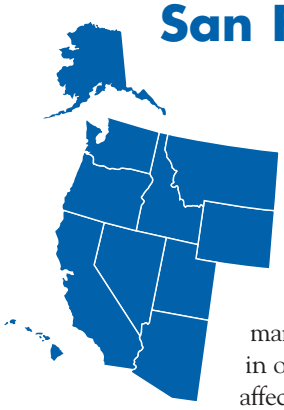
In addition to strong loan growth, insured institutions reported robust deposit growth. The median growth rate of non-interest-bearing deposits was about 13 percent from March 2002 through March 2003. The growth in deposits can be attributed, at least in part, to the fact that consumers are willing to accept the trade-off between potentially higher, yet volatile, equity market returns and the security of insured deposits during a period of stock market uncertainty. During the same period, noncore funding increased at a median rate of just over 10 percent. Meanwhile, institutions continued to use leverage programs that raise low-cost, noncore funds and invest in assets to increase net interest income. Deposits and borrowings represent an inexpensive source of short-term funds, allowing insured institutions some control over NIMs. However, as consumers become more confident in investing in alternative products, funding costs could increase. Higher funding costs, coupled with large concentrations of long-term assets, could heighten interest rate risk, directly affecting the bottom line if interest rates move adversely.

Despite the weak economy, asset quality measures continue to appear favorable, helping to boost profitability among the Region's insured institutions. On an aggregate basis, during the past year total past-due loans declined; however, deterioration has occurred among certain groups of banks and specific loan types. For example, during the 12-month period ending March 2003, the median past-due ratio for single-family residential real estate loans increased 40 basis points to 1.16 percent among the Region's large savings institutions (those with assets of at least $10 billion) and 19 basis points to 1.42 percent among small commercial institutions (those with assets of less than $10 billion). The latter group also reported a 15 basis point increase in the commercial loan past-due ratio to 1.65 percent during this period. Although some insured institutions reported greater increases in past-due loans, aggregate levels remain historically low and manageable. Loan losses and provision expenses also remain low, helping to boost earnings.

Going forward, certain trends could constrain insured institutions' profitability. Strong loan growth may be masking some of the negative effects of the slow economy, but should the Region's economy remain sluggish, commercial and commercial real estate loan portfolios could begin to show deterioration, resulting in higher charge-off rates and provision expenses. On the other hand, even a recovering economy may present challenges, as rising interest rates would affect the value of fixed-rate securities portfolios adversely and could hurt NIMs in institutions that have invested significantly in long-term assets.

New York Staff

San Francisco Regional Perspectives



State Budget Deficits Could Constrain the Region's Economic Recovery

The fragile economy, sustained weakness in the high-tech sector and stock markets, and a temporary decline in oil prices during 2001 have affected state government tax collections adversely and may constrain the economic recovery in the San Francisco Region. State tax collections declined more than 10 percent in the Region during fiscal year 2002 (see Table 1), following almost a decade of average annual revenue growth of 6.7 percent. Tax collections rebounded somewhat in fiscal year 2003, in part thanks to tax increases, but budget gaps were expected to persist in most of the Region's states through fiscal year 2004.[1] Strategies used by state governments to mitigate the effects of reduced tax collections, such as eliminating staff, cutting expenditures, and raising taxes or fees, could hurt local economies. This is particularly true in areas in which strong job growth in the state and local government sector bolstered local economies during the recent recession. This article assesses the potential effects of these strategies on local economies as well as on insured institutions headquartered in the San Francisco Region.

The Severity of Budget Deficits Varies Across the Region

The size of projected 2004 state budget deficits varies significantly and depends greatly on each state's source of tax revenues. State economies that relied more heavily on volatile tax sources, such as personal income or corporate taxes, were affected more adversely during the 2001 recession and are not expected to recover quickly. In contrast, states that relied more on sales taxes exhibited less tax revenue stress.

Tax revenue declined dramatically during fiscal year 2002 among the Region's state governments that relied heavily on personal income tax collections. Significant job losses, particularly in the high-paying technology sector, contributed to personal income tax shortfalls in **California, Idaho, Oregon,** and **Arizona.**[2] Sustained weakness in the stock market also contributed to declining personal income tax collections as capital gains and employee stock option wealth evaporated. Personal income taxes, which represented more than 35 percent of all state tax collections in the Region during fiscal year 2002, declined 23 percent, compared with 11 percent for the nation. Personal income tax collections in the Region are not expected to recover soon because of the sluggish near-term outlook in the high-tech industry and the stock market.

Corporate tax collections have declined in states with a high concentration of employment in the high-tech industry, which has slowed dramatically during the past couple of years. In California, corporate tax collections declined almost 23 percent during fiscal year 2002, in large part because of stress in the high-tech sector and the general economic downturn. In addition, a temporary decline in oil prices during 2001 hurt corporate tax revenue in **Alaska,** where collections fell by nearly one-third during fiscal year 2002.

As a result of declining revenue from personal and corporate taxes, reliance on sales taxes has increased. However, even among the states that generated a significant share of revenue from sales taxes, Arizona and **Nevada** are projecting two of the five highest relative budget shortfalls in the Region. The key tourism sector slowed during the 2001 recession and after 9/11, contributing to declines in overall tax revenue. In addition, robust employment growth in Arizona and Nevada during the past decade has pressured state and local governments to keep pace with needed public services, such as enhancements to infrastructure and education. Rising government expenditures have left these states particularly vulnerable to the recent slowdown in tax collections and the resulting shortfall.

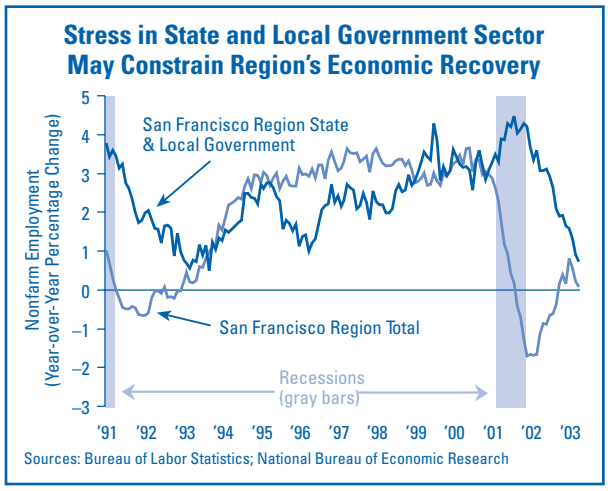
State Budget Woes Could Affect Local Economies and Insured Institutions Adversely

The Region's state and local government sector represented one of the few sources of job growth during the

[1] National Conference of State Legislatures, *State Budget Update: April 2003,* April 2003.

[2] Idaho, Oregon, Arizona, and California ranked among the top seven states nationally during 2001 in the share of employment in the electronic component manufacturing industry.

Chart 1



recent recession; however, employment growth in this sector decelerated sharply during 2002 and early 2003 (see Chart 1).[3] Layoffs in the state and local government sector could dampen the Region's recovery, impair the debt servicing ability of individuals and businesses, and challenge the performance of insured institutions. In addition, bank asset quality and liquidity could be affected adversely by exposures to municipal bonds, loans, or deposits during a time of increasing fiscal stress.

Decelerating growth in the state and local (nonfederal) government sector could have a disproportionate effect on insured institutions operating in states that have higher exposures to nonfederal government jobs and expect budget deficits in fiscal year 2004, such as Alaska, Nevada, Idaho, and **Washington** (see Table 1). Alaska's relatively large reserve funds are expected to mitigate the risk of layoffs among its state and local government employees, however. Throughout the Region, less-populated, rural areas may be particularly vulnerable to additional layoffs because nonfederal government jobs typically represent a relatively high share of employment in rural counties.[4] Job losses in rural areas could further pressure already high delinquent loan ratios reported among insured institutions based outside of metropolitan areas. Since 1998, established community banks headquartered in rural areas have reported higher past-due loan ratios than those based in metropolitan areas.[5,6]

Job losses in the nonfederal government sector also could have a disproportionate effect on counties that are home to state capitals. For example, in counties surrounding seven of the Region's state capitals, at least 20 percent of nonfarm workers are employed in the nonfederal government sector—Juneau County, AK (37 percent); Thurston County, WA (37 percent);

Table 1

Declining State Taxes Could Hamper Job Growth in the Region

	Estimated 2004 Deficit (%)[a]	State Tax for Fiscal 2002 (% Change)[b]	State and Local Gov. Job Share[c]
Alaska	25.0	–23.7	23.2
Arizona	25.0	1.4	15.3
California	20.6	–14.0	15.6
Oregon	17.0	–12.8	15.9
Nevada[d]	9.8	3.0	18.8
Washington	8.9	–0.4	17.4
Idaho	8.8	–11.2	18.0
Montana	8.3	–3.5	11.4
Hawaii	2.9	–2.5	15.6
Utah	0.0	–3.6	15.5
Wyoming	0.0	–2.7	23.6
San Francisco Region		**–10.5**	**15.8**
Nation		**–4.7**	**14.9**

[a] Estimated state deficit for the fiscal year ending June 30, 2004, as a percentage of the General Fund Budget.
[b] Year-over-year percentage change for fiscal year 2002.
[c] Represents state and local government employment as a share of nonfarm employment for April 2003.
[d] Because Nevada's information was not available for fiscal year 2004, the deficit and General Fund Budget data for fiscal year 2003 are shown.

Sources: National Conference of State Legislatures; Bureau of Labor Statistics; U.S. Census Bureau

[3] Employment growth in the state and local government sector during 2001 was amplified somewhat by the reclassification of Native American tribal jobs into the sector beginning in January 2001. Even absent this reporting change, state and local government job increases during 2001 far outpaced growth rates reported in other major industry groupings.

[4] As of 2000, the median ratio of state and local government employment to total nonfarm employment was 20 percent in counties with nonfarm labor forces of 150,000 or fewer, well above the 13 percent median in counties with larger workforces (includes only those counties that reported state or local government employment for 2000 via Global Insight).

[5] This grouping excludes insured commercial banks open less than three years, industrial loan companies, and any insured banks reporting more than $1 billion in total assets, consumer loans exceeding 300 percent of Tier 1 capital, unfunded loan commitments exceeding total assets, or loan-to-asset ratios less than 25 percent. These criteria help isolate insured institutions that are more likely to invest a high share of assets in the headquarters county. Thrift Financial Report filers are excluded from this analysis because of data limitations.

[6] As of March 31, 2003, the median past-due loan ratio among established community banks based outside of the Region's metropolitan statistical areas (MSAs) was 2.6 percent, compared with 1.1 percent among established community banks headquartered within MSAs. Disparities in median delinquencies could be due in part to differences in the geographic, size, and age composition or asset niche of MSA-based insured institutions compared with rural institutions.

Carson City County, NV (30 percent); Sacramento County, CA (28 percent); Laramie County, WY (26 percent); Marion County, OR (24 percent); and Lewis and Clark County, MT (24 percent).[7] Should deficit strategies prompt layoffs in the government sector, borrowers could find it more difficult to service their debts, and insured institution asset quality could weaken.

Fiscal woes also could affect the quality of bonds issued by municipalities. As a result, insured institutions could experience some weakening in securities portfolio credit quality and liquidity. Across the Region, weaker tax revenues contributed to fewer municipal bond rating upgrades during 2002 and early 2003.[8] During the 15-month period ending March 2003, Moody's Investors Service downgraded general obligation bonds issued by the states of California and Oregon and several health, housing, education, lease, and redevelopment bonds issued by local municipalities in Arizona, California, **Hawaii**, Oregon, and Washington. Although municipal bond exposures among insured banks based in California, Arizona, and Nevada (states experiencing some of the Region's more severe deficits) are low, holdings among banks based in the Region's more rural states—Alaska, Idaho, **Wyoming, Montana,** and Oregon—are higher (see Table 2).

State and local budget deficits also could pressure liquidity among insured institutions that rely on state and local public deposits to fund assets. Declining tax revenues could constrain municipal deposit volumes should state and local payrolls decline or should municipalities have less excess cash available to invest in certificates of deposit. Liquidity pressures could be more significant among banks headquartered in Wyoming, Washington, Montana, Alaska, and Idaho, where median municipal deposit-to-total asset ratios are higher than in the Region as a whole (see Table 2).

The Effects of Fiscal Stress on Local Economies and Insured Institutions Could Lag

Although budget deficits have been in the news for some time, some state and local governments have only begun to announce layoffs, cut services, and increase tax rates. Thus, the Region's local economies and insured institutions have not yet felt the full effects of this heightened fiscal stress. Bank management should continue to monitor any deterioration in credit quality or liquidity resulting from budget shortfalls and deficit reduction strategies.

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

Table 2

Municipal Securities and Deposit Exposures Tend to Be Higher Among Insured Institutions Based in the Region's Rural States

State	General Obligation Bond Ratings		Municipal Loans & Securities/Total Assets (Median %)	Municipal Deposits/ Total Assets (Median %)	Municipal Loans, Securities & Deposits/Total Assets (Median %)
	Moody's	S&P			
Alaska	Aa2	AA	4.3	2.4	8.9
Arizona	NR	NR	0.0	0.0	0.0
California	A2	BBB	0.0	0.5	1.5
Hawaii	Aa3	AA–	0.1	1.5	4.7
Idaho	NR	NR	2.8	2.1	7.9
Montana	Aa3	AA–	2.6	2.8	6.5
Nevada	Aa2	AA	0.0	0.0	0.2
Oregon	Aa3	AA	2.9	1.8	4.7
Utah	Aaa	AAA	0.0	0.1	0.3
Washington	Aa1	AA+	0.5	4.5	6.4
Wyoming	NR	NR	2.6	9.1	13.7
San Francisco Region			**0.4**	**1.3**	**3.4**
Nation			**2.5**	**5.2**	**9.5**

Notes: S&P = Standard and Poor's. NR = Not rated, in part because these states had no general obligation debt outstanding. Region data exclude insured banks headquartered in American Samoa, Federated States of Micronesia, and Guam.
Sources: Moody's Investors Service and Standard and Poor's via Bloomberg (July 30, 2003); Bank Call Reports (March 31, 2003)

[7] Nonfederal government employment concentrations are based on employment estimates for 2000 from Global Insight.
[8] For more information, see Moody's Investors Service, "Special Comment: Sluggish Economy Weighs Down Municipal Rating Revisions in 2002," January 2003, and "Special Comment: First Quarter Muni Upgrade/Downgrade Ratio Nears Parity; States' Fiscal Stress Hits Localities," April 2003.

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