

**Remarks
By
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Effective risk management is the bank manager's most important bulwark against credit loss and bank failure. This is true not only in bad times, but in the best of times.

A century ago, Nashville was triumphantly riding the crest of a strong economic expansion, whose remnants can still be seen and enjoyed today just 13 miles from here: Centennial Park - the Parthenon - and the magnificent Union Station.

That boom ended - just like they all do.

Today, the United States is triumphantly riding the wave of the longest economic boom in our history. As of November 2000, we entered our 115th straight month of expansion.

With this expansion has come the most profitable period in banking history. Record commercial bank profits have been reported each year since 1992. These record profits have been accompanied by an equally impressive decline in non-performing bank assets - from 3.02 percent of total assets in January 1992 to .066 percent as of June 30, 2000.

Real estate markets have become particularly robust in the past decade. Office Vvacancy rates nationally stood at 8.1 percent through the first half of 2000.

This growth in real estate markets is reflected on bank balance sheets. Commercial real estate loans grew from \$258 billion at the end of 1992 to \$447 billion through June of this year. Construction and development loans have more than doubled to \$150 billion from their low point of \$62.6 billion at mid-year 1994.

Much of this growth has occurred over the past two and a half years. In 1998, construction and development loans grew 21 percent. In 1999, construction and development loans grew 27 percent. Through June 2000, they grew at a 23.5 percent annualized rate.

And that brings one to wonder: Can there be too much of a good thing?

I'm not the only one asking questions like that.

Your president and CEO Al Sanborn recently wrote to you about rising risk levels. He pointed out the increased level of problem loans identified in the Shared National Credit Review exam, the increased corporate leverage, and increases in default rates.

We agree that these are worrisome trends. In addition to these trends, we believe that some banks have developed certain portfolio characteristics that leave them vulnerable to potential softening in local real estate markets.

The FDIC has been acting recently as a kind of economic weatherman. We've pointed out that a number of cities nationwide are at risk for overbuilding commercial real estate. This does not necessarily mean that these cities are headed inevitably for the kind of real estate crisis we experienced in the late 1980s and early 1990s. A tornado watch does not mean severe weather is inevitable. It does, however, mean that conditions exist for the development of a tornado and that one needs to keep up to date on the latest weather information.

In the same way, FDIC's recently-released list of cities at risk for overbuilding commercial real estate "at-risk" list means that bankers in those markets need to keep a weather eye out, because conditions are favorable for damage to occur in the event of an economic downturn.

Problems in commercial real estate markets were integral to the 1980's banking crisis in the United States and were at the heart of the banking crisis in Asia in 1997-1998. Therefore, the FDIC is especially watchful of steadily increasing volumes of construction and development loans and commercial real estate loans in the banking industry in general, particularly when these loans are concentrated in certain markets.

That's why the FDIC two years ago began developing an offsite model for identifying banks that may be susceptible to a downturn in the local commercial real estate market. In order to develop a method for identifying these banks, we needed to analyze a previous real estate crisis.

We chose the New England experience of the early 1990s because the history of the crisis was very clear., and the crisis occurred well after the Tax Reform Act of 1986 You may remember that the New England economy had grown rapidly following the 1981-82 recession. Five years later, New England was enjoying a booming commercial and residential real estate market, and, by the beginning of 1988, the unemployment rate had fallen to 3 percent.

But the stock market crash in October 1987, combined with other factors such as the decline in defense spending as the Cold War ended, resulted in a sharp decline in New England's economy and a collapse in the real estate markets.

With this well-defined economic scenario as a basis, o Our model asks one pointed question: What would happen to banks today if they encountered a real estate crisis similar to that of the New England Crisis? At the core of the model is a comparison of

the condition of New England banks that were CAMEL rated 1 or 2 in 1987 to the condition of those same banks in 1990.

In 1987, with the local economy booming, the banks in New England were apparently very healthy, but by 1990, many of these banks had evident problems. Using Ccall Rreport information we were able to identify risk profiles in 1987 that resulted in severe financial distress or failure in 1990. We refer to the model as the Real Estate Stress Test or REST.

After we developed this model, we needed to test it in order to gain some confidence in the model's ability to identify a risky real estate portfolio. We looked at the Southern California real estate downturn in the early 1990s. We concentrated on banks and thrifts that had CAMEL ratings of 1 or 2 in 1988, well before troubles had developed, and tried to identify banks that would be rated CAMEL 4 or 5 or had failed between 1991 and 1995.

Our model tested true. Approximately 75 percent of banks and thrifts that the model identified as potential problems became a CAMEL 4 or 5 or failed.

Certain asset and liability categories drive the results of the REST model. The primary risk factor is the ratio of construction and development loans to total assets. Banks with high volumes of construction and development loans seem to be the most vulnerable when a real estate crisis hits. Secondary risk factors are the percentage of commercial real estate loans, percentage of multifamily loans, and percentage of commercial and industrial loans. Additional risk factors include high non-core funding and rapid asset growth. A bank with a high concentration in construction and development loans, coupled with rapid asset growth, would appear to be riskier than a bank with similar concentrations but low asset growth.

We have calculated REST scores for the banking industry as a whole from 1987 to the present and have seen a significant deterioration in the scores since 1995. Between 1987 and 1995, a period that included the New England and Southern California crises, the percentage of very vulnerable institutions per the REST model never exceeded 5 percent of the industry.

But by December 1999, that percentage had increased to 8 percent of the industry. It now exceeds 9 percent of the industry.

On top of this, an additional 16 percent of the industry is identified as somewhat vulnerable to a downturn. Combine the two figures, and one fourth of the industry is potentially affected.

However, it is important to understand that, like other models, REST has its limitations. It only identifies banks with exposures that may be vulnerable to a downturn. REST is a "worst-case" scenario based on patterns from the severe New England Crisis of the early 1990s, the depths of which may never be seen again. The model does not take

into account federally mandated changes in underwriting standards since the early 1990s. Nor can the model reflect a particular bank's underwriting standards or the terms and conditions of its loans. Also, the model is based on Call Report data, which is limited, and, for instance, cannot tell us whether construction loans are centered in residential or commercial real estate, which have very different risk characteristics. Because of these limitations, REST, like other offsite tools, provides clues for examiners to further explore. Onsite examination or other follow-up action would be necessary to determine the reasons behind REST results.

Despite the above caveats, we do have concerns about the trends in real estate concentrations. find this a disconcerting trend.

Conditions are indeed favorable for damage in the event of an economic downturn. The rising level of risk is accompanied by a geographic concentration of much of the risk. In 14 metropolitan areas, over 40 percent of the banks are identified as "very vulnerable." In Atlanta, almost 70 percent of the banks have high-risk profiles. In Portland, Oregon, 55 percent are deemed "very vulnerable."

The FDIC is not alone in its concern. A recent newsletter by Tucker Anthony Capital Markets listed 50 publicly traded commercial banks that they felt "have developed heavy exposure in the higher-risk and commercial real estate loan areas." The rising level of risk is accompanied by a geographic concentration of much of the risk. In 14 metropolitan areas, over 40 percent of the banks are identified as "very vulnerable." In Atlanta, almost 70 percent of the banks have high-risk profiles. In Portland, Oregon 55 percent are deemed "very vulnerable."

It should be pointed out here that the REST model only identifies banks that may be vulnerable to a real estate downturn. It does not reflect the banks' underwriting standards or the term and conditions of their loans. The model also does not predict a decline in the real estate sector; it only shows what may happen if a downturn occurs. In other words, the REST model is analogous to a tornado watch. Conditions, it says, are favorable for damage to occur in the event of an economic downturn.

The FDIC not only looks at portfolio risks in banks, but also at the risks within local economies. We recently published an analysis of commercial real estate markets in the latest edition of our Regional Outlook. As risk managers you are acutely aware that commercial real estate markets are prone to periodic bouts of overbuilding caused by the business cycle, which decreases demand for new space as business activity slows.

But another, perhaps more important factor, is the lag time in the development process as new construction moves from inception to completion. High demand and growing demand that may exist when projects are started can sometimes turn into little demand and no growth by the time projects are completed. This can cause large decreases in the value of properties and subsequent loan defaults and loan losses for the project's lender.

The FDIC has identified commercial real estate markets potentially at risk for overbuilding on the basis of comparative rankings in the rates of growth in commercial space. We rank U.S. metropolitan areas based on new construction activity as a percentage of existing stock for five main property types: office, industrial, retail, multifamily, and hotel. We identify an area as "at risk" for overbuilding if it ranks in the top ten metropolitan areas in two of the five categories. Based on this criterion, the cities considered at risk are: Atlanta, Charlotte, Dallas, Denver, Fort Worth, Jacksonville, Las Vegas, Orlando, Phoenix, Portland (OR), Salt Lake City, and Seattle.

When the list of cities "at risk" for overbuilding commercial real estate are is compared to the 14 cities REST identifies as concentrations of high-risk banks, six are found on both lists. These cities are: Atlanta, Las Vegas, Phoenix, Portland (OR), Salt Lake City, and Seattle.

The FDIC has been making the best possible use of this information. Examiners are tuned in to their local markets and which banks are exposed to concentrations through the supervisory process. As part of this process, REST information is made available every quarter to FDIC staff. This information is one of several the many offsite models that are available for supervisory staff to review during the examination planning stage. Exposures identified by the model can be used to focus examiners on risk areas to review during the onsite examination help identify staffing needs and expertise when forming an examination team. Our examiners use REST can be used as an opportunity to view a "worst-case" stress scenario based on the risk exposures from the last Ccall Rreport. The on-site examination includes a review of the many factors that are not observable solely from financial data. This allows the examiner an opportunity to review the institution's risk management practices. REST information is also shared with the other federal banking agencies and with state regulators who have expressed an interest.

The FDIC believes that the supervisory process, supplemented with the long forecasting horizon of the model, allows examiners to discuss the identified issues with management while time still exists for corrective action to take effect.

Some banks have responded to the data warnings by slowing their real estate lending growth. Others have tightened underwriting standards, but continued adding credits. Still others believe that their markets are healthy and see no reason to change their business strategy.

I, too, hope that the economic expansion will continue unabated and that local real estate markets remain healthy and stable. However, as you know, hope is not a risk mitigation technique.

(Pause)

On April 16, 1998, a tornado passed directly through the heart of Nashville during the evening rush hour. This tornado was one of a line of storms that claimed more than 100 lives in the region.

For the people who live in Nashville, the 1998 tornado laid to rest forever the myth that tornadoes never strike big cities. Along with the usual damage to businesses and homes, it damaged the Hermitage - the beautiful home of Andrew Jackson - and uprooted most of the 100-year-old trees in Centennial Park. It even bent the recently-restored winged statue of Mercury on the clock tower of Union Station so that it was parallel to the ground.

If you have the opportunity to visit some of the sights of Nashville during your stay here, you will see that the damage from that tornado has been largely repaired. In a parallel way, the sustained economic boom we are still enjoying has given the banking industry the opportunity to recover economically from the disastrous events of the late 1980s and early 1990s.

But I am willing to bet that the citizens of Nashville will forever go on the alert when they know a tornado watch has been issued. Because this will mean that conditions are favorable for the development of a damaging event.

In the same way, all of us - regulators, risk managers, and developers - need to remain alert when signs begin to indicate the industry might be vulnerable.

Working together, we can weather any future turbulence.

Thank you.

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