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Commercial Banking Outlook—Midyear 2003 Update

Jeanette Ganousis

We continue to look for changing trends in the banking industry over the next 6 to 12 months. However, some changes we had anticipated are taking longer to occur due to the sluggishness of the economic recovery.

In the area of loan growth, the first half of 2003 looked similar to 2002, with good consumer demand and weak demand for commercial credit. We continue to expect some changes in the second half of the year. Consumer demand has been primarily in the mortgage area and has driven the third consecutive year of record mortgage originations. While the current mortgage pipeline indicates demand remains relatively strong, we have likely seen the peak in demand and expect mortgage originations to slow sometime in the fourth quarter.

On the commercial side, we are beginning to see some evidence of loan growth but progress here remains dependent on the pace of the recovery. Net interest margins have been down in the first half of the year as expected. We anticipate pressure to continue in the second half of the year as reinvestment yields remain low and deposit pricing is about as low as it can go. Margins would benefit from a rate increase but this is not likely in 2003.

We continue to believe fee income will transition in the second half of 2003. Mortgage banking fees have been strong in the first half of the year but similar to our expectations for mortgage originations, we expect mortgage-related fee income to decline late in the year. Capital markets fees, however, should rebound with a better market helping asset management fees. Expense growth in 2003 has been higher than in 2002, as expected. Banks have not been able to offset increases in pension and health care costs.

Credit quality should be a bright spot for banks in the second half of the year. Problem loans and loss rates are improving, with no new areas of problems on the horizon. Overall, the industry remains well capitalized and fundamentally sound.

In general, the pace of activity in the commercial sector has improved during the second quarter. We expect to see continued increases in capital expenditure budgets for the second half of 2003.

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From the Editor

This issue of the *Colorado Business Review* presents a midyear update of the Colorado economy and examines the implementation of the North American Industry Classification System (NAICS). The article on this page provides a perspective on where the financial industry is today and examines changes that may occur in the short term. An update for all sectors of the Colorado economy is presented on pages 3 and 4.

We are interested in your suggestions for topics of future issues of the *CBR*. Please contact me at 303-492-1147.

—Richard L. Wobbekind

Implementation of NAICS: North American Industry Classification System

Brendan Hickey

The rapidly changing structure of the U.S. economy made it necessary to establish a new industry classification system. The Standard Industrial Classification (SIC) system, which had been used since 1939, could no longer adequately describe our dynamic economy. Emerging industries such as information services, biotechnology, photonics, and health care could simply not be studied under the SIC system. After four years of work by the Office of Management and Budget, and agencies in Mexico and Canada, NAICS (North American Industry Classification System) was introduced in 1997, and was officially adopted in January 2001.

The new NAICS system has several key advantages over the old SIC system. First, it will allow the United States to directly compare our economic data with that of other NAFTA members, Canada and Mexico. Second, NAICS is more relevant to the modern economy. The industry sectors have been expanded and now include far more detail. Economic data will better reflect the evolving market and include some of the emerging sectors in the high-tech and service fields. As our economy continues to transform, the NAICS system will easily adapt. Updates and revisions, planned to occur every five years, will allow NAICS to account for future industry revolutions. Perhaps the most significant benefit of NAICS is that it classifies organizations based on how they produce their good or service, not simply what they produce (i.e., the process is more important than the product). Businesses that engage in similar activities, and use similar inputs, capital equipment, and labor are now classified in the same industry.

One of the major drawbacks of the crossover from SIC to NAICS is that it causes a break in historical time series. Since SIC and NAICS are not comparable, historical employment and wage data will no longer be consistent.

NAICS uses a hierarchical six digit coding system (compared to the four digit SIC system) to classify all economic activity into 12 groups, or "supersectors" (compared to 10 in the SIC system), and 21 sectors. See the table below for a list of the supersectors.

Every sector of the economy has been restructured or redefined. Several significant differences from the SIC system should be noted. First, the Services Sector has been broken into 9 new sectors, and 250 new service industries are now recognized at the subsector level. In addition, the Manufacturing Sector has been restructured to account for new high-tech industries. Eating and drinking places have been moved out of Retail Trade, and into the new Accommodation and Food Services Sector. Today's information-based economy is now recognized by the new Information Sector, which is comprised of companies from communications, publishing, motion picture, sound recording, and online services industries. Also, corporate headquarters are now distinguished from the industry of the products or services they produce, and form the new Management Sector.

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North American Industry Classification System

Natural Resources and Mining
NAICS code 11 (Agriculture, Forestry, Fishing, and Hunting)
NAICS code 21 (Mining)

Construction
NAICS code 23 (Construction)

Manufacturing
NAICS code 31-33 (Manufacturing)

Trade, Transportation, and Utilities
NAICS code 42 (Wholesale Trade)
NAICS code 44-45 (Retail Trade)
NAICS code 48-49 (Transportation and Warehousing)
NAICS code 22 (Utilities)

Information
NAICS code 51 (Information)

Financial Activities
NAICS code 52 (Finance and Insurance)
NAICS code 53 (Real Estate and Rental and Leasing)

Professional and Business Services
NAICS code 54 (Professional, Scientific, and Technical Services)
NAICS code 55 (Management of Companies and Enterprises)
NAICS code 56 (Administrative Support and Waste Management and Remediation Services)

Educational and Health Services
NAICS code 61 (Educational Services)
NAICS code 62 (Health Care and Social Assistance)

Leisure and Hospitality
NAICS code 71 (Arts, Entertainment, and Recreation)
NAICS code 72 (Accommodation and Food Services)

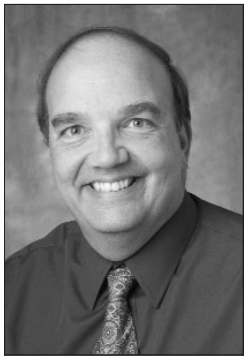
Other Services
NAICS code 81 (Other Services)

Public Administration
NAICS code 92 (Public Administration)

Unclassified
NAICS code 99 (Unclassified)

2003 Mid-Year Update on the Colorado Economy: Sector Highlights

Richard L. Wobbekind



A meeting of Colorado Business Economic Outlook Forum sector chairs and representatives was held in June to review 2003 forecasts made in December. The following paragraphs briefly summarize the outlook for the state.

Employment—The state economy appears to have bottomed out. Job losses have slowed, and sales are looking slightly better. Even so, job growth in 2003 will probably not make the 1.0% gain forecasted in December. At this time, a more likely growth scenario would be about 10,000 new jobs, a 0.5% increase. On a positive note, the job outlook is better for 2004, with 1.0 to 2.0% growth anticipated.

Agriculture—Fortunately for the farmers and ranchers, prices have held up through the drought. Some areas of the state, particularly the southern part, are still experiencing severe drought conditions; however, over 10 inches of rain in some areas has made for a favorable outlook for crop output. The effects of last year's drought will continue to be felt as many of the cattle owners who sold their breeding stock last year have postponed making a decision on whether to rebuild their herds until next year.

Oil, Gas, and Mining—Employment in the sector is expected to increase in 2003. Coal production and demand for construction material may be down in 2003, but it will still remain strong.

Construction—Construction activity is down in 2003. Multifamily permits have declined, and are not expected to pick up in the near future. Although the T-Rex project is still going strong, overall sector employment is 4% below last year's level. The home improvement segment is the lone bright spot in the residential area.

Manufacturing—Employment is down 3% compared to last year. Layoffs are still occurring, but much more infrequently, particularly in the high-tech subsector. Firms are now making business investments, since activity in this area has been minimal since Y2K. Manufacturers continue to be concerned whether they can hire workers with the specific skills they need.

Finance, Insurance, and Real Estate—Unlike the majority of the economy, the Finance Sector appears to be going strong. Overall employment in April is up 3.3% from last year. Significant employment growth is in the area of credit intermediation and related activities. Insurance and real estate, rental and leasing employment have been constant. Commercial real estate continues to be depressed as a result of the weak state economy and lack of job growth. In April, Denver vacancy rates for office, retail, and industrial markets were 22.7%, 8.9%, and 9.1%, respectively. These rates are not expected to return to optimal levels until 2008.

Wholesale Trade and Retail Trade—Retail trade sales have shown about a 1.0% increase compared to last year, largely in restaurants. With the recent stock market gains, consumers are more comfortable with spending, and retail trade sales should continue to rise. On the other hand, wholesale trade is falling behind, with a 1.9% decrease. In many areas, retail vacancy rates are high, as the retail market is overbuilt. The last six weeks of the year will be critical in determining whether this sector will have

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NAICS, *continued from page 2*

Furthermore, in the NAICS system, government and private units will be classified together if they perform the same activity. For example, all air traffic control is now classified as NAICS 488111.

A look at Colorado employment data from 2002 will aid in understanding the changes. In the old SIC system the largest sector was Services, with employment totaling approximately 675,000 people. This was followed by Trade with 519,000 employees and Manufacturing with 186,000. With NAICS, the largest supersector of the Colorado economy is Trade, Transportation, and Utilities, employing approximately 413,000 workers. Professional and Business Services is next with 290,000 employees, followed by Leisure and Hospitality with 247,000.

For more information on NAICS, visit <http://www.census.gov/epcd/www/naics.html>.

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normal or subpar performance for the year.

Services—This sector as a whole appears to be doing slightly better than last year, although some subsectors are still struggling. Health care employment is up, but is expected to flatten out. Educational services are fluctuating. Engineering employment is starting to rise, but there is still a lack of design work. The tight state budget is affecting government spending, which impacts many construction-related areas.

Tourism, Outdoor Recreation and Conventions—Statewide, tourism appears to be up year over year. Winter tourism was strong, and the reduced drought and fire danger should aid the summer numbers.

Government—Even if sales tax revenue turns around in the near term, employment levels will lag behind until at least the beginning of 2004. There is a hiring freeze in federal agencies, but the good news is that there are no lay offs at this time.

International Trade—Despite the sluggish economy and international conflicts, Colorado exports appear to be recovering. Exports totaled $1.84 billion through April, an increase of 2.6% from the same period in 2002. This marks the first period since August 2001 that exports have shown positive growth. Compared to a year ago, shipments to Asia are up 16% and Latin America up 7%. On the other hand, shipments to the European Union are down 10%, and shipments to Canada declined 9%. Worldwide shipments of electronic integrated circuits, a category that has historically been very strong for Colorado, are up 64%. If these trends continue, exports are expected to exceed the 2% growth forecast for 2003.

Richard Wobbekind is associate dean of external relations and director of the Business Research Division in the Leeds School of Business. He can be reached at <Richard.Wobbekind@colorado.edu>.