



# Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

## I. Implications of Housing Downturn: Residential C&LD Loan Quality Issues

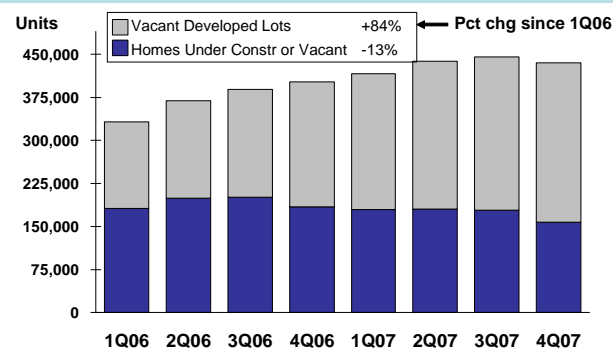
**Figure 1:** A central issue in the current housing slump is excess inventory. This is a symptom of slow sales and rising foreclosures, and is an obstacle to near-term price appreciation. The number of vacant new homes plus those under construction (blue bars) has fallen as builders slashed prices and reduced starts. Despite that progress, the number of vacant developed lots (VDL) has continued to grow (grey bars), keeping builders' total home and VDL inventories near the 450K peak levels (based on data for a large portion of the West). Builders are incurring carrying costs on their VDLs; some may build at any sign of market recovery, possibly stalling a price recovery. Nationally, unsold inventory levels remain extremely high both for new homes (11 months) and for existing homes (9.5 months).<sup>1</sup> Starts and inventories will need to fall further before a price recovery can begin.

**Figure 2:** Prices have reacted to the excess supply. All 12<sup>th</sup> District markets in the Case-Shiller index have seen prices decline from their peaks, with Arizona, California and Nevada MSAs particularly hard-hit. We're unlikely to see a price turnaround for several quarters.

**Figure 3:** Loan quality is showing effects of the housing downturn. While delinquencies and losses are rising in all major loan categories, the greatest concern is with residential C&LD loans<sup>2</sup>. Many banks have significant concentrations including loans on speculative projects that are suffering from a sharp fall-off in home demand, price declines, and tight credit. The average District bank C&LD loan delinquency rate shot up to nearly 6% due to credit stresses associated with the residential slowdown. This is the highest rate since 1994. Net C&LD loan losses also climbed sharply to \$338M in aggregate in the 1Q08 alone, representing an annualized net charge-off rate of 1.5% for District banks. This is the highest rate since the 2%-4% rates from 1991 to 1993.

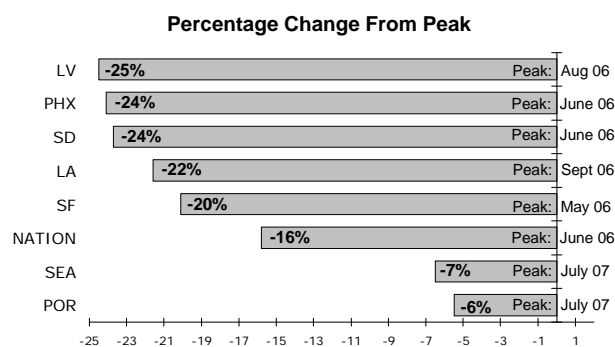
Many banks are proactively recognizing emerging credit weaknesses and are working with borrowers to remargin loans, update valuations, and take other prudent steps. However, in this extremely challenging period, some banks may not be fully recognizing the extent of developing credit issues. We are in the early stages of a down credit cycle, so banks with residential C&LD exposures in weak markets should work actively with distressed borrowers on prudent workout arrangements, and also should consider preserving or raising new capital to mitigate possible future credit losses. With generous capital cushions, banks' ability to continue to fund creditworthy projects and remain profitable over the long run is enhanced.

### 1) Under construction & finished inventory slowly receding in the West, while vacant lots grow



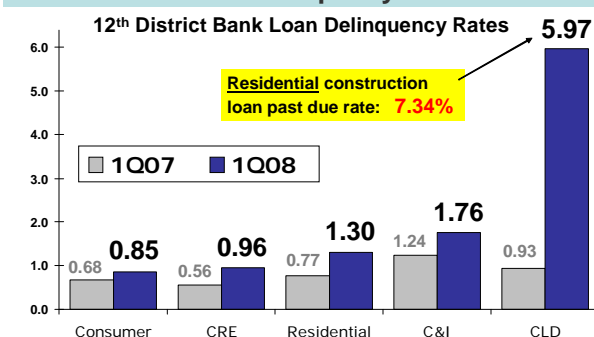
Source: Metrostudy (West = Calif, Boise, Las Vegas, Phoenix, Reno, Salt Lake City, St. George)

### 2) Home prices have dropped sharply on oversupply



Source: Standard & Poors Case-Shiller Index. Data as of Feb 2008

### 3) Construction/development at the forefront of bank loan quality issues



Source: Call Reports. Past due 30+ days & nonaccrual loans; adjusted average ratios for District commercial banks; excludes De Novo banks

<sup>1</sup> Sources: U.S. Census Department, Nat'l Association of Realtors. Months' supply numbers are based on the recent rate of sales/closings within each sector (new homes, existing homes).

<sup>2</sup> C&LD loans: Construction & land development loans



## II. Commercial Real Estate: Holding Up So Far

**Figure 4:** As the economy has slowed, CRE vacancy rates have edged up and are forecast to rise for several more quarters. Markets dependent on housing and finance employment (e.g. PHX, LV, SD, OC) are seeing the biggest growth in office vacancies as demand for space decreases while new construction adds to supply. In these markets, rent growth should weaken or turn slightly negative through 2009. The retail sector also has vulnerability given weak retail sales and outlook. Despite near-term softness in CRE markets, vacancy rates in general should remain below previous peaks across the District and rents should hold up much better than they did in the 2002-2003 downturn.

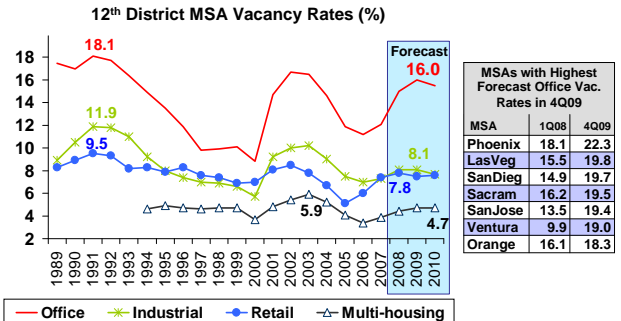
**Figure 5:** Capital markets have been tumultuous, extending from subprime concerns to CMBS and CRE transaction financing. Risk is being repriced and CRE investors are demanding higher returns on their investments. Capitalization rates are starting to reflect this through a widening of spreads relative to Treasury rates. The combination of weak rent growth and rising cap rates should provide further pressures on property values.

**Figure 6:** CRE property values have in fact weakened in recent months and some believe that values will fall sharply, leading to substantial credit losses. However, the concern is alleviated somewhat by the reasonably strong cash flows underlying CRE. According to one forecast, CRE prices should fall moderately this year, but recover in 2009-2010 with a net positive 3-year annual appreciation return for each major sector except full-service hotel. The expected performance will be mixed across the District depending on supply/demand dynamics within each MSA.

**Summary:** The housing downturn has prompted a turn in the credit cycle after years of strong performance. Banks with concentrations in residential C&LD are particularly vulnerable and many likely will incur considerable credit losses in this area. But all areas of credit will need close attention, especially if the economy remains weak.

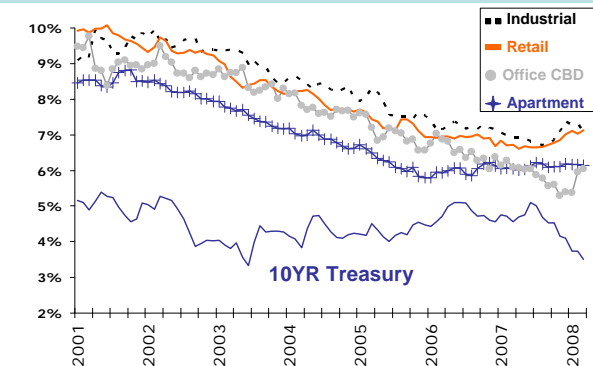
CRE markets are soft due to the weakened economy, real estate related job losses, and slow retail sales. Fundamentals (vacancies & rents) and property values will weaken further in some MSAs. But overall, CRE markets should hold up better than housing.

### 4) CRE: District vacancy rates are rising but should remain well below prior peaks



Source: Torto Wheaton Research, Summer 2008 Outlook; retail and apartment sector rates are unweighted averages.

### 5) Cap rates are edging up



Source: Real Capital Analytics. National data as of March 2008

### 6) CRE property values – a moderately weak outlook for appreciation

Forecast Appreciation – Avg. Annual Rate 2008–2010 (District MSA medians)			
Property Sector	Avg. Apprc. Rate	Stronger outlook for values (6% and higher)	Weaker outlook for values (-3% and lower)
Multi-housing	3.5%	Honolulu, SaltLake, SanFran, SanJose	Las Vegas, Oakland
Industrial	3.2%	LasVegas, Phoenix, SanFran, Tucson	Oxnard, SanDiego, Vallejo
Hotel: Ltd Srvc	2.8%	Seattle	
Retail	1.2%	LasVegas, LA, Orange, Phoenix, Riverside, Sacto	Oakland, Portland, SaltLake, SanFran
Office	0.9%	Honolulu	Oxnard, SanDiego, SanJose
Hotel: Full Srvc	-0.7%		Orange, Phoenix, Portland, Tucson

Source: Torto Wheaton Research, Spring 2008 Investment Fundamentals

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