



Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

I. Some Positive Signs For A Housing Rebound But Obstacles Remain

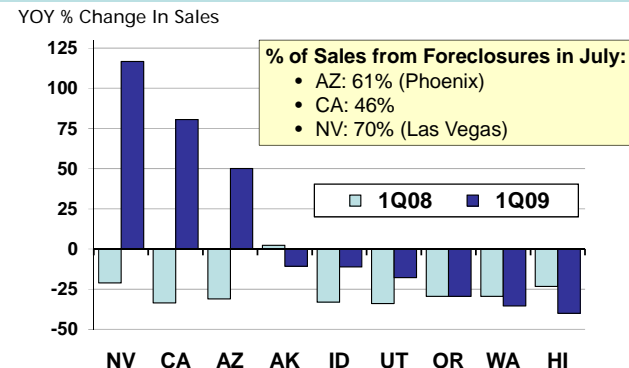
Figure 1: A housing market recovery cannot occur without an increase in sales. The good news is that sales are rising in District states that had some of the largest price drops. In 1Q09, Nevada had a 117% increase in sales versus 1Q08. California and Arizona also had strong year-over-year increases. Only in Hawaii, Washington, and Alaska, where prices declined later and less, were sales lower in 1Q09 than in 1Q08.

Median prices have continued to decline, year over year, due in part to larger price declines for inexpensive homes and more such homes (including foreclosures) in the mix of homes sold than in the previous period. Tight credit conditions continue to dampen sales of homes priced above FHFA conforming limits. As the sales mix stabilizes and stronger sales reduce supply, median prices will move higher. In fact, the latest Case-Shiller Composite-20 index reflected a slight increase in the median home price in May, the first increase since prices peaked in July 2006, possibly signaling an inflection point.

Figure 2: Excess housing supply is being reduced. By one measure of District supply, the number of existing homes for sale is below 300k for the first time since early 2007. The traditionally strong spring selling season, foreclosure moratoriums, tax incentives, and low interest rates have lowered supply. Unfortunately, these positives are temporal and a potential flood of new supply may squelch the improving numbers. The largest source is pent-up supply from sellers who kept their homes off the market. At first sign of rising prices these sellers may swamp the market before higher prices can gain a foothold. The expiration of foreclosure moratoriums, which have temporarily halted a significant source of low priced supply, will also add to supply.

Figure 3: The pipeline of potential foreclosures continues to increase. As of May 2009, nearly every county in the District had a higher percentage of first lien mortgages 90 days or more delinquent than a year earlier. These numbers are unlikely to decrease in the near term. According to several studies (OCC, Fitch), loan modifications are showing re-default rates greater than 50% within one year of modification. Prime borrowers, approximately 85% of the total, are now experiencing steeper increases in delinquencies than subprime borrowers. Continuing job losses and home price declines are pressing prime borrowers.

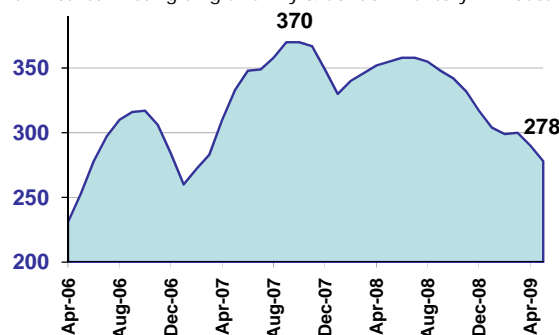
1) Foreclosure Sales Fuel Spike in Existing Home Sales in Hardest Hit States



Sources: National Association of Realtors, MDA DataQuick.
Total existing home sales = single family, condominium, and co-ops

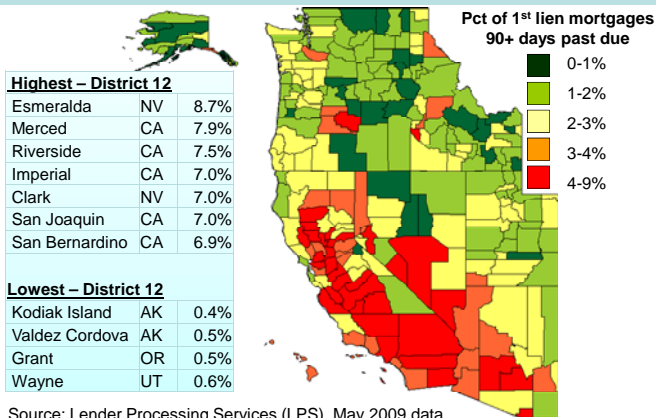
2) For Sale Home Inventory Trending Down – Possibly Short Lived

12th District Existing Single Family & Condo Inventory - Thousands



Source: HousingTracker
12D= BOIS,HON,LA,LV,OC, PHX,POR,RIV,SAC,SD,SEA,SF,SJ,SLC,RENO,RIV,TUC

3) Loans 90+ Day Past Due Highlights More Foreclosures in the Pipeline



Source: Lender Processing Services (LPS). May 2009 data



II. Commercial Real Estate: More Trouble Ahead

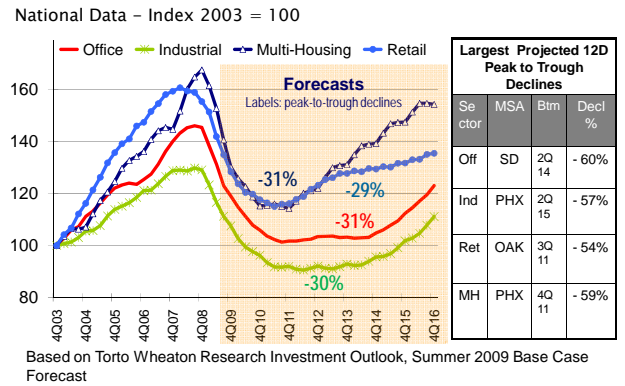
Figure 4: In contrast to residential real estate which is showing some signs of a bottom, commercial real estate conditions are weakening sharply and price declines are accelerating. Property values are falling across CRE sectors as the economic recession and anemic credit markets impact all sectors. Investor demand for higher returns is also eroding value. According to one set of projections, prices will fall around 30% from peaks for all sectors. However, recovery times vary significantly. Office and industrial sectors may not begin recovering until 2014. Retail and multi-housing may see steeper initial declines, but then begin recovering in 2011. At the MSA level, some harder-hit District markets have forecast peak-to-trough declines double the national declines.

Figure 5: Noncurrent rates for income producing CRE loans are climbing but remain far lower than construction & land development (C&LD) loan rates. As fundamentals continue to deteriorate, noncurrent rates are likely to rise for both income property and C&LD loans in the near to intermediate term. Additionally, in the current environment, loan growth is slowing, which naturally contributes to noncurrent rates increasing. For C&LD loans the situation will be made worse as interest reserves which have been keeping some of these loans current are depleted.

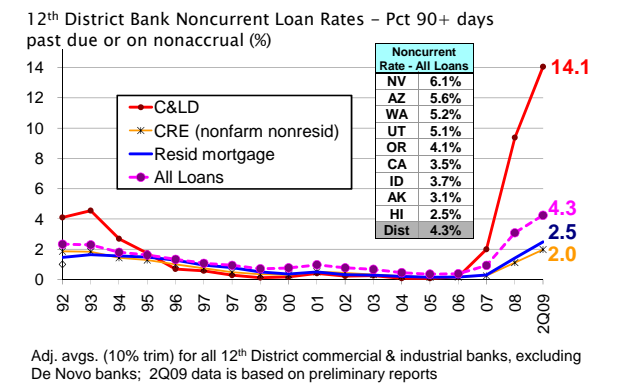
Figure 6: Credit losses on income property likely will rise materially from negligible levels in recent years. Maturing CRE loans may experience significant losses as some borrowers will be unable to contribute more equity to support depreciated collateral values. But non-near-maturity CRE loans also face rising risks. Figure 6 presents results from one CRE default risk model. Based on a prototypical portfolio of CRE loans, the model suggests that expected loss rates have surged, particularly for hotel and office sectors, which traditionally perform more poorly in recessions. Our prototypical CRE portfolio has an overall expected loss rate of 0.59% per year for the next five years. While well higher than recent bank loss rates, it is still below peak CRE loss rates in the early 1990s (1.5% to 2.0%). Despite expectations of rising vacancy rates, net operating income on many properties should hold up reasonably well in the near term, a factor the model considers in projecting default probabilities.

Summary: There are some positive signs in housing markets, although pressures on homeowners will not abate for some time. CRE is further from a bottom than housing. Income property markets are starting to struggle from the weak economy, pressures on rents & steep value declines. The CMM model suggests rising loss rates over the next several years for longer-maturing loans, but also predicts loss rates should remain relatively moderate. Refinance risk of maturing CRE loans, on the other hand, remains high. Unless the economy and credit markets recover more quickly than expected, CRE credit losses on some of these loans could become significant.

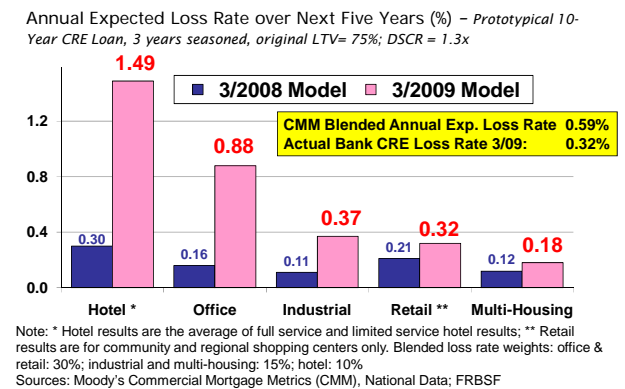
4) CRE Property Values Declining as Fundamentals Deteriorate & Risk is Repriced



5) District Bank Avg. Noncurrent Rate at Record High, Driven by C&LD Loan Deterioration



6) Expected CRE Loss Rates Have Jumped Sharply Per PD/LGD Model



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