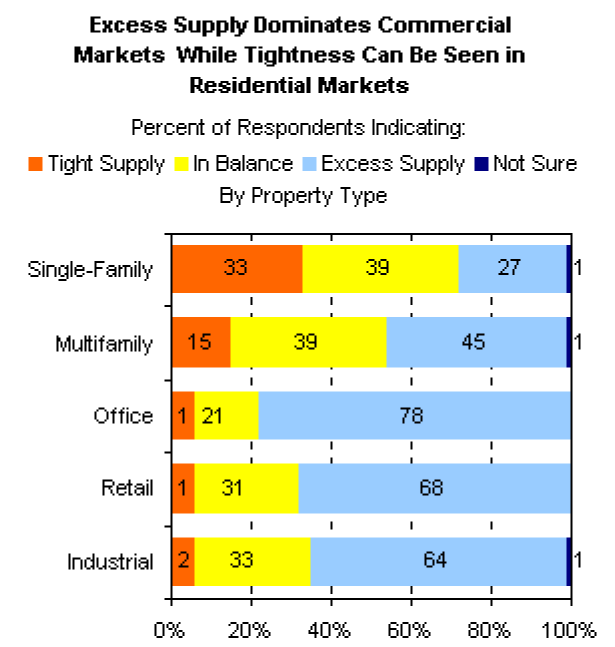
A Look at Residential and Commercial Real Estate Markets

September 19, 2002

Senior examiners and asset managers at federal bank and thrift regulatory agencies continue to see deterioration in the condition of commercial real estate markets while markets for single-family residences generally remain strong. These results, published today in the FDIC's *Survey of Real Estate Trends*, reflect the nature of the recession that began in March 2001 and raise some important risk management issues for the immediate future.

Chart 1



Source: FDIC *Survey of Real Estate Trends*, July 2002

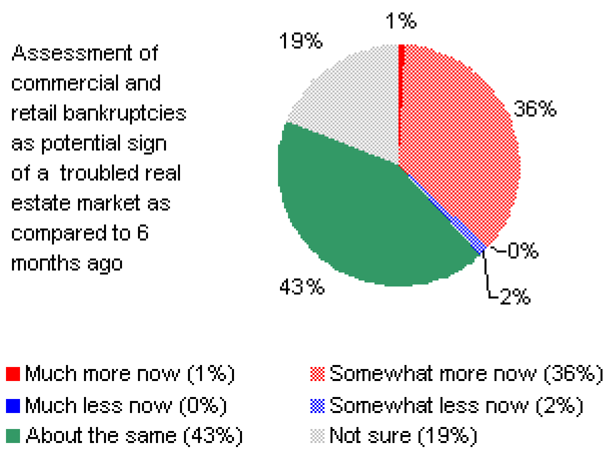
According to today's report, which covers the six month period from January through June 2002, conditions of excess capacity continued to dominate the nation's office, retail, industrial and multifamily real estate markets. Respondents characterized these conditions in terms of falling rental rates and sales prices, along with an increasing prevalence of leasing concessions (such as free rent or financial assistance for modifying the property) in the commercial and multifamily sectors.

In every commercial real estate category, a majority of survey respondents saw excess supply. The percent of respondents noting either "some excess capacity" or "excess inventory" in these markets totaled 78.6 percent for office markets; 67.8 percent for retail markets; 63.4 percent for industrial markets; and 45.2 percent for multifamily residential markets (see Chart 1).

When asked to compare conditions in these market segments during the first six months of this year *versus* year-end 2001, a much higher proportion saw conditions deteriorating as opposed to those who saw them improving. These results are roughly consistent with commercial vacancy trends reported by private market analysts.[1] Much of the excess capacity that has developed in commercial markets has been attributed by analysts to a collapse in the demand for space on the part of corporate tenants who have failed or experienced financial problems during the recession that began early last year.[2] The growing financial problems of commercial tenants are reflected in concerns expressed by survey respondents about commercial and retail bankruptcies, as indicated in Chart 2.

Chart 2

Survey Respondents See Bankruptcies as a Growing Problem for Commercial Real Estate Markets



Source: FDIC *Survey of Real Estate Trends*, July 2002

The survey results for single-family residential markets were more positive than for commercial markets, but respondents were less optimistic about the period than might have been expected. A greater percent of respondents (33.2 percent) noted either "some tightness" or "a tight market" for single family residences than those who noted either "some excess capacity" or "excess inventory" (27.1 percent). Sales volumes were even more mixed. Respondents noting higher sales of existing homes barely outweighed reports of declining sales (30 percent versus 28 percent), while those who saw rising new home sales outweighed reports of declining sales (32 percent versus 25 percent). It is noteworthy that these responses reflect a comparison with the previous six-month period, when the September 11 terrorist attacks may have tempered respondents' views, thereby depressing the base period. The results are also decidedly less positive than the record seasonally-adjusted annual rates of new and existing home sales published by the Bureau of the Census and the National Association of Realtors, respectively.[3]

Sales prices of new and existing homes continued to increase in the first half of 2002 according to most respondents. The number of respondents who saw higher prices for existing homes exceeded those who saw lower prices by a ratio of almost 7 to 1, while reports of higher prices for new homes predominated by a 10 to 1 margin. Although rising home values have been consistently reported by survey participants in recent years, the results in the previous issue (covering July through December 2001) were considerably less one-sided than the results of the current report. Also of note in the current *Survey* were comments received from respondents on both the East and West coasts noting the potential for price bubbles as a result of the rise in home values in recent years.

Taken together, the results of this *Survey* point to at least two issues of concern to lenders, risk managers and regulators. One centers on the potential effect that higher vacancies and lower rental rates could have on future levels of problem commercial and multifamily loans in bank portfolios. As of June 2002, commercial banks reported noncurrent construction and commercial real estate loans equal to 1.08 and 0.97 percent, respectively, of all such loans.[4] While these levels remain near historic lows, problem loans could be expected to rise from these levels if commercial properties continue to experience rising vacancy rates and falling rental rates.

Second, the combination of appreciating home values and record-low mortgage rates that have sustained the housing sector through the economic downturn cannot be expected to persist indefinitely. Despite these favorable conditions, mortgage loans in foreclosure rose to a record 1.23 percent in the second quarter of 2002.[5] When conditions change and borrowers face higher mortgage rates, slower home price appreciation, and fewer benefits from mortgage refinancing, home lenders may face still higher losses and much lower loan volumes.

The complete results of the FDIC's *Survey of Real Estate Trends* for the period January through June 2002 are available at: http://www.fdic.gov/bank/analytical/survey/index.html.

Send comments on this FYI to: Cynthia Angell cangell@fdic.gov

Send feedback and technical questions about the FYI series to: fyi@fdic.gov

---

[1] For example, the composite U.S. office vacancy rate compiled by Torto-Wheaton Research rose from 11.3 percent in June 2001 to 15.7 percent in June 2002, while the composite industrial vacancy rate rose from 8.2 to 10.8 percent.

[2] Thomas Murray, "Slowing Economy Reduces Demand for U.S. Office Space," Regional Outlook, FDIC, 3rd Quarter 2001, pp. 3-11, http://www.fdic.gov/bank/analytical/regional/ro20013q/na/Infocus.html.

[3] According to the Bureau of the Census, the annualized rate of new home sales reached a record-high 954,000 units in the second quarter of 2002. The National Association of Realtors reported that existing homes sold at a record annualized rate of 5.78 million units in the first quarter of 2002.

[4] Noncurrent loans include loans 90 days or more delinquent plus those placed in nonaccrual status.

[5] Based on quarterly data (not seasonally adjusted) published by the Mortgage Bankers Association of America.

Chart 1

Chart 1: Excess Supply Dominates Commercial Markets While Tightness Can Be Seen in Residential Markets

Percent of Market Participants Indicating:

Market	Tight Supply	In Balance	Excess Supply	Not Sure
Industrial	2	33	64	1
Retail	1	31	68	
Office	1	21	78	
Multifamily	15	39	45	1
Single-Family	33	39	27	1

Source: FFDIC Survey of Real Estate Trends, July 2002

Chart 2

Chart 2: Survey Respondents See Bankruptcies as a Growing Problem for Commercial Real Estate Markets

Assessment of commercial and retail bankruptcies as potential sign of a troubled real estate market as compared to six months ago

Response	Percent of Respondents
Much more now (1%)	0.9
Somewhat more now (36%)	35.8
Much less now (0%)	0.0
Somewhat less now (2%)	1.7
About the same (43%)	42.8
Not sure (19%)	18.8

Source: FDIC Survey of Real Estate Trends, July 2002