FYI: An Update on Emerging Issues in Banking

How Long Can Bank Portfolios Withstand Problems in Commercial Real Estate?

June 23, 2003

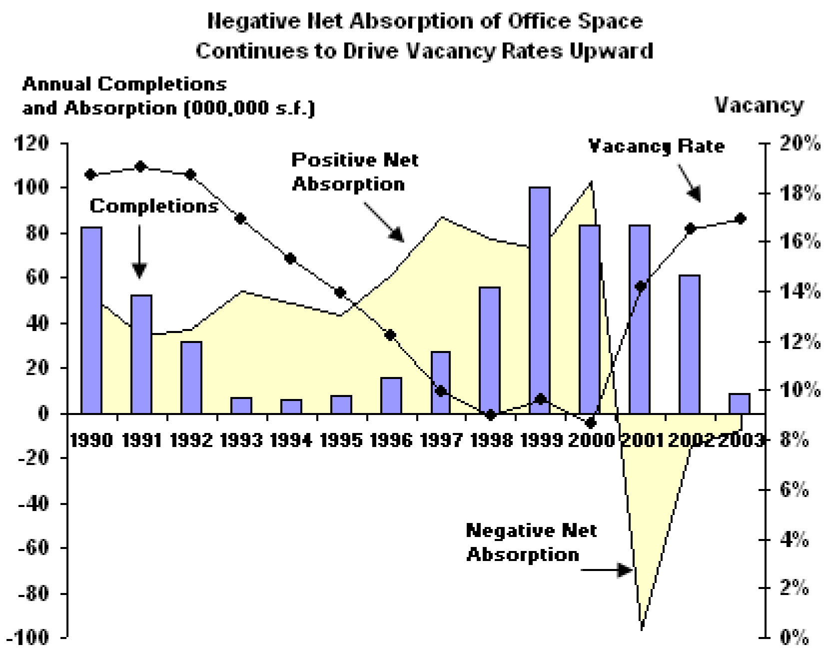
Overview

Fundamental measures of commercial real estate (CRE) market activity, such as vacancies, rents and absorption levels, have deteriorated significantly over the past two years.[1] Faced with diminished demand and flat job growth in a slower-growth economy, many office property owners are confronted by tenants demanding lower rents as they also pare back their holdings of space. In contrast to the CRE downturn of the late 1980s and early 1990s, the present situation is more the result of rapidly diminished demand rather than excessive volumes of new construction. Still, just as in the last cycle, the resulting imbalance between supply and demand has caused market fundamentals to deteriorate and threatens to impair the future performance of banks' CRE loan portfolios. Surprisingly, measures of problem CRE loans at commercial banks, including past due loans and loan charge-offs, remain near historically low levels.[2] This *FYI* reviews the declining fundamentals in U.S. office markets and offers reasons why CRE loan performance has remained strong at FDIC commercial banks. The key question going forward is how long will bank CRE portfolios remain strong in the face of weak market fundamentals.

Demand for Office Space Continues to Decline

Performance in most U.S. office markets continues to deteriorate by almost all measures. During eight of the last nine quarters, U.S. office markets have experienced *negative net absorption*, a situation where the amount of space given up by existing tenants exceeds the amount of space occupied by new tenants. This development is unprecedented in the sense that, prior to 2001, U.S. office markets had never experienced negative net absorption in the 20 years for which comparable data are available. (See chart 1). In the face of retrenching demand by business tenants, office vacancies have shot up to levels not seen since the last cycle in the late 1980s and early 1990s, while rents are down by as much as one-half in some markets.

Chart 1



Source: Torto Wheaton Research. 2003 results as shown are as of first quarter.

Rapid rises in space available for sublease are also contributing to declining office fundamentals. Space available for sublease is estimated to account for up to 50 percent of vacant office space in some cities, creating special problems for landlords. Seeking to cut expenses and losses in any way possible, many companies solicit new tenants to assume their existing leases by offering enticements such as rental rates far below market levels. Depending on the severity of the rental rate cuts and the pervasiveness of the practice in a given city, subleasing has been a major contributor to downward pressure on market rental rates over the past two years.

In addition to pressures in the sublease market, the problems associated with "*shadow space*" are likely to put further downward pressure on rents and upward pressure on vacancy rates. Shadow space is the unused but still-leased office space that a company retains after cutting back on staffing levels, prior to the point of lease renewal. Tenants have tended to retain this space only until the lease comes up for renewal, when it is carved out of the total square footage requirements in the renewed lease.

In addition to the sublease and shadow space factors, landlords are also seeing declines in market rental rates at lease renewal time. This is particularly the case for leases that were executed at higher prevailing rates when market conditions were considerably tighter in 1999 and 2000. Declining lease rates are another factor that could impair the cash flows associated with office properties and make it more difficult for borrowers to service their debt.

Office Vacancy Rates are Nearing Highs of Last Cycle

The nation's office vacancy rate last peaked at 19.2 percent of available space in 1991, during the height of the last major U.S. commercial real estate downturn. Thereafter, vacancies gradually declined; however, the national vacancy rate remained in double digit territory through 1997 before bottoming out at 8.6 percent in 2000.[3] Since the turning point in 2001, the office vacancy rate has risen at an unprecedented pace, nearly doubling to 16.9 percent as of the first quarter of 2003.

The increase in office vacancy rates has occurred in every major U.S. market. New York City is the only major U.S. market still registering a single digit office vacancy rate--9.6 percent as of March 2003. In contrast, as recently as 2000, nearly one-half of the 55 office markets tracked by Torto Wheaton had single digit office vacancy rates.

A number of cities with very low office vacancy rates at year-end 2000 have now experienced sudden and sharp increases in vacancies. Six cities that had office vacancy rates below 5 percent at year-end 2000 have each now climbed to at least 15 percent. The largest increase has taken place in Austin, Texas, where the office vacancy rate has climbed from 5 percent to 25.7 percent over the last 9 quarters. (See Table 1).

Table 1
U.S. Metro Areas with the Highest Office Vacancy Increases in Past Two Years

City	Net Increase in Office Vacancy Rate, December 2000 - March 2003	Office Vacancy Rate, March 2003	Office Vacancy Rate, December 2000
Austin	20.7	25.7	5.0
San Jose	18.6	20.0	1.4
San Francisco	16.1	20.3	4.2
Atlanta	12.4	22.3	9.9
Oakland	12.4	15.6	3.2
Denver	12.0	21.0	9.0
Portland	11.8	18.9	7.1
Boston	11.8	15.7	3.9
Seattle	11.2	15.6	4.4
Kansas City	10.5	19.2	8.7
Northern New Jersey	10.3	17.6	7.3
Nation	8.3	16.9	8.6

Source: Torto Wheaton Research.

Rental Rates are also Under Pressure

Rental rates are also suffering in predictable fashion, as office vacancy rates have risen. During the last cycle, office rental rates declined for just two years, 1992 and 1993 at -3.9 and -8.1 percent, respectively. Similarly, in this cycle, rents began falling in 2002 when they dropped by 6.7 percent. Through March 2003, rents nationwide had fallen by 1.5 percent from year-end 2002.[4] Some markets in this cycle have had extreme rental declines that followed rapid rises from just a year or two earlier. Downtown San Francisco, for example, had office rental growth of 44 percent in 2000. Since then, the San Francisco market has experienced a 50 percent plunge in rental rates in 2001, followed by another drop of 27 percent in 2002.

Problems in CRE Fundamentals Extend to Other CRE Property Types

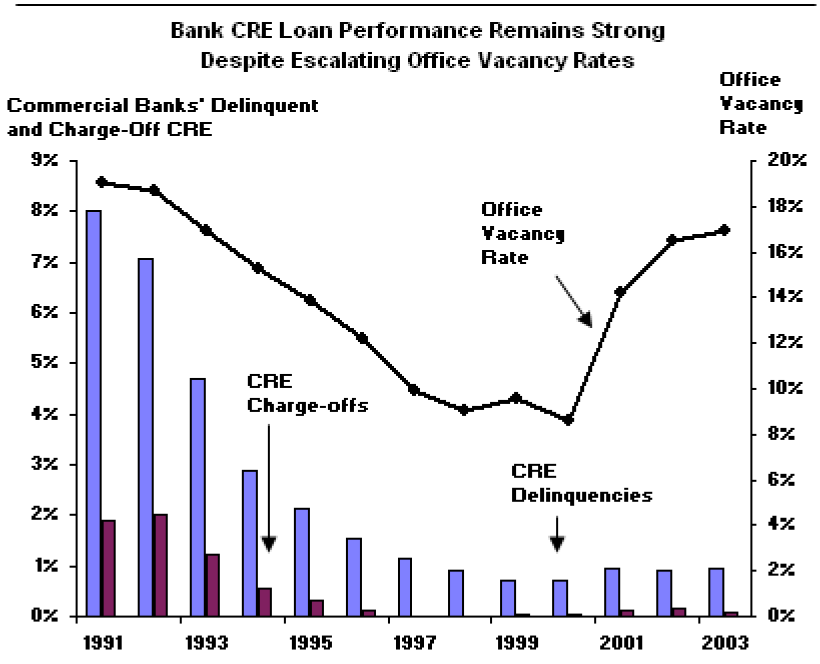
Vacancies for industrial properties as of first quarter 2003 climbed to 11.3 percent, a record level eclipsing a previous high of 10.7 percent reached in 1992. Industrial fundamentals have nearly paralleled office property performance with negative absorption occurring for the first time on a national scale for industrial properties in 2001 and continuing through first quarter 2003. Concerns in the retail sector include bankruptcies of many large and small companies and falling profits extending even to the discount operators. Hotel properties still have not recovered from the sharp drop in demand since the September 11th terrorist attacks and rates have stayed low as operators seek to attract lodgers. Formerly thought to be a safe harbor in any CRE downturn, apartment managers are experiencing falling demand as lower interest rates enable more individuals to afford home ownership.

Demand for all CRE property types has suffered and is expected to remain weak for sometime due to general economic conditions. At least for an uncertain period, office and industrial absorptions are expected to be lower, even as recovery gains momentum, as employers have shifted strategies to get by with fewer workers.

Bank CRE Loans Continue to Perform Well

Despite declining CRE market fundamentals, there has been to this point only minimal effect on bank CRE portfolios. A repeat of the large-scale losses experienced in commercial bank CRE portfolios in the last cycle does not appear likely at present. (See chart 2). Still, the nation's commercial banks registered increases in their non-current CRE loan portfolios of $530 million, or 7 percent, during the first quarter of 2003 and charge-offs are trending upwards. As a percentage of total outstanding commercial bank CRE loans, however, the non-current portion is still at a low 0.95 percent, a moderate increase from 0.90 percent at year-end 2002 and 0.94 percent at year-end 2001. Charged-off CRE loans have steadily increased from a low of $38 million in 1997 to $1.17 billion in 2002 and as a percent of average CRE loans outstanding, net charge-offs increased in the same period from 0.01 percent in 1997 to 0.14 percent at year-end 2002. Even with these upward movements, in percentage terms, CRE delinquencies and charge-offs at commercial banks have remained near historical lows during the past two years.

Chart 2



Source: FDIC, Torto Wheaton Research. 2003 as shown is first quarter, with charge-offs annualized.

Commercial Banks' CRE Portfolios are Performing Better than Commercial Mortgage Backed Securities

Commercial mortgage backed securities (CMBS) defaults are rising faster and higher than non-current levels for commercial banks' CRE portfolios. A recent study performed by FitchRatings on fixed-rate CMBS transactions reports on the growing level of CMBS defaults and found that the cumulative default level on mortgage loans securing CMBS pools were 2.66 percent as of year-end 2002. The study noted that the default rate by loan balance "…has increased steadily since year-end 2000, growing from 1.07 percent at the end of 2000, to 1.75 percent as of year-end 2001, to the current 2.66 percent rate at year-end 2002."[5]

One possible explanation for the relative CMBS weaker performance compared to banks' CRE portfolios is that the CMBS market often provides funding for CRE projects that might not meet the stringent underwriting standards for bank CRE loans. As such, these properties are likely to be much more vulnerable to underlying real estate market weakness. As a result, the performance of CMBS can be viewed as a leading indicator for the future direction, but not necessarily the severity, of performance for bank CRE portfolios.

A Buffer is Shielding Bank CRE Loans - For Now

A "buffer" comprised of at least three major components has helped to insulate banks' CRE portfolios from the effects of the deteriorating office market fundamentals in this recent cycle. These factors are: 1) this cycle's low interest rate environment; 2) the tremendous growth in public, non-government mortgage securitization; and 3) the greater degree of regulator oversight and more stringent CRE lending standards.

Lowest Interest Rates in Decades Have Been a Boon for Cash Flows

The low interest rate environment during this cycle has allowed bank borrowers to more easily service their total debt payments. Additionally, in this cycle, CRE borrowers have not encountered difficulty in refinancing properties.[6] In the last cycle, the national office vacancy rate was reaching its peak of 19 percent at year end 1991, just when the prime rate and the targeted federal funds rate were 7.21 and 4.00 percent, respectively. In contrast, at 16.9 percent, the nation's office vacancy rate is fast approaching the high point of the past cycle, yet the current interest rate environment is far more favorable for borrowers with the prime rate and targeted federal funds rate now at 4.25 and 1.25 percent respectively.

With this cycle's favorable interest rate environment, many borrowers have reamortized or refinanced their existing debt loads at lower interest rates and reduced their loan payments. To date, reductions in payments have been enough for many borrowers to offset cash flow shortfalls resulting from declining rents. Additionally, the lower interest rate environment, conceptually, enables business owners to restructure all of their outstanding debts to "tighten up" their balance sheet to help weather the current downturn. Certainly, CRE borrowers are better able to endure the current downturn by refinancing and reamortizing their loans. However, to the extent that cash-out refinancing of CRE occurs, there are concerns that one result may be the depletion of the remaining equity cushion.

Low Interest Rates Spawn Low Capitalization Rates

Today's low interest rate environment is partly responsible for exceptionally low capitalization rates as shown by recent CRE property sales.[7] Perhaps the more surprising aspect of the lower capitalization rates is that they have been falling for most property types, while market fundamentals have declined. Fueling the lowered capitalization rates, beyond just lower interest rates, has been the perception by many investors of a lack of viable investment alternatives to CRE. This has kept demand levels high for purchasing good, positive cash-flowing CRE properties, particularly as investors shift money from the stock market in search of higher returns. However, should office property values begin to suffer, as some analysts have predicted, investors may change strategies once again and bypass further office purchases.[8]

Increased Role of Capital Markets in CRE Ownership

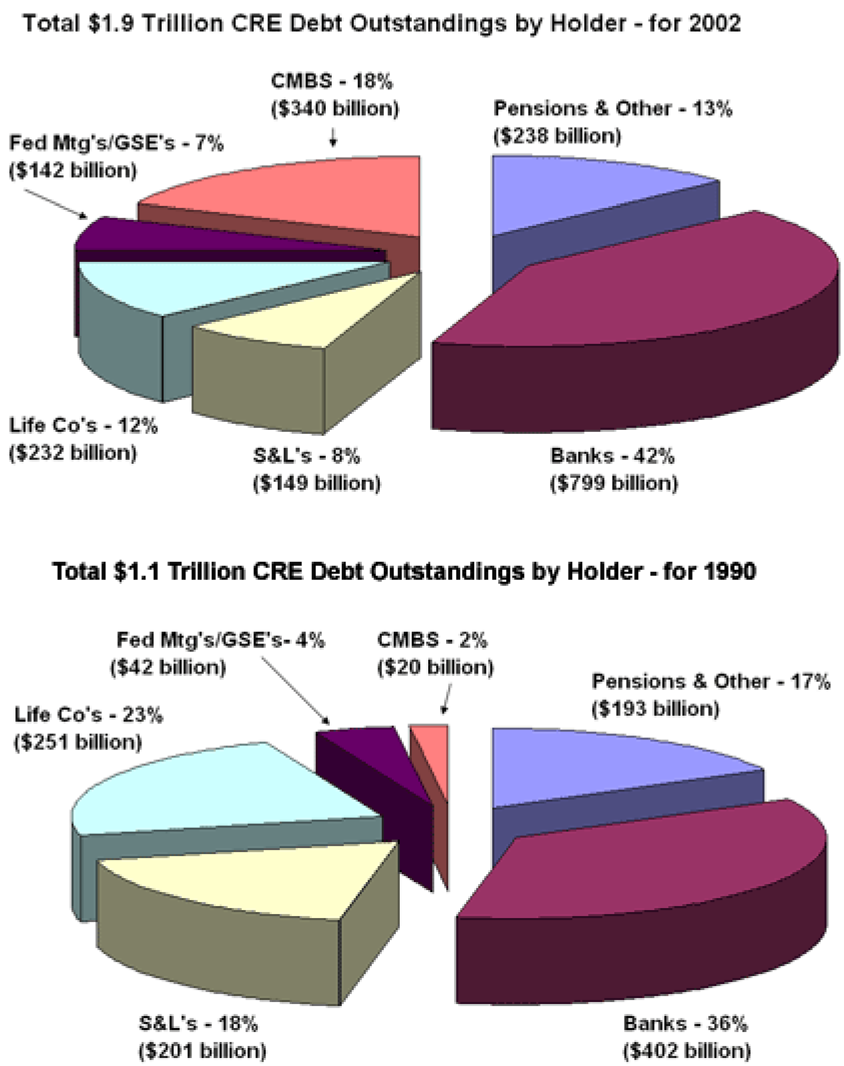
The second component of the buffer contributing to the sustained performance of bank CRE loans in this cycle is the tremendous growth in public market, non-government mortgage securitization occurring since the last cycle and the enhanced transparency that comes with the public scrutiny of CRE markets.

Along with the increase in credit availability by public market funding sources such as commercial mortgage backed securities and Real Estate Investment Trusts (REITs), there has been a significant increase in the volume of public and private information on real estate supply, demand and project performance. [9,10] As a result of the greater monitoring and coverage of CRE conditions, both lenders and developers can more thoroughly and easily evaluate the feasibility of proposed projects.

The public appetite for holding CRE debt has shown remarkable growth since the last cycle. To a great extent, a large acceleration in the volume and marketing of securitized assets is attributable to the asset disposition strategies of the Resolution Trust Corporation (RTC) in the early 1990s.[11] Since that time, many private institutions have entered the market, implementing procedures to serve as "conduits." These institutions originate and package CRE loans for a fee. As a result, many CRE loans now bypass the balance sheets of financial institutions entirely and are instead held by the public market in the form of CMBS. Additionally, the readily available CRE securities market provides banks with the ability to make CRE loans and then choose to retain them within their own portfolios or to sell them through the securitization process.

Chart 3 shows both the large growth in CRE debt (from $1.1 trillion in 1990 to $1.9 trillion in 2002) and the shifts in shares of the holdings between the two periods. Financial institutions (commercial banks and savings and loans) held 54 percent of the debt in 1990, while CMBS represented only 2 percent of the market. In comparison, financial institutions still held about 50 percent of the debt in 2002 while the public market CMBS share increased to 18 percent.

Chart 3: CMBS Have Assumed a Much Larger Role in Funding CRE Debt During This Cycle.



Sources: FDIC, Haver Analytics, Federal Reserve Flow of Funds.

Public Market Scrutiny

As the volume of public investments in CRE has grown, so has the need for information on CRE markets. The demand for CMBS and REIT-related information has led to a large number of Wall Street analysts who track and provide complete reporting on industry trends, CRE conditions and operating performance. In addition, Torto Wheaton Research (TWR), Property & Portfolio Research (PPR), REIS, Cushman Wakefield, Grubb & Ellis, and Costar are among the largest private vendors of CRE data.

Tighter CRE Lending Requirements and a Greater Degree of Regulator Oversight

The third major component of the buffer results from this cycle's tighter CRE lending requirements and a greater degree of regulator oversight. As an outgrowth of more liberal real estate lending practices of the last cycle and the heavy toll the resulting losses took on financial institutions, the FDIC Improvement Act of 1991 (FDICIA) became law. Section 304 of FDICIA requires federal banking agencies to establish maximum lending limits for different real estate categories.[12] Other tightened underwriting standards since the last cycle are requirements for higher debt service coverage ratios along with pre-leasing commitments.

A 1999 FDIC study titled "*Recent Trends in Construction Lending Practices*" found that with few exceptions, banks in the early years of this cycle were complying with the lending limits established by FDICIA.[13] In this study, over 400 real estate construction loans were reviewed at 29 institutions to assess underwriting standards and practices. The study found that equity levels in real estate loans were markedly improved from the last cycle. For example, the review of commercial construction loans found that 81 percent possessed equity investments of 10 percent or more of the loan amount and that 91 percent had loan-to-value ratios of 85 percent or less. The study concluded that lending standards had improved substantially since the last real estate cycle.

How Long Will the Buffer Insulate Banks from the Effects of CRE Problems?

Many analysts believe that recovery for CRE fundamentals is at least a year or more away, and perhaps even longer for the hardest hit office markets, such as San Francisco and Austin. There appears to be consensus that CRE problems have been mitigated by the improved factors outlined in this report. Opinions are divided, however, as to whether high levels of delinquencies will be avoided entirely, or perhaps just postponed as a result of the changed conditions in CRE markets.

Referring to the improved conditions over the past cycle, Dottie Cunningham, CEO of the Commercial Mortgage Securities Association, writes that "[Delinquencies] have been kept down by low interest rates, the discipline of the rating agencies and the tranching of deals which puts the risk where it belongs."[14]

At the same time, Moody's Investors Service Vice President and Senior Credit Officer, Sally Gordon, predicted recent increases in CMBS delinquencies and stated they will not peak until *after* the economy recovers. She explains "real estate lags the general economy, and mortgage defaults lag the rest of real estate. We don't expect delinquencies to peak until after the economy recovers. … Even if the economy is robust in 2003, there will be an increase in delinquencies and defaults, because 2003 delinquencies will be the result of the 2002 economy."[15]

Conclusion

CRE fundamentals such as absorption rates, rents and vacancies have deteriorated nearly in tandem with the modest growth performance of the national economy. Unlike the last cycle, a number of other forces such as lower interest rates, higher levels of CRE securitization and transparency along with greater degrees of regulatory oversight and stricter lending requirements have kept CRE property owners' problems from becoming bankers' problems. The length of time that this stand-off will last is uncertain, but so far the degree to which the problems have not been transferred to banks in the form of CRE delinquencies and charge-offs serves at least as partial testimony to the changes implemented since the last cycle. Still, some declines in credit quality as shown by non-current and charge-offs in the nation's banks' CRE portfolios appear likely to increase. However, because of the factors previously discussed, it appears unlikely that the declines will approach the severity of the last cycle's lows. Although the banking industry as a whole is expected to avoid the severity of the last cycle, performance by individual banks will not be uniform across the board due to different exposures to specific markets and property types and different underwriting practices. Going forward, banks have every reason to continue their diligence in evaluating their CRE portfolios and to continue to assess their market and property type exposures.

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[1]Absorption refers to office space (existing or new construction) that is newly occupied. "Positive net absorption" refers to the net new space that is occupied in any given period over the prior period's occupied space level. The reverse occurs with "negative net absorption" when more space is vacated than occupied during the new period. Office net absorption, rent and vacancy data are from Torto Wheaton Research (TWR). TWR reports that second quarter 2002 was the only quarter of the past nine where the nation's office markets had positive net absorption of office space.

[2]Commercial bank CRE referred to in this *FYI* represents the three loan types of: 1. construction and development; 2. nonfarm, nonresidential; and 3. multifamily. It is important to note that construction and development loans encompass construction loans for both commercial and residential properties.

[3] Many CRE analysts consider a 10 percent office vacancy rate to represent an equilibrium point between supply and demand factors. Different cities are expected to have varying equilibrium levels for their own particular demand and supply constraints, but 10 percent is an acceptable benchmark.

[4] Reported rental rates do not truly capture the full extent of real rental declines. CRE journals and abstracts report that rental concessions have been rampant in this cycle as landlords offer inducements to keep and gain tenants and attempt to avoid lowering their reported rents.

[5] MacNeill, Mary; Stafford, Erin; O'Rourke, Mary, "2003 CMBS Conduit Loan Default Study," *FitchRatings Structured Finance, Commercial Mortgage Special Report*, May 27, 2003.

[6] An argument could be made that, in the last cycle, the market place would have looked less favorably at CRE refinancing in light of CRE oversupply conditions, declining bank profits and plummeting CRE prices.

[7] Cap rates, short for capitalization rates, are equivalent to the amount of net operating income a property generates in a given year, divided by its sales price. Alternatively, and more traditionally, the equation is viewed as net operating income divided by the capitalization rate to yield the sales price for a given property.

[8] Starkman, Dean. *The Wall Street Journal*. "Property Values Finally Decline With Office Space Falling 1.7%," May 28, 2003.

[9] Commercial mortgage-backed securities are backed by the cash flow of a pool of commercial real estate mortgages. After the deduction of servicing expenses, principal and interest payments of the mortgage are passed through directly to the certificate holder in sequential payment order.

[10]REITs enable investors of any size to invest in large-scale, income-producing real estate. For the most part, the universe of REITs is comprised of publicly-owned companies that own and in most cases operate income-producing CRE property. In order to retain their tax exempt status, REITs are required by law to distribute 90 percent of their net taxable income to investors in the form of dividends.

[11]See, for example, Freund et al. *History of the Eighties: Lessons for the Future*, FDIC, 1997.

[12]The supervisory maximum loan-to-value limits established through FDICIA are: 65 percent for raw land, 75 percent for land development, 80 percent for commercial development and 85 percent for 1 - 4 family residential development.

[13]Burton, Steven K., "Recent Trends in Construction Lending Practices," *Bank Trends*, July 1999.

http://www.fdic.gov/bank/analytical/bank//bt9901.pdf.

[14] "Uncertainty Reigns, Interest Rates, War Cloud 2003 CMBS Outlook," *Commercial Property News*, January 1, 2003.

[15] Ibid.

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

Disclaimer

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Chart 1 Negative Net Absorption of Office Space Continues to Drive Vacancy Rates Upward

Date	Completions	Vacancy Rate (%)	Net Absorption
12/31/90	82	0.1872	52.70
12/31/91	53	0.1904	34.90
12/31/92	32	0.1868	37.30
12/31/93	7	0.1691	54.10
12/31/94	6	0.1530	48.50
12/31/95	8	0.1392	43.10
12/31/96	16	0.1220	61.60
12/31/97	28	0.0993	86.90
12/31/98	56	0.0897	77.00
12/31/99	101	0.0961	72.50
12/31/00	83	0.0865	103.10
12/31/01	83	0.1420	-96.50
12/31/02	61	0.1650	-14.70
3/31/03	9	0.1690	-7.10

Source: Torto Wheaton Research. 2003 results as shown are as of first quarter

Chart 2 Bank CRE Loan Performance Remains Strong Despite Escalating Office Vacancy Rates

Date	FDIC Commercial Banks Past Due CRE Loans as % of o/s CRE Loans	FDIC Commercial Banks' Charged-Off CRE Loans as % of o/s CRE Loans	Office Vacancy
03/31/03	0.95%	0.09%	16.90%
12/31/02	0.90%	0.14%	16.50%
12/31/01	0.94%	0.12%	14.20%
12/31/00	0.71%	0.05%	8.60%
12/31/99	0.71%	0.03%	9.60%
12/31/98	0.91%	0.01%	9.00%
12/31/97	1.14%	0.01%	9.90%
12/31/96	1.54%	0.11%	12.20%
12/31/95	2.14%	0.30%	13.90%
12/31/94	2.88%	0.57%	15.30%
12/31/93	4.68%	1.23%	16.90%
12/31/92	7.07%	2.00%	18.70%
12/31/91	8.00%	1.88%	19.00%

Source: FDIC, Torto Wheaton Research. 2003 as shown is first quarter, with charge-offs annualized.

Chart 3 CMBS Have Assumed a Much Larger Role in Funding CRE During This Cycle

Total $1.9 Trillion CRE Debt Outstandings by Holder - for 2002		
	2002	**Dollar ($ Billion)**
Pensions/Other	13%	$238
Banks	42%	799
S&L's	8%	149
Life Co's	12%	232
Fed Mtg's/GSE's	7%	142
CMBS	18%	340

Total $1.1 Trillion CRE Debt Outstandings by Holder - for 1990		
	1990	**Dollar ($ Billion)**
Pensions/Other	17%	$193
Banks	36%	402
S&L's	18%	201
Life Co's	23%	251
Fed Mtg's/GSE's	4%	42
CMBS	2%	20

Sources: FDIC, Haver Analytic