Keynote Remarks

by

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Introduction

Good afternoon. It is great to be with you all in New York City. Thank you for being part of today's conference to exchange ideas and perspectives on commercial real estate trends and risks. New York City is a particularly fitting location to discuss the dynamics of the commercial real estate market. We only have to look around the city to see a wide variety of commercial real estate – from the iconic Empire State Building to new developments such as Hudson Yards.

While commercial real estate lending has been an important contributor to economic growth, it has also been a notable factor in recent banking crises. But the characteristics of each downturn, and the role played by commercial real estate, are unique. And this history is what I plan to discuss today.

Early Thoughts on Commercial Real Estate Credit Cycles

Commercial real estate cycles and their related challenges are not a new phenomenon. One of the first studies to formalize the idea that real estate markets move in boom and bust cycles comes from Homer Hoyt in 1933, the year the FDIC was created.[1] Hoyt's study looked at the success and failure of real estate projects and the related financing arrangements in Chicago's commercial real estate market.

Hoyt noticed periods of rapid growth in real estate markets followed by periods of rising vacancies, falling rents, and lower property values. He observed that the lack of information available for the commercial real estate market led to a mismatch between the supply of commercial space and the demand for using that space – common knowledge to market participants today. However, the idea that market inefficiencies exist due to imperfect data or a lack of transparency continues to play a role in today's real estate cycles.

But transparency is not the only theme that we see repeated across commercial real estate cycles. Lending cycles also tend to be product specific – one sector may be growing while another undergoes retrenchment or fundamental change – as we are seeing with the dynamics between retail and industrial properties today. And commercial real estate cycles tend to be local. While national factors like the business cycle and interest rates can weigh on commercial real estate across market geographies, regional trends can serve to moderate, or to exacerbate, the trends in local markets.

Commercial Real Estate and Banking Crises in the 1980s and 1990s

One of the most iconic periods of commercial real estate stress is the 1980s and early 1990s. The commercial banking industry during this era was defined by strong demand for real estate investments, fueled by a growing economy and a boom in commercial construction activity. Many banks grew their commercial real estate lending in tandem with the growth in the real economy. However, debt coverage and underwriting standards loosened along with the growth, meaning that borrowers had little or no equity at stake, and in some cases lenders shouldered much of the risk.

[1] Hoyt, Homer. *One Hundred Years of Land Values in Chicago: The Relationship of the Growth of Chicago to the Rise of Its Land Values, 1830–1933*. Chicago, Illinois: University of Chicago Press, 1933.

However, the commercial real estate stress was not universal. Specific industries and geographies were vulnerable to the boom and bust pattern, and banks that were active in these areas were susceptible to the risk.

Southwest: An Oil-Driven Real Estate Downturn

The economic downturn in the late 1980s was particularly devastating to the Southwest. Oil was both the foundation of the region's economy and the primary force behind the ensuing banking crisis. As oil prices crashed in the early to mid '80s, banks in the region looked to the then-booming real estate markets to drive continued growth. In hindsight, this strategy did not work out very well because the health of the real estate markets was tied to the health of the region's energy markets. The Texas banking industry was particularly hard-hit by the real estate boom and bust. More than 400 commercial banks from Texas failed during the 1980s, including nine of the state's 10 largest bank holding companies.

Northeast: A Real Estate Downturn Exacerbated by Changes in Bank Structure

Real estate markets also played an important role in the 1980s boom and subsequent bust in the Northeast, but were driven by different factors than were present in the Southwest. Between the end of the recessions in 1982 and 1988, economic growth in the Northeast outperformed the national trend and its commercial and residential real estate markets boomed. However, later in the decade, growth slowed substantially because of several local industry factors. One factor was the decline in the computer and defense industries in the Boston area. Another was cuts by Wall Street firms after the stock market crash in October 1987. The weakening of the regional economy exacerbated the problems of the overbuilt real estate markets.

Some of the most serious difficulties in the commercial real estate markets occurred in New England's condominium market, where some developers went bankrupt when units failed to sell. The area's residential real estate market also had a volatile decade. Rapid rises in home prices spurred residential construction. In many local markets, prices were rising based on the expectation of future price increases. When residential construction finally caught up with the price increases, the region was overbuilt. In New York and New Jersey, the commercial real estate sector was also overbuilt and exhibited serious problems. In New York City, for example, zoning and tax incentives had prompted a flurry of excess building. Office vacancy rates escalated throughout the 1980s, leaving Manhattan with about 25 million square feet of vacant office space at the end of the decade.

Like the experience in the Southwest, the end of the real estate cycle in the Northeast was accompanied by failures of both large and small banks. During the 1980s, 27 institutions failed, and as the real estate downturn progressed, another 111 institutions failed by 1992.

California: Defense and Manufacturing-Led Real Estate Downturn

Compared with the crises in the Southwest and the Northeast, California's recession of the early 1990s was relatively mild in terms of bank failures. Forty-seven banks failed in California during the four-year period from 1990 to 1994, out of a total of 641 banks in 1990. This was a lower failure rate than other parts of the country, and the banks that failed were smaller in asset size than in other parts of the country. Several factors contributed to this result, including the localized nature of the recession, which was primarily concentrated in Southern California, and the prominence of the state's four largest banking organizations, whose geographically diversified portfolios were in a better position than other banks' portfolios to withstand the rigors of the recession. Most of the failures were relatively new banks chartered during the 1980s or those with a geographic focus in Southern California. Failed banks had generally pursued aggressive real estate lending strategies, favoring higher-risk construction and commercial real estate loans over more conservative lending options.

The Financial Crisis of 2008

As the saying goes, "History doesn't repeat itself but often rhymes." This was particularly true with regard to commercial real estate exposures and the resulting vulnerability of banks during and after the financial crisis of 2008, relative to our experience in the 1980s and early 1990s.

As we are all aware, the financial crisis originated in and was fueled by the residential mortgage market. Books have been written and movies have been made detailing these issues and players.

What some are less aware of is how the residential mortgage crisis spread through commercial real estate. As housing markets were booming, many banks, in particular in the South and West, were eager to extend financing to support residential real estate construction. This eagerness resulted in aggressive growth in residential construction lending at banks. Unfortunately, as the housing market cooled, many of these residential construction projects and loans soured.

However, I would distinguish the performance of construction and development loans relative to the broader commercial real estate market during the crisis. Eventually, as the recession continued and spread to a wider set of geographic areas and industry segments, the commercial real estate downturn also broadened. Loan delinquency rates and charge-offs increased for all segments of the commercial real estate portfolio, but no component suffered more losses than construction lending. And, geographically, banks located in areas that had experienced the sharpest boom and bust in the housing markets – Arizona, California, Florida, Georgia, and Nevada – experienced steep delinquency rate spikes and increased failure rates. These construction loans were often key contributors to the 531 bank failures experienced during the crisis.

Bank Exposure to Commercial Real Estate Is at a Record High

So, within this historical context, what risk exists in today's commercial real estate portfolios?

As of second quarter 2019, banks hold about $2.4 trillion in commercial real estate loans, eclipsing the 2008 peak. Banks hold more than 61 percent of commercial real estate loans outstanding, near a record high. Consistent with the record economic expansion, commercial real estate loan performance at banks is strong.

There are also many players and increased competition in the commercial real estate lending market. Commercial real estate loan balances at FDIC-insured banks have grown for 25 consecutive quarters, since early 2013. Commercial mortgage-backed securities (CMBS), life insurance companies, and other nonbank lenders are active in the market. In addition, private equity firms, public and private real estate corporations, and real estate owners and developers have entered the market and are providing financing for real estate projects.

Multifamily real estate loans, for apartments and condominiums, have also been an area of growth. This segment of the commercial real estate portfolio reached a record high level of $445 billion in second quarter 2019, as well as a record share – 18.4 percent – of the total outstanding commercial real estate loans at FDIC-insured banks. This growth has been driven by both large multifamily lenders expanding their portfolio as well as community banks expanding their real estate loan offerings to multifamily projects.

Of course, none of us can accurately predict when, where, or how the next downturn in the economy, or in the commercial real estate sector, will occur. However, we do know that commercial real estate holds challenges for the banking industry, including potential boom and bust cycles and asset/liability mismatches. In addition, the commercial real estate market, like all markets, is always adapting. Today, retail and office space are currently undergoing significant evolutions, as an increasing share of retail shopping moves online, for instance. This evolution provides opportunity, but it also brings uncertainty to the lending environment.

Conclusion

We look forward to continuing this conversation with different areas of the commercial real estate industry, from bankers to investors to industry analysts and academics. Together, we can work to understand the market more clearly and be prepared to respond appropriately to changing conditions.

Thank you again for participating.