FDIC Speeches

RTC Seminar Remarks

FDIC/RTC Real Estate Project

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Good afternoon, ladies and gentlemen. It's a pleasure to be with you in Dallas today. It is particularly gratifying to see so many of you interested in buying from the RTC -- at a bargain, of course.

Today, I hope you learn everything you need to know about how to buy real estate from the RTC. And, of course, I hope you brought your checkbooks. We're selling some fine products, look at those pictures on the wall.

Others will tell you how to buy real estate from the RTC. But I am going to talk about real estate markets and the FDIC efforts to design an indicator of risks in real estate markets. I'll leave the details to our RTC sales experts.

Real estate values are a major policy concern at the FDIC and RTC for two reasons.

First, because the FDIC and RTC combined, is the largest real estate sales organization in the country. As of the first of the year we have close to $200 billion in real estate or real estate related assets -- and all of it's for sale.

And second, because we are the insurer of the country's largest real estate lenders -- S&L's and banks.

In recent years, many banks have turned to real estate activities to maintain growth and to achieve profit objectives. A few statistics tell the story. Since 1986, bank assets have grown 12 percent. Bank real estate loans, however, have grown four times as much--48 percent. Unfortunately, nonperforming real estate loans have grown even more--54 percent.

The increased involvement of banks in real estate activities and the fact that S&L's are primarily real estate lenders, has prompted the FDIC interest in the price risk in real estate markets.

Because real estate values fell in certain areas and banks and thrifts failed because of it, the FDIC and the RTC have large inventories of real estate to sell. Further, we believe the success of our sales program will depend on our knowledge of conditions in local real estate markets.

Therefore, we are developing an early warning system to help alert us to possible real estate difficulties. A perfect forecasting capability is obviously beyond anyone's reach. Nevertheless, we'd like to develop some indicators of the degree of price risks in the marketplace. These can be used by financial institutions and our own organization.

The difficulty of the task, however, is highlighted by the fact that real estate analysts in the private sector often disagree on the condition of a local market and the trend it is taking.

For example, recently we were reviewing information on the Atlanta, Georgia market. One respected private sector source predicts that the Atlanta office vacancy rate, approximately 20 percent now, will fall to 14 percent. Another equally respected private sector source forecasts a rise to 27 percent. "Pay your money and take your choice." ----The wide variation of opinion exemplifies the uncertainty inherent in the real estate analysis business.

Unfazed by this private sector divergence, we are going to use the Atlanta region to test the survey methodology in our real estate project.

Here's where we are in developing our risk indicators.

As most of you know, real estate cycles can be both more pronounced and more prolonged than other supply and demand cycles. Because this "long cycle" requires early action, we'd like to have lenders know more, and move quickly when supply and demand appears to be getting seriously out of balance.

One indication that supply may becoming excessive is faster-than-average growth. Our preliminary work has led us to conclude that extraordinary growth is often followed by an economic downturn, although perhaps not for a considerable period of time. Still, unusual growth seems to be enough of a danger sign to warrant an effort to identify markets where growth is far above average.

Let me emphasize that the FDIC is by no means against growth. After all, a growing economy and a stable banking system go hand-in-hand. But imprudent growth can result in real estate supply getting ahead of market demand, sometimes with extremely unfavorable results, such as occurred here in Texas.

Consequently, in our search for an early warning system for real estate difficulties, we are concentrating on indicators that show a market growing at an above normal rate.

Please take a look at pages 2 and 3 of the hand-out you've received -- pretty isn't it..... colorful........ maybe even useful. We have divided real estate markets into three categories: commercial, residential, and bank lending.

In the commercial category, we have assembled five indicators. For the present, we used three as our indicator: new office space created, employment growth, and vacancy rates. The markets at the top of the table are the ones that indicate the greatest degree of risks. Which is to say, they have the most space created, the least employment growth and the highest vacancy rates.

Phoenix is at the top of the list since its high rate of office starts is occurring in a market with an increasing vacancy rate and a low rate of employment growth.

Phoenix is no surprise as its problems have been well documented. The next two markets on the table, however, have not received much attention. In both Nashville and Anaheim, a relatively high rate of office starts is occurring in conjunction with increasing vacancy rates and low employment growth.

Does this mean that Nashville and Anaheim are in for real estate crashes? We don't know, but we'd <u>like</u> to know. We do think that markets with these trends have a higher than normal

risk indicator and deserve close watching. Supply is increasing in the face of indications that demand is stagnating.

What do the commercial indicators tell us about Dallas and Houston? In Dallas, the office vacancy rate was still trending upwards in 1989, and office employment growth was very low. But office starts were increasing only modestly. The result is that Dallas is ranked in the middle of the commercial indicators table. This means that the risk of price decline does not appear to be above average at the present time.

From the standpoint of price risk, Houston is ranked at the bottom of the table. <u>That's good!</u> Low price risk indicated! Office starts were increasing at a rate well below the national average, office employment growth was relatively high, and the office vacancy rate was declining. Demand appears to be picking up in Houston, but the increase is not triggering a rush to build.

Our efforts so far at the FDIC have been primarily on indicators for the commercial segment of the market. Just as an example of what might be done regarding the residential segment, however, we have included a table ranking markets by the percentage change in median housing prices. Increasing prices often trigger more development, which at some point in the future might lead to an excess of supply, and lower prices.

No surprise, neither Dallas nor Houston is among the top 25 percent of the markets ranked on the basis of increases in housing prices. Buy now when prices are low!

The third table contains indicators of bank involvement in a market. The indicators are measures of construction lending and problem real estate loans. A high listing on the table indicates that banks in the market have some combination of above average growth in construction lending and in problem real estate loans.

What the indicators help us to determine is the extent to which banks are involved in real estate markets with potential adverse lending trends. While, an increase in lending per se is certainly not something we are trying to discourage, we do want people to know when a market appears troubled.

Indications that banks are significantly increasing their real estate financing, particularly their construction financing in a market, might indicate problems down the line. This would especially be true if the commercial and residential indicators told us that supply might be getting ahead of demand.

In both Dallas and Houston, construction lending by banks has been falling significantly. However, in Dallas nonperforming real estate loans and repossessed real estate continue to increase. Therefore, Dallas is ranked in the middle of our bank

lending indicators table. Again, Houston is ranked near the bottom because the banks are not reporting increases in real estate lending problems. Houston appears to be a low risk market.

A few additional facts can be stated about the Dallas and Houston markets. These facts are illustrated by graphs in the handouts. With respect to housing, the signs are encouraging. Median home prices in both markets are increasing, which indicates that recovery is underway.

Permits for the construction of new housing have been on the decline for several years. The market is not in immediate danger of overheating---to say the least.

In the future, we plan to add reports from our supervisors and liquidators in the field to our analysis. This will give us some "real time" in the field reports to add to our information on pricing behavior.

We hope to use the analytical tools we are developing to help moderate the supply-demand imbalance that caused banks so much trouble in the 1980's. Real estate losses have been at the heart of the bank failures that cost the FDIC many billions of dollars.

My father always said..... we are not able to predict what the American people will do, but we <u>can</u> predict they'll do it all at once.

We know we can't change human behavior. But, perhaps these risks indicators will help to moderate that unfortunate behavioral problem, so often evident in real estate lending.

Thank you.