Statement of
Sandra Thompson, Director,
Division of Supervision and Consumer Protection,
Federal Deposit Insurance Corporation
On
The Current State of Commercial Real Estate Finance
and Its
Relationship to the Overall Stability of the
Financial System
before the
Congressional Oversight Panel,
Washington, DC
February 4, 2011

Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the commercial real estate (CRE) market and its relationship to the overall stability of the financial system. My testimony will describe the FDIC's observations about commercial real estate lending and how this sector has affected the condition of insured depository institutions. I will also draw a distinction between the types of CRE loans originated by banks to explain how the more risky elements, such as acquisition, development, and construction (ADC) lending, has experienced much higher loss rates than categories such as owner-occupied loans to small businesses. I will close with a summary of the FDIC's supervisory activities related to CRE lending and current market trends.

As the Panel well knows, the events surrounding the financial crisis of late 2008 have taken a heavy toll on real economic activity across our nation. The effects of the dislocations in real estate finance that triggered the crisis are still with us in the form of depressed real-estate prices, high levels of foreclosures and credit distress, and elevated levels of unemployment.

In response to these challenging economic circumstances, banks are clearly taking more care in evaluating applications for credit. While this more conservative approach to underwriting may mean that some borrowers who received credit in past years will have more difficulty receiving credit going forward, it should not mean that creditworthy borrowers are denied loans.

In retrospect, it is clear that the bank regulatory agencies could have been more aggressive in their approach to institutions with the riskiest CRE exposures, especially in real estate development lending. As outlined later in my testimony, the FDIC has taken steps to address our supervisory approach while at the same time recognizing that we, as bank supervisors, have a responsibility to encourage institutions, regularly and clearly, to continue to make soundly structured and underwritten loans. There is a balance that must be met. Bank lending is an essential aspect of economic growth and will be vital to facilitating a recovery. Our efforts to communicate supervisory expectations to the industry should help banks become more comfortable extending and restructuring loans, and in turn promote the availability of credit as the economy recovers.

The Boom Years

The early and middle years of the last decade were marked by strong housing market activity and rising home prices. In addition, residential construction lending was a rapidly growing part of insured institutions' lending activity, especially among community banks. The annual number of single-family housing starts averaged 1.4 million between 2001 and 2007, well above the average of 1.1 million starts between 1980 and 2000. At the same time, home prices were growing faster than disposable personal incomes. Average U.S. home prices as measured by the S&P/Case-Schiller National Home Price Index rose by 89 percent between 2000 and 2006, while total disposable personal income rose by 35 percent. During 2005, the total number of housing units grew at a rate two-thirds faster than the population, while the homeownership rate stood just below the all-time high of 69 percent reached in 2004.

As housing boomed, ADC loans also grew rapidly. Construction of single-family housing also tends to spur demand for new commercial developments to serve growing communities. The total volume of outstanding ADC loans held by FDIC-insured institutions increased from $360 billion as of the first quarter of 2005 to a peak of $630 billion as of the first quarter of 2008, an increase of 75 percent in just three years. Along with this rapid growth in total holdings came increases in the magnitude of bank portfolio concentrations of ADC loans. The banking industry average concentration of ADC loans to total capital rose from 26 percent in 2000 to a peak of 50 percent in third quarter 2007. Similarly, the percentage of insured depository institutions with ADC concentrations exceeding total capital rose from 8 percent to 28 percent between 2000 and 2008.

All of these measures of housing market and construction activity reflected a boom that could not last. Home prices peaked in early 2006 and then fell by 31 percent – the largest nationwide decline in home prices since at least the 1930s – before stabilizing in mid-2009. Meanwhile, annual housing starts have declined by more than 70 percent from peak levels, and the homeownership rate declined to 66.7 percent by the third quarter of 2010. The record levels of mortgage credit distress that triggered the wider financial crisis began in subprime and nontraditional loans, but spread to prime loan portfolios. FDIC calculations based on the First American Corelogic database of privately-securitized mortgages shows that more than half of subprime loans originated in 2006 and 2007 had defaulted by November 2010. Further, more than 40 percent of Alt-A loans and more than 15 percent of prime loans made in those same years had defaulted in the same time period. This mortgage credit distress has led to record levels of loans entering foreclosures. FDIC estimates based on data from the Mortgage Bankers Association show that foreclosures reached 2.8 million in 2009 and appear to have exceeded 2 million again in 2010.

Impact of Housing Declines on CRE Loan Portfolios in the Banking Sector

Severe mortgage and housing market distress has adversely affected the credit performance of construction and other commercial real estate loan portfolios, both directly and indirectly. The most direct effect involves the decline in collateral values for residential properties and undeveloped land that serve as collateral for residential ADC loans. As these values declined in the last half of the decade, sales proceeds were insufficient to retire debt as planned and the percentage of problem residential ADC loans soared.

I would like to make a distinction between the risk management challenges posed by ADC loans, and loans collateralized by income-producing properties that are past the construction phase or are owner-occupied. While both of these are subcategories of what is commonly referred to as "commercial real estate lending," they differ a great deal in their cash flow characteristics and the losses they generate in periods of real estate market distress. What we observed in an earlier banking crisis, between 1989 and 1992, and what we are experiencing now, is that the largest percentage losses are incurred in ADC portfolios, and that these losses tend to occur earlier in a real estate market downturn. By contrast, losses on other CRE loans tend to be more modest, but also tend to take more time to be fully realized during economic downturns.

Noncurrent residential construction loans held by FDIC-insured institutions rose from 1.45 percent of outstanding balances in the first quarter of 2007 to 25.7 percent at the end of 2009, before falling slightly in 2010.1 In addition, the wider economic effects of the real estate market bust and the financial market crisis of 2008 have included a marked deterioration in the cash flow characteristics and collateral values of commercial real estate construction and development projects.

As conditions worsened in residential and commercial real estate markets in the latter years of the decade, the level of total problem ADC loans – including both residential and commercial projects – also rose rapidly. The ratio of total noncurrent ADC loans held by FDIC-insured institutions rose from a cyclical low of 0.4 percent at the end of 2005 to a peak of 16.9 percent in first quarter 2010 before declining slightly by September 2010. Net charge-off rates for total ADC loans followed a similar pattern. After falling to a cyclical low of 0.01 percent in the second quarter of 2005, the annualized net charge-off rate for ADC loans held by FDIC-insured institutions rose steadily to a peak level of 8.08 percent by the fourth quarter of 2009, before declining modestly in the first three quarters of 2010. As institutions worked through the unprecedented decline in residential construction and home values, construction financing as a percentage of CRE lending declined from 32 percent in the fourth quarter of 2007 to 20 percent as of September 30, 2010.

The historic real estate market downturn we have recently experienced is contributing to acute credit distress in portfolios of ADC loans as well as other commercial real estate loans, which the banking industry is addressing. Since the end of 2007, FDIC-insured institutions have charged off almost $64 billion in ADC loans, while the outstanding balances of these loans have fallen by 44 percent. Over the same period, charge-offs in the somewhat larger nonfarm nonresidential portfolios have totaled $21 billion.

Commercial Mortgage Backed Securitizations

An important non-bank source of CRE financing during the last decade was commercial mortgage-backed securitizations. Issuance of commercial mortgage-backed securities, or CMBS, peaked in 2007 at $230 billion, having more than doubled from a total of less than $100 billion in 2004.2 These securitizations focus almost exclusively on large, fully-leased investor properties. It is important to note that the CMBS market does not typically include ADC credits, or owner-occupied (small business) loans which represent a significant portion of community bank CRE lending. At the peak, CMBS accounted for almost 28 percent of all CRE financing. However, with the deterioration in CRE market fundamentals that occurred thereafter, combined with heightened risk aversion by investors in general that was centered on mortgage-backed securities, CMBS issuance ground to a complete halt in late 2008 and early 2009. The CRE Finance Council estimates that total CMBS issuance was just $3 billion in 2009 and $12.3 billion in 2010, while Moody's projects that total CMBS issuance will rise to $37 billion in 2011. Disruption in the CMBS market has had a significant impact on market liquidity and has contributed to lower CRE valuations since 2007. A return of CMBS financing is likely to be slow, improving gradually over time with the recovery in CRE market fundamentals. In the interim, CRE valuations will likely remain under pressure, and the sector will continue to be highly dependent on depository institutions for new credit.

Effect of Declining CRE Values on Bank and Thrift Performance

The FDIC directly supervises nearly 5,000 community banks, many of which have some level of credit concentration in CRE. From a supervisory standpoint, the past three years have been difficult for many institutions that focus on CRE lending, especially in home construction. A large number of institutions have failed, and as of September 2010, some 860 banks were designated as "problem institutions." Many of these troubled institutions entered the financial crisis with high concentrations in ADC and non-owner occupied CRE loans.

Distressed CRE loan exposures take time to work out, and in some cases, require restructuring and/or charge-offs to establish a more realistic and sustainable repayment program given cash flow deterioration. A number of community banks supervised by the FDIC are still contending with these CRE lending problems. They are striving to overcome an environment of high credit-related costs (charge-offs, other real estate holding costs, loan workout expenses), lower interest income and weak loan demand.

The combination of high concentrations in ADC lending and the sharp deterioration in credit performance has made ADC lending an important factor in bank and thrift failures that have taken place since the start of 2008. FDIC analysis shows that institutions that failed during this period had concentrations of ADC loans to total assets that were roughly three times the average concentrations of non-failed institutions. Of the 322 insured institutions that failed during this period, more than 86 percent exceeded the CRE concentration levels that were defined in the December 12, 2006, Joint Guidance on CRE Lending.3 This is more than twice the proportion of banks with elevated CRE concentrations observed in the industry as a whole. At the same time, it must be recognized that many institutions with CRE concentrations have weathered the financial crisis. As of December 31, 2008, there were over 2,200 institutions that had CRE concentrations according to the 2006 Joint CRE guidance and many of those institutions continue to operate in a safe and sound manner and serve the credit needs of their communities.

Largely driven by trends in CRE and ADC lending, the number of failed institutions has increased in each of the past four years, reaching 157 in 2010 – the highest annual total since 1992. While the number of failures is expected to remain elevated in 2011, we expect that 2010 represented the peak year for failures in this cycle.

It is important to note that capital levels at insured institutions are relatively strong. Of the 7,770 insured depository institutions reporting as of September 30, 2010, some 96 percent are in the "well-capitalized" category according to the calculation used for Prompt Corrective Action. We expect that these capital levels will help most financial institutions absorb potential future losses on CRE loans.

Although a number of financial institutions have reported poor results for the past several years, there are emerging signs of stabilization. Year-over year earnings have improved for five consecutive quarters through September 30, 2010, and loan-loss provisions have declined. In dollar terms, noncurrent loan balances have declined, with the largest decline occurring in the construction and development lending sector which saw a $5.7 billion drop in noncurrent loans in the third quarter of 2010. Thus far, improved performance has been most evident among larger institutions, with performance still lagging somewhat at community banks considered as a group, especially those with elevated CRE concentrations. While the rate of noncurrent loans in the nonfarm nonresidential CRE category rose to 4.36 percent in the third quarter of 2010 from 3.41 percent the previous year, we expect credit performance in these portfolios will begin to improve as the economic recovery strengthens.

FDIC and Federal Bank Supervisory Agency Action on CRE Issues

The FDIC has taken a number of steps to better understand the nature and extent of CRE concentrations, and address banks' outsized credit exposures in a timelier manner. For example, we now have more detailed quarterly Call Report data reported by insured depository institutions on owner-occupied CRE exposures so that we can more readily differentiate among potentially more or less risky elements of banks' portfolios. The FDIC also has expanded the use of supervisory visitations at institutions with CRE concentrations and has broadened our off-site surveillance programs of institutions' data to better capture CRE outliers.

Moreover, we are beginning to ask bankers at each examination for their views on credit availability and to gauge how the regulatory process might positively influence banks' interest in originating new loans. The FDIC's supervisory process continues to evolve based on the lessons learned from this crisis, and we will continue to use our bank examination procedures to identify prospective risks that could affect an institution's safety and soundness. At the same time, the FDIC will continue to encourage banks to make prudent loans in their markets.

The FDIC monitors changes in a bank's condition between examinations by following-up on significant issues and analyzing financial reports. ADC loans and other CRE loans are necessarily a significant focus of our examinations and have been for some time. However, the FDIC provides banks we supervise with considerable flexibility in dealing with customer relationships and managing loan portfolios. We do not require banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated or is otherwise clearly warranted. Write-downs on assets to "fire-sale" or liquidation values would be counterproductive for the economy and contrary to regulatory guidance.

The FDIC understands that businesses rely on banks to provide credit for their operations, and that extensions of credit from banking institutions will be essential in supporting economic growth. Accordingly, we have not instructed banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value. To the contrary, through the 2009 interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts4 (CRE Workout Guidance), the FDIC has encouraged prudent and pragmatic CRE workouts within the framework of financial accuracy, transparency, and timely loss recognition. The FDIC expects that banks will work with commercial borrowers who remain creditworthy despite some deterioration in their financial condition. This interagency guidance has helped banks become more comfortable extending and restructuring loans, which will help businesses and expedite economic recovery. At the same time, we recognize that the economic environment for real estate continues to be stressed, and we expect that banks will continue to accurately recognize losses in a timely manner in accordance with accounting and financial reporting standards. We conducted follow-up surveys of institutions which restructured or renewed loans in accordance with the guidance. The results of our survey were positive as approximately 97 percent of respondents said that the guidance was helpful. Nearly 88 percent of respondents said there were not any specific regulatory policies that were impeding their ability to work constructively with CRE borrowers.

The FDIC has also been a strong supporter for new, sound lending. Since the onset of the crisis, we have actively encouraged banks to make good loans to consumers and businesses that are seeking credit. Accordingly, on November 12, 2008, the FDIC joined the other federal banking agencies in issuing the Interagency Statement on Meeting the Needs of Creditworthy Borrowers,5 which encourages banks to continue making loans available to creditworthy borrowers and to work with mortgage borrowers that have trouble making payments. On February 12, 2010, the FDIC joined the other agencies again in issuing the Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers,[6] which reminded banks of the harmful economic effects of an excessive tightening of credit availability for small businesses, and stated that institutions engaging in prudent small business lending will not be subject to criticism as long as a comprehensive review of a borrower's financial condition is conducted. We believe that these efforts have helped banks become more comfortable originating credit in this difficult environment.

More recently, the FDIC hosted a Small Business Forum on January 13, 2011, with industry and government leaders to identify obstacles to small business lending. The Forum covered a range of issues, including the impediments that are constraining the availability of credit for small businesses, and articulated ideas for overcoming these obstacles. Small businesses rely heavily on commercial real estate to collateralize borrowings for working capital and other needs. Community banks fulfill critical small business lending needs for cities and towns across the country. The FDIC will continue its support for small business credit availability, and in particular, credit availability needs for borrowers with commercial real estate.

Current Trends

Recent signs point to a tentative stabilization of the residential and commercial property sector, with improvement in price and vacancy rates. After weakening slightly in recent months, the S&P/Case-Shiller National Housing Index shows just a 2 percent year-over-year decline in residential real estate prices through September 2010. Similarly, the Moody's/REAL Commercial Property Price Index rose by almost 3 percent in the year ending in November 2010. But while vacancy rates appear to have leveled off for most major commercial property types, rental rates – typically a lagging indicator of market conditions – do not yet show clear signs of a broad-based stabilization. Through the fourth quarter of 2010, gross asking rents for office properties had declined for three consecutive quarters.[7] By contrast, average apartment rents increased in both the second and third quarters of 2010, while full- and limited-service hotels reported an increase of over 9 percent in revenue per available room during 2010.[8] As CRE cash flow fundamentals slowly recover, so will the ability of CRE borrowers to service their debt out of current income.

Just as in the case of residential property markets, declines in commercial real estate prices that have taken place during the past few years will pose a longer term problem for commercial real estate lenders. Declines in CRE prices are leaving some borrowers with insufficient collateral to refinance their current loans when they come due, and are also inhibiting the ability of commercial borrowers to access new credit backed by the real estate they own. Concerns over collateral shortfalls for existing loans have been expressed by a number of analysts as property prices and market fundamentals have deteriorated. However, it is difficult to precisely measure the volume of CRE loans that will come due in any given year, or how many will experience collateral shortfalls. In any event, supervisory measures undertaken by the federal banking agencies to promote the responsible restructuring of CRE loans will help to ensure that the resulting credit distress is minimized.

Conclusion

The FDIC understands the significant challenges faced by banks and their borrowers in the commercial real estate market as the economy and financial sector recover from the dislocations that precipitated the crisis. Accordingly, the FDIC has enhanced its regulatory program and joined with other federal financial institution regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties. Community banks play a critical role in helping local businesses fuel economic growth, and we support their efforts to make good loans in this challenging environment.

Thank you. I am pleased to answer any questions from members of the Panel.

1 Noncurrent loans include loans 90 or more days past due or on nonaccrual status.

2 Source: Commercial Real Estate Finance Council, www.crefc.org.

3 See: FIL 104-2006, http://www.fdic.gov/news/news/press/2006/pr06114.html. The concentration levels are construction and development loans greater than 100 percent of total capital or total commercial real estate loans to total capital greater than 300 percent.

4http://www.fdic.gov/news/news/financial/2009/fil09061.html

5 http://www.fdic.gov/news/news/financial/2008/fil08128.html

6 http://www.fdic.gov/news/news/financial/2010/fil10005.html

7Source: CBRE Econometrics.

8Source: CBRE Econometrics.

Last Updated 2/4/2011