FOR YOUR INFORMATION FYI
An Update on Emerging Issues in Banking

Weak Fundamentals for U.S. Office Markets

March 21, 2002

The U.S. commercial office sector eclipsed a variety of records for speed of decline in 2001. The amount of occupied U.S. office space declined for the first time in the 20 years such data have been collected. This 89 million square foot reduction in occupied office space--an amount roughly equivalent to all of the office space in Denver, Colorado--contributed to record increases in U.S. office vacancy rates.[1] Commercial real estate lenders may experience rising delinquencies in 2002, as office vacancy rates appear likely to increase further.

As commercial real estate construction gradually picked up steam over the past five years, the FDIC has closely monitored market conditions and has published a number of analyses covering the various commercial property types.[2] Through the end of 2000, a strong U.S. economy supported large annual increases in demand for U.S. office space and kept vacancy rates low. During this period, however, many high-tech firms engaged in "speculative leasing," signing agreements to lease office space in excess of their current needs in anticipation of tight market conditions in the years to come.

During 2001, as the U.S. economy slowed and the high-tech equity bubble deflated, many of these same firms attempted to unload excess space by offering it for sublease. The result has been a glut of available office space in many markets. Torto Wheaton Research reports that 36 of 53 major metropolitan areas experienced *negative net absorption* of office space in 2001.[3]

The flood of sublease space put upward pressure on office vacancy rates, which increased in 51 of 53 major markets during 2001.[4] In three markets--Austin, San Francisco, and San Jose--the office vacancy rate increased by more than 10 percentage points. Taken as a whole, the nation's office vacancy rate increased by 5.3 percentage points during the year, from 8.4 percent to 13.7 percent. Rents also declined, on average, by nearly 10 percent during the year. Currently, leasing activity for office buildings is slow or nonexistent in many markets as potential tenants reassess their future needs.

Similarly, demand for other commercial property types has also retrenched. Industrial properties, for example, also experienced negative net absorption for the first time in 2001. Declining conditions in retail, single- and multi-family properties are further documented in the FDIC's Survey of Real Estate Trends.

Because of the time lag inherent in commercial real estate construction, many projects that were started in response to high demand in 2000 will be completed sometime later this year, and will place further pressure on office market fundamentals. Chart 1 identifies ten U.S. office markets that had both rapidly rising vacancy rates in 2001 (horizontal axis) and a large amount of new construction in progress (vertical axis). Completions of these projects in 2002 will put continuing upward pressure on vacancy rates in these markets.

Chart 1: High construction activity and rising vacancy rates could stress some office markets.

Metropolitan Market Name	Vacancy Rate Increase: Change in Vacancy Rate During 2001, in Percentage Points	Construction Activity: Square Feet of Office Space Under Construction at Year-End 2001 as a Percentage of Total Rentable Space
Austin	14.90	7.5%
San Jose	13.10	3.4%
San Francisco	12.30	4.4%
Boston	9.60	3.0%
Seattle	9.00	7.2%
Oakland	8.00	4.4%
Denver	7.40	1.6%
Northern New Jersey	7.40	6.4%
Wilmington	7.40	4.5%
Washington, DC	6.80	3.4%
Fort Lauderdale	6.70	4.3%
West Palm Beach	6.70	0.6%
Phoenix	6.50	2.8%
Columbus	6.20	0.7%
San Diego	6.20	2.5%
Portland	5.90	5.0%
Chicago	5.80	2.8%
Orange County	5.50	0.7%
Ventura	5.40	4.0%
Kansas City	5.30	1.4%
Sum of Markets	5.30	2.7%
Fresno	5.20	0.0%
Salt Lake City	5.10	2.2%
Stamford	5.00	0.8%
Atlanta	4.90	2.6%
Dallas	4.80	2.1%
Detroit	4.80	1.7%
Indianapolis	4.40	0.0%

Orlando	4.40	1.6%
New York	4.30	1.8%
Las Vegas	4.20	5.2%
Nashville	4.10	1.5%
Westchester	4.10	1.3%
Cincinnati	4.00	1.4%
Miami	4.00	5.1%
Jacksonville	3.60	2.2%
Philadelphia	3.50	3.0%
Charlotte	3.40	4.0%
Tucson	3.30	1.4%
Hartford	2.40	0.0%
Long Island	2.40	1.6%
Baltimore	2.30	3.5%
St. Louis	2.30	1.3%
Sacramento	2.20	3.8%
Tampa	2.10	0.9%
Houston	2.00	2.1%
Los Angeles	2.00	2.0%
Fort Worth	1.60	2.0%
Minneapolis	1.60	1.3%
Cleveland	0.80	2.9%
Oklahoma City	0.70	0.0%
Albuquerque	0.50	2.4%
Riverside	(0.40)	0.0%
Honolulu	(0.50)	0.0%

Source: Torto Wheaton Research

Despite the sharp decline in office demand, analysts cite a number of factors in support of the belief that the magnitude of this office market downturn will be less severe than in the cycle of the 1980s. These factors include heightened market transparency resulting in better and more timely market information, better loan underwriting and greater liquidity. Still, many analysts do not anticipate office market recovery to commence until later this year at the earliest. [5]

A large number of FDIC-insured institutions extend credit for office construction through construction and development (C&D;) loans and commercial real estate (CRE) loans. [6] Chart

2 shows the percentage of insured institutions over time with moderate to high exposures to these combined loan types as a percent of equity capital. The chart shows that while the percentage of the industry with the highest exposures (more than 500 percent of capital) is lower now than during the late 1980s, the percentage of institutions with moderate to high exposures (200 to 500 percent of equity capital) is higher now than at any point in at least the last 17 years.

Concentrations of commercial real estate loans to capital have risen sharply since 1998.

Percent of FDIC-Insured Institutions with construction and commercial real estate loans-to-equity capital greater than:

Year	200 percent	300 percent	400 percent	500 percent
1984	15.13	8.15	5.17	3.83
1985	16.63	9.06	5.61	3.96
1986	19.91	11.17	6.94	4.89
1987	20.92	11.44	7.15	5.04
1988	21.74	11.42	6.86	4.68
1989	21.38	11.07	6.42	4.12
1990	21.00	10.64	5.91	3.66
1991	19.94	9.17	4.65	2.74
1992	18.24	7.47	3.47	2.00
1993	17.47	6.93	2.85	1.44
1994	19.67	7.89	3.14	1.44
1995	18.16	7.02	2.46	1.04
1996	19.98	8.29	3.19	1.25
1997	20.76	8.49	3.24	1.26
1998	21.54	9.67	3.90	1.43
1999	26.92	13.72	6.44	2.54
2000	28.61	14.49	6.70	2.77
2001	31.55	17.83	8.72	3.67

Source: Bank Call Reports; Thrift Financial Reports (FDIC)

Despite this increase in exposures, commercial real estate loan performance remains solid at present. At the end of 2001, noncurrent C&D; loans (or loans 90 days or more past due and those in non accrual status) for the industry totaled $2.4 billion (or 1.1 percent of all C&D; loans), compared to $1.6 billion a year earlier. By comparison, at the end of 1991, the worst year of the last cycle, noncurrent C&D; loans reached $17.5 billion or 13.6 percent of all C&D; loans.

Performance has deteriorated more noticeably among commercial real estate loans held by issuers of Commercial Mortgage Backed Securities (CMBS). Standard & Poor's recently noted that a dramatic increase in overall CMBS delinquencies has occurred since the third quarter of 2001. Although these delinquencies are primarily centered in lodging property loans, concerns are noted for the high vacancy rates in office properties and the risk that these may lead to a "substantial increase in the mortgage delinquency rate" if the economic downturn does not reverse shortly. [7]

The outlook for commercial real estate credit quality depends both on the depth and duration of the current economic slowdown. In spite of signs of a recovery in the U.S. economy, many analysts do not predict an uptick in office absorption to occur until early 2003. In the interim, further office vacancy increases and rental declines can be anticipated before a return to equilibrium occurs.

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[1] Office space as tracked by Torto Wheaton Research covers competitively leased office properties that are 10,000 square feet or more.

[2] See previous Regional Outlook articles: "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," Third Quarter 2000 and "Slowing Economy Reduces Demand for U.S. Office Space," Third Quarter 2001, http://www.fdic.gov/bank/analytical/regional/index.html.

[3] Torto Wheaton Research. Spring 2002. *Office Outlook*. Absorption represents the measure of demand for commercial real estate space. Negative absorption occurs when previously occupied space is returned to the market as vacant space available for lease or sublease.

[4] The only two markets with office vacancy declines were Riverside, California and Honolulu.

[5] Gordon, Sally. "CMBS: The Commercial Real Estate Cycle Is Past the Peak But Poised for a Pick-Up," *Moody's Investors Service*. March 11, 2002.

[6] C&D; loans include both residential and commercial construction loans. A breakout by category type is not available.

[7] Chun, Roy and Peter P. Kozel, Ph.D. February 15, 2002. "CMBS Delinquency Rates Rise; Moderation in Future Rise Depends on Mid-Year Economic Recovery." Standard & Poor's Structured Finance.