# CRE Market Trends:

## What Bank Supervisors are Watching

## Lambda Alpha International
## Land Economics Society

**January 27, 2016**

**12th Federal Reserve District**


*Gary Palmer, Senior Manager*
*Financial Institution Supervision & Credit*
*Federal Reserve Bank of San Francisco*




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# CRE: Why the Concern from Bank Supervisors?

1. CRE Prices / Transaction Volume
2. Looser Lending Standards
3. Construction / New Supply
4. CRE Loan Growth / Concentrations
5. Rising Interest Rate Scenario & Impacts

6. Interagency Statement to Banks, Dec 2015
Prudent Risk Management for Commercial Real Estate Lending

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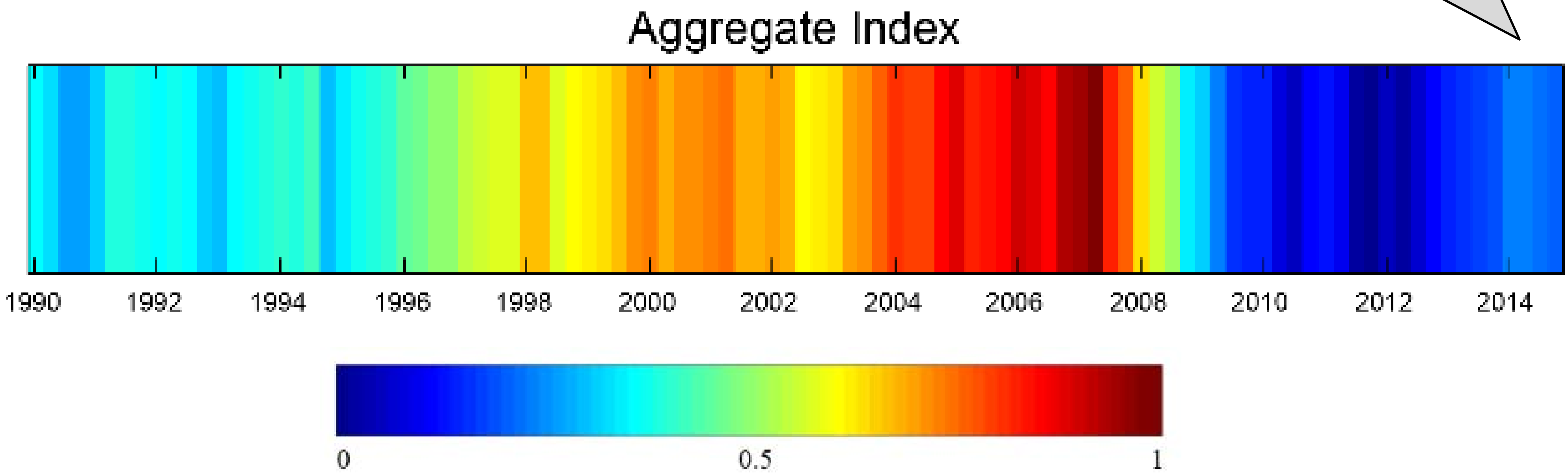
# Heat Map of US Financial System Risk: Overall, Risks are Contained. . .

**"Mapping Heat in the U.S. Financial System" (BoG Working Paper, May 2015)**

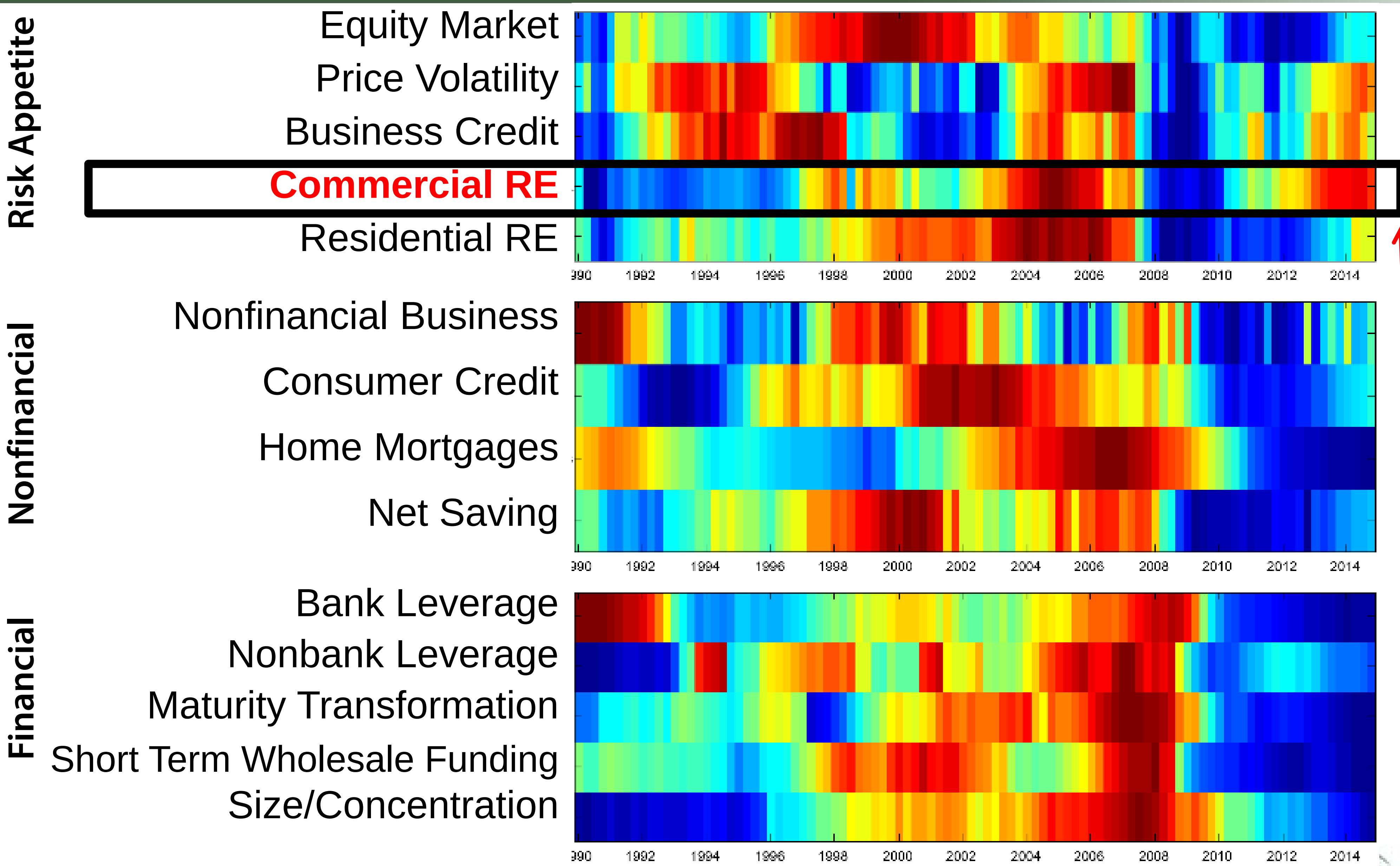
Very low financial system risk at present




Heat map: color assigned each quarter based on 44 indicators of financial system risk based on scale of 0 to 1. At values near zero, vulnerabilities appear subdued; values near 1 indicate acute vulnerabilities.

http://www.federalreserve.gov/econresdata/notes/feds-notes/2015/mapping-heat-in-the-us-financial-system-a-summary-20150805.html

# However, of 14 Heat Map Components, CRE Stands Out




**14 risk components, based on 44 indicators**

**CRE Heat Drivers: prices & lending standards**



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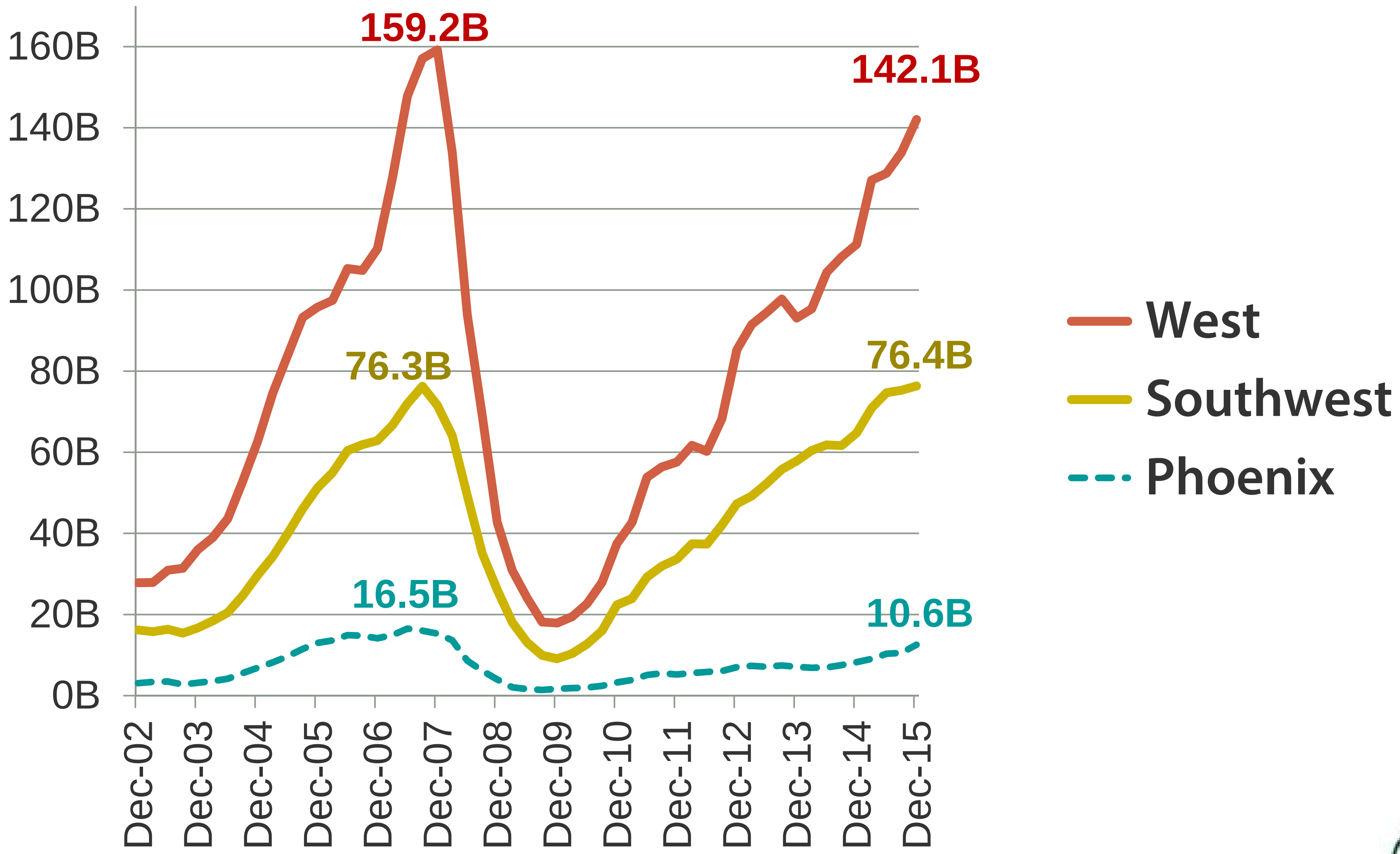
# (1) CRE Transaction Volume Continues to Surge

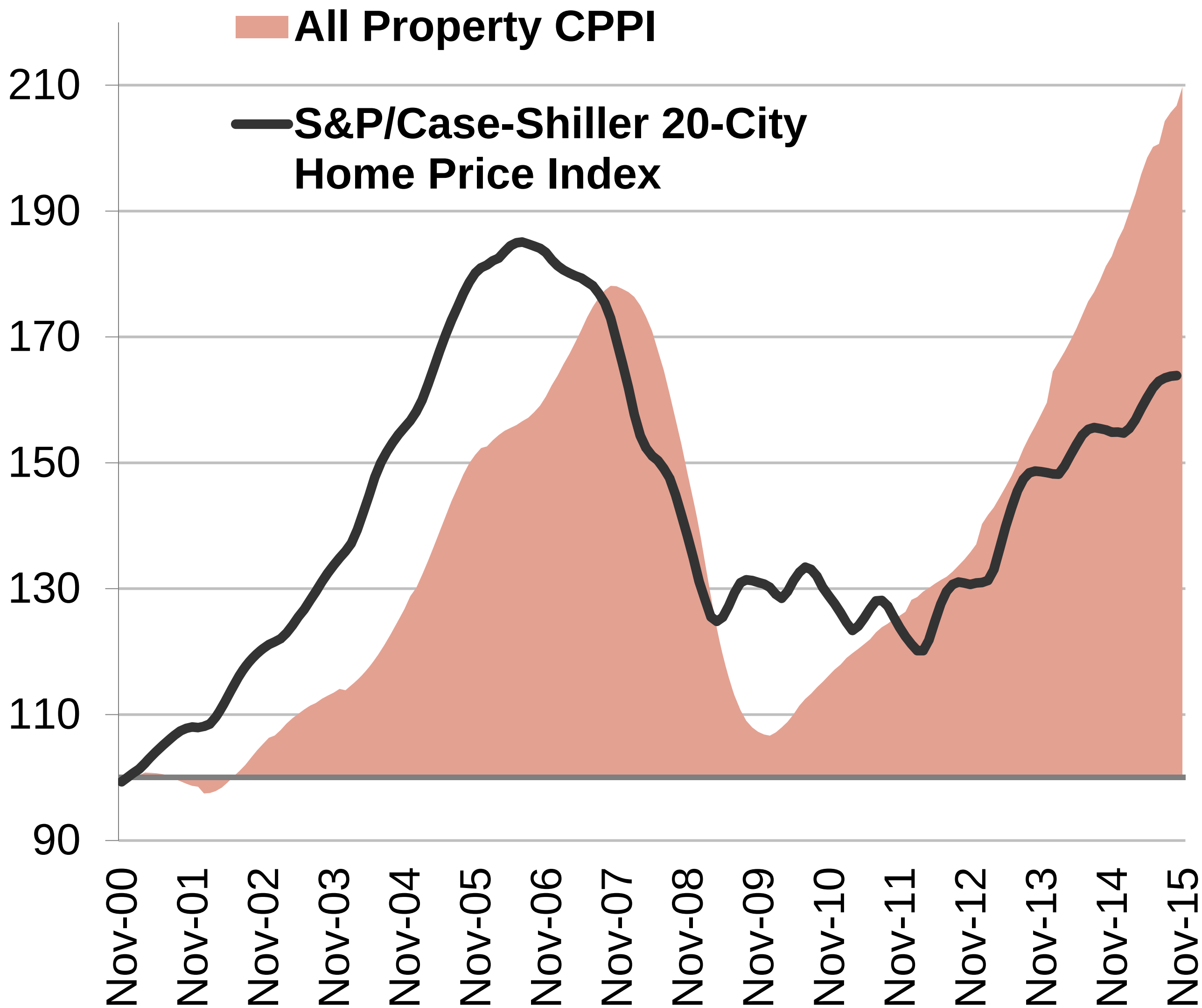
**CRE Transaction Volume – 12 Month Rolling Sums**




West: AK, CA, HI, ID, MT, NV, OR, UT, WA, WY; Southwest = AZ, CO, NM, NV, OK, TX; based on properties and portfolios $2.5 million and greater. Source: Real Capital Analytics

# CRE Prices Have Soared Post-Crisis;
*Gains from Trough Nearly Tripled Housing's Gains*

## CRE vs Housing Price Indices (Dec '00= 100)




| | Chg. from Prior Peak | Chg. From Trough |
|---|---|---|
| CRE | +18% | +97% |
| Homes | -12% | +36% |

CPPI includes some "smoothing" to address low transaction volumes

Sources: Moody's Commercial Property Price Index, S&P Case-Shiller 20 City National Home Price Index



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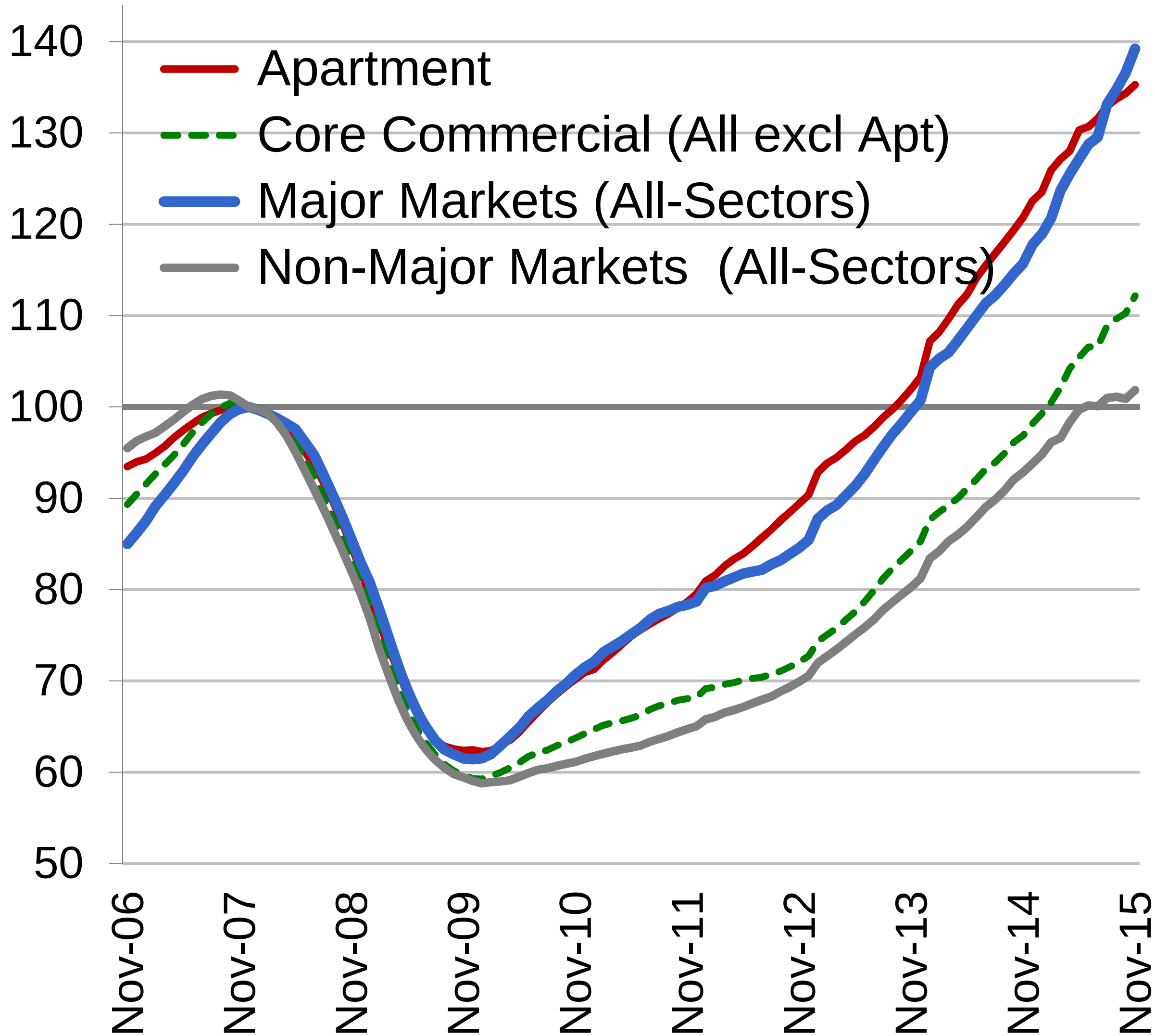
# Apartment and Major Markets Resurgence Especially Strong

**Commercial Real Estate Price Indices (Dec '07= 100)**




| CRE Price Index | Chg. From Prior Peak |
|---|---|
| Major Markets (all sectors) | +39% |
| Apartment | +35% |
| Core Commercial (All except Apt) | +12% |
| Non-Major Markets (all sectors) | +0.5% |

Major Markets defined as: Boston, Chicago, Los Angeles, New York, San Francisco and Washington, DC, gateway markets with unique price performance and the ability to attract capital. Source: Moody's CPPI



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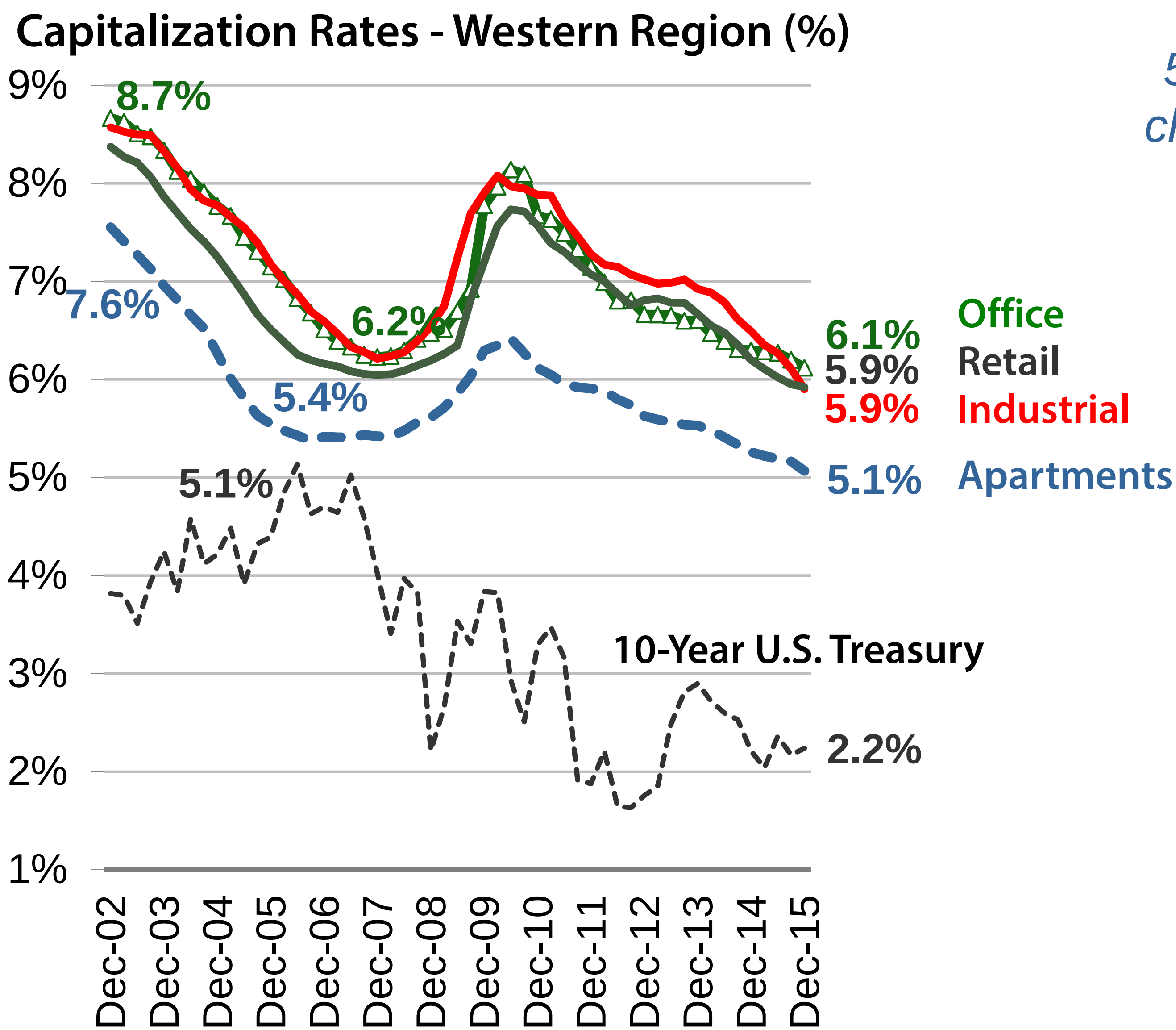
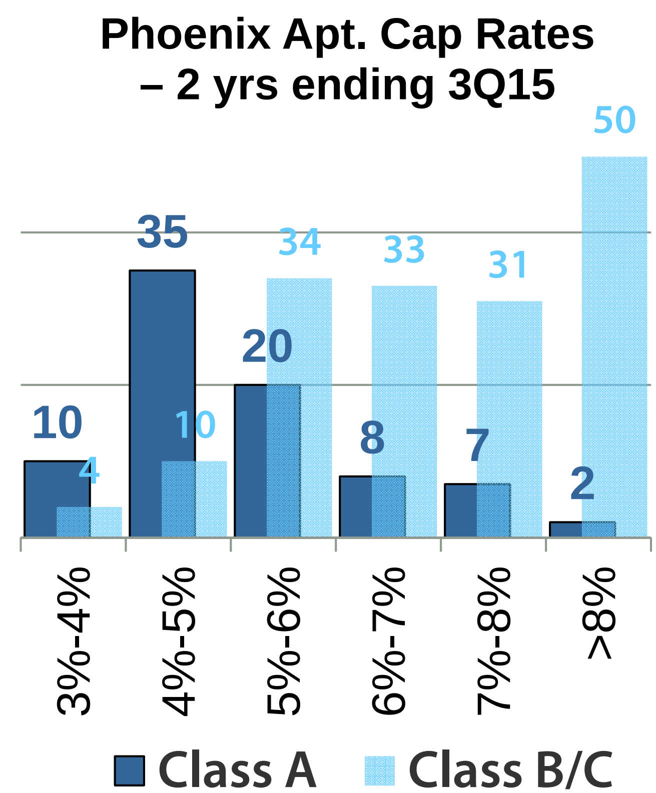
# Cap Rates Are Low, Especially for Apartment




*55% of cap rates on Phoenix class A apartment transactions have been under 5%*




# of purchase transactions by cap rate.
Source: Reis

Source: Real Capital Analytics



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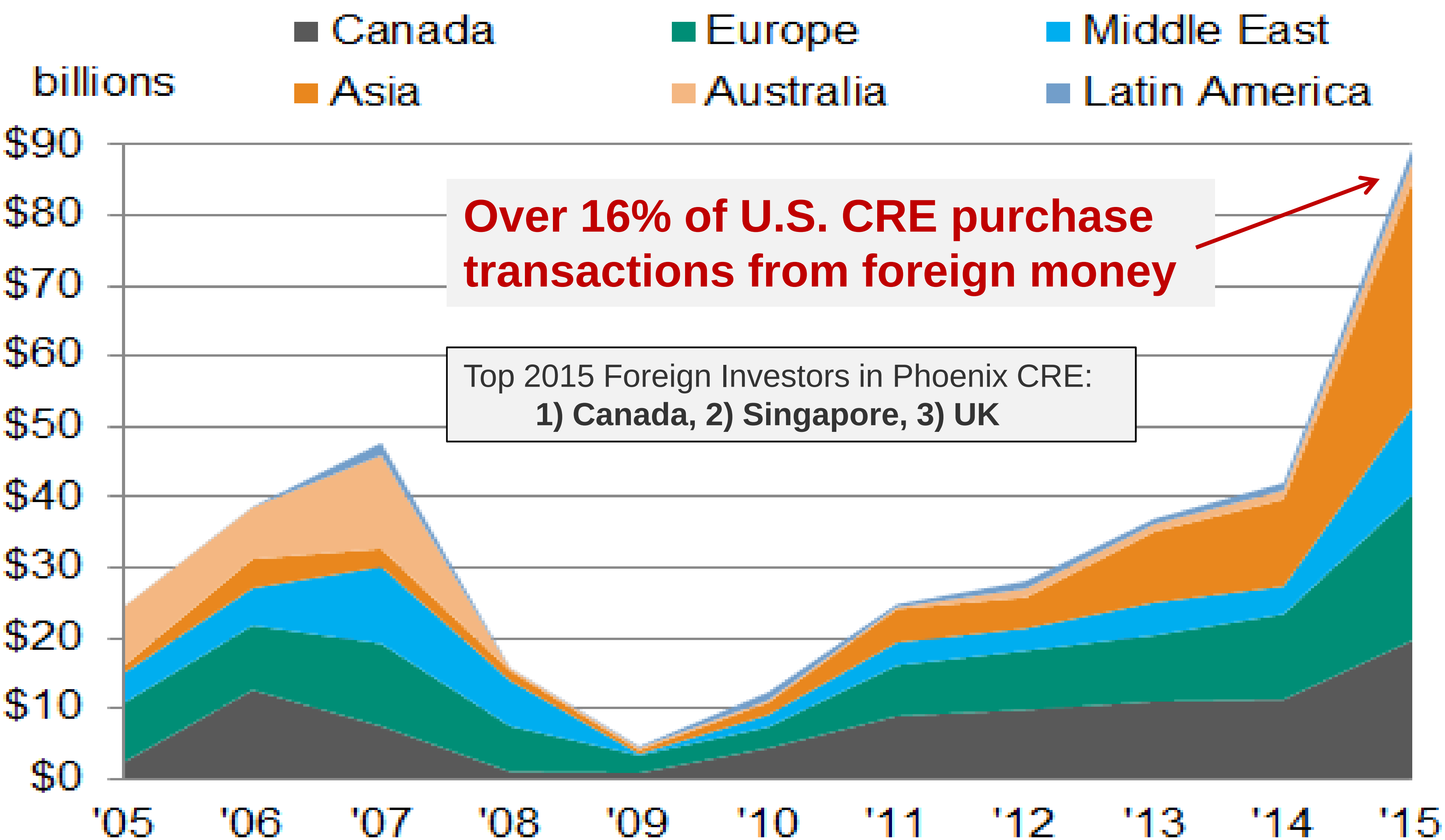
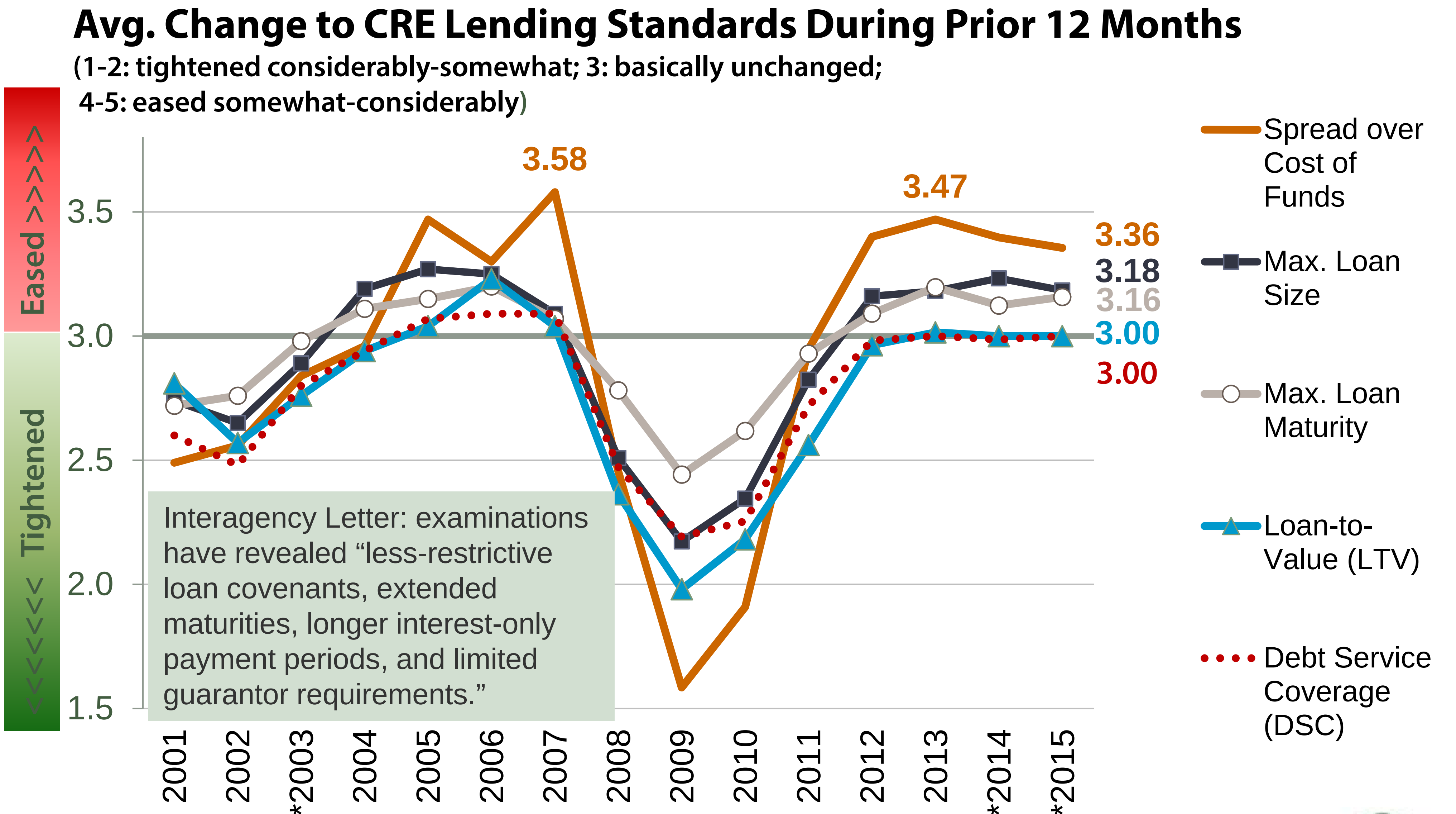
# Foreign Capital Inflows
# Playing a Role in Driving Cap Rates Lower

**U.S. Foreign Capital Inflows by Investor Region**




Based on properties and portfolios $2.5 million and greater.
Source: Real Capital Analytics

# (2) Looser Lending Standards: Fed SLO Survey suggests CRE Lenders Conceded on Pricing, Size, and Maturity –(Not as much on DSC or LTV)




Based on an annual sample of loan officers at 54–76 domestic banks (number varies by reporting period); survey conducted in January or April (*) of each year; Source: Federal Reserve Senior Loan Officer Opinion Survey



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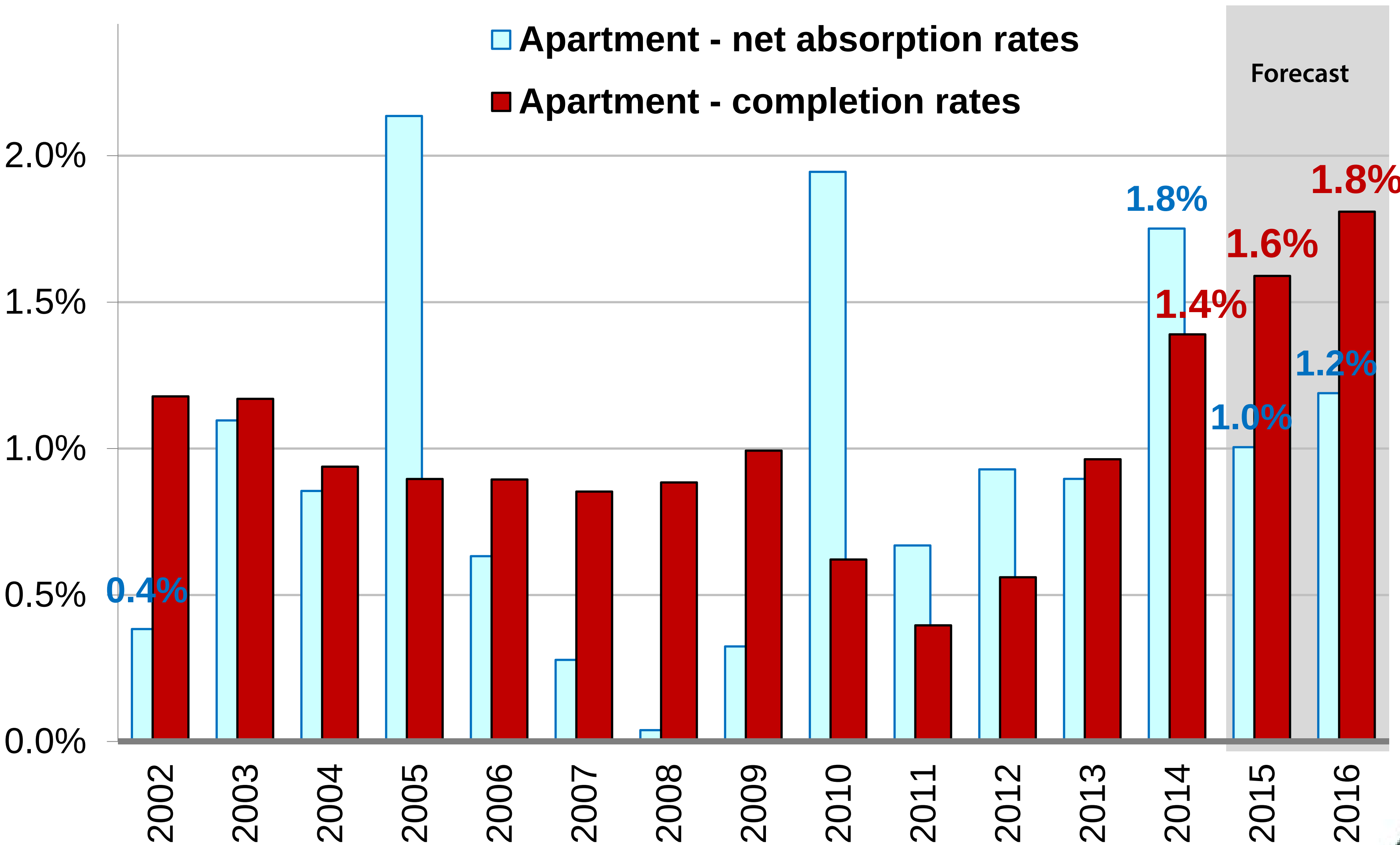
# (3) Construction/New Supply: Apartment Construction Rates Rising Sharply

## 12-Month Trailing Completions / Average Stock – Nation




Based on aggregates across over 60 large metropolitan areas, based upon number of units; Source: CBRE-Econometric Advisors 3Q15



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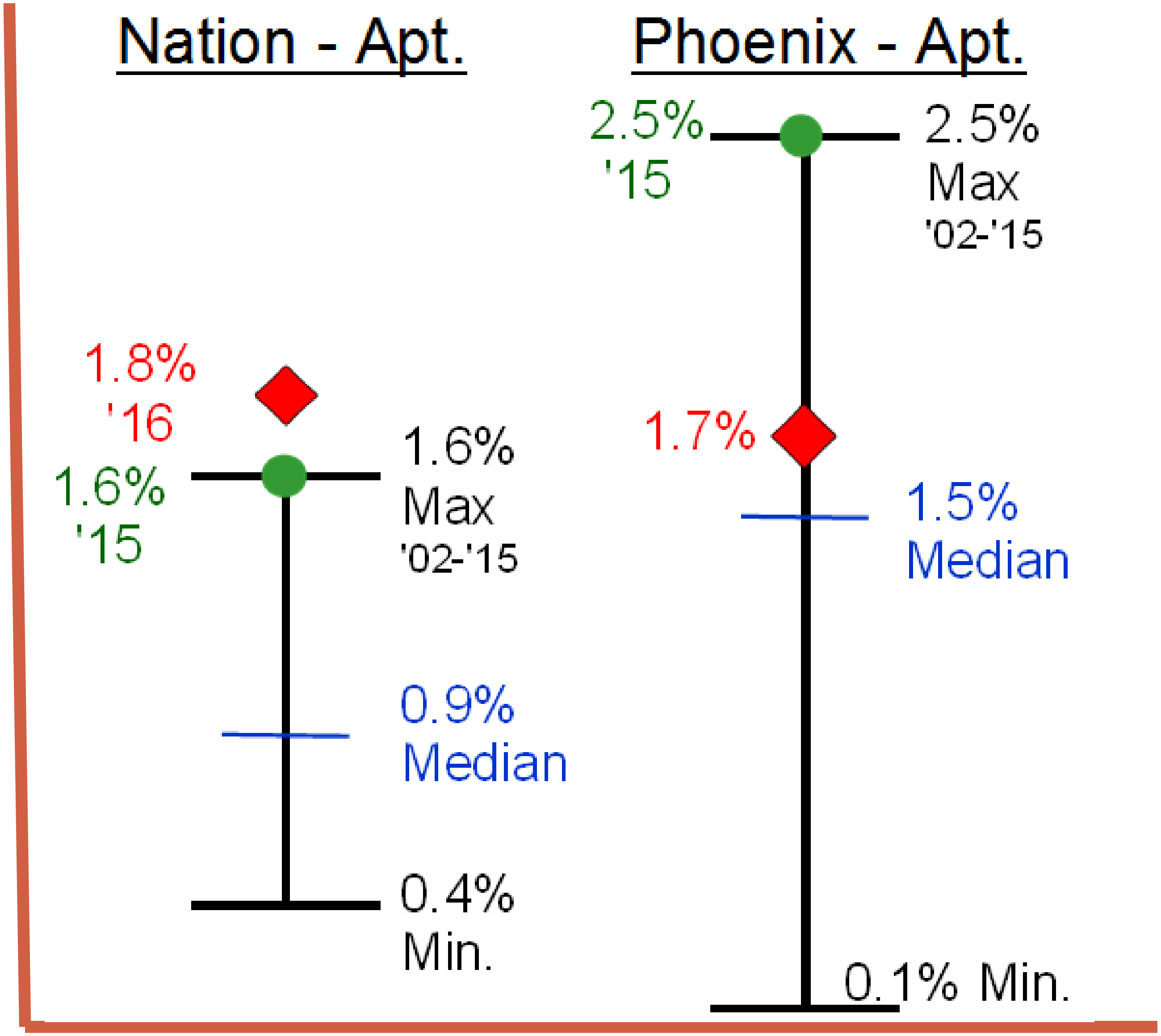
# Apartments – 2016 Will See Highest Rate of New Construction Nationally in Over 15 Years; Phoenix: 2015 was Highest

**12-Month Trailing Completions / Average Stock – Annual Range 2002 - 2015**



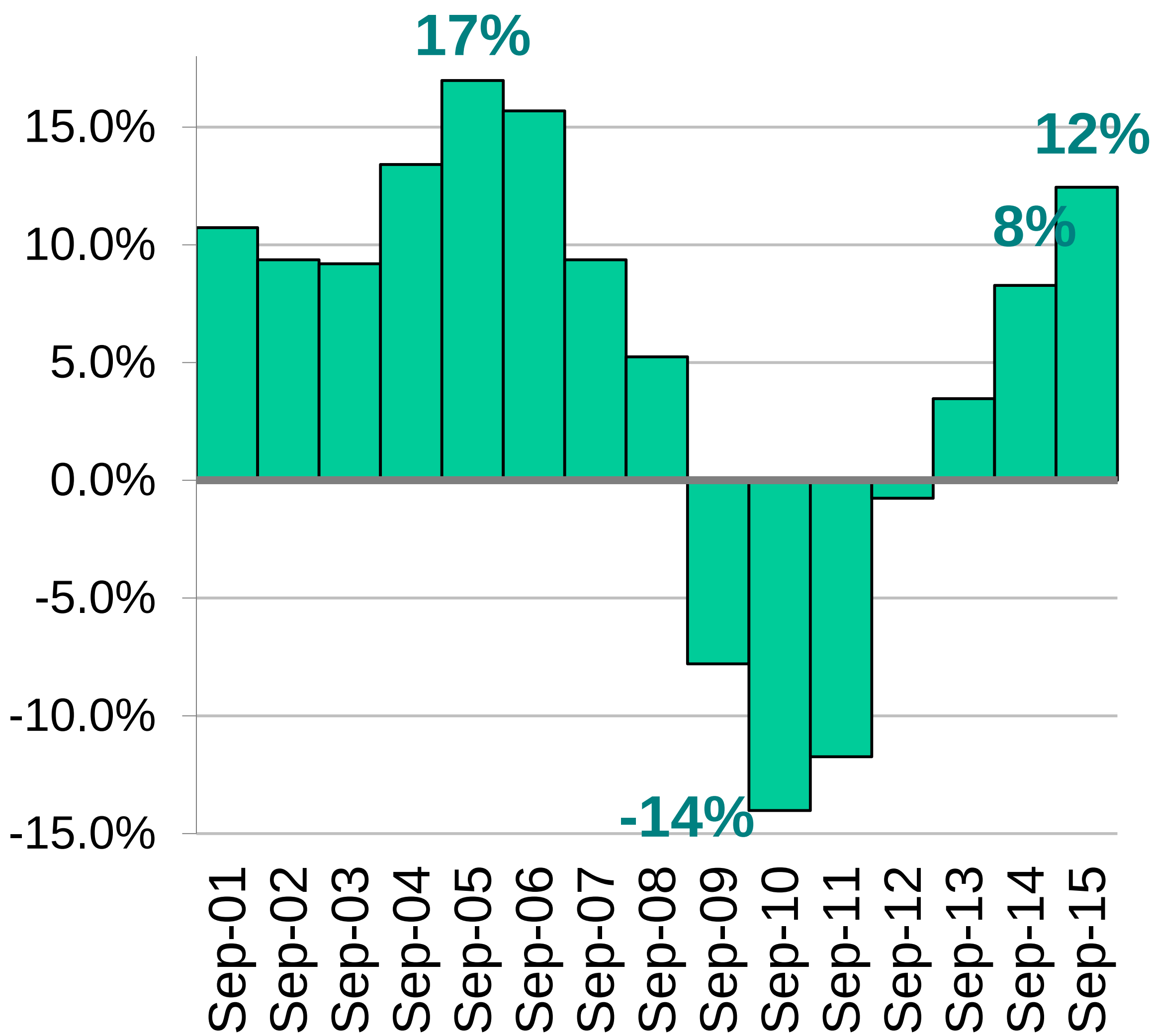

| Highest Forecast Apt. Completion Rates in 2016 | | |
|---|---|---|
| 1 | Nashville | 6.5% |
| 2 | Austin | 4.3% |
| 3 | Charlotte | 4.0% |
| 4 | Raleigh | 3.7% |
| 5 | San Antonio | 3.7% |
| 26 | Phoenix | 1.7% |
| 50 | Tucson | 0.9% |

*Other major CRE sectors still have relatively low construction rates*

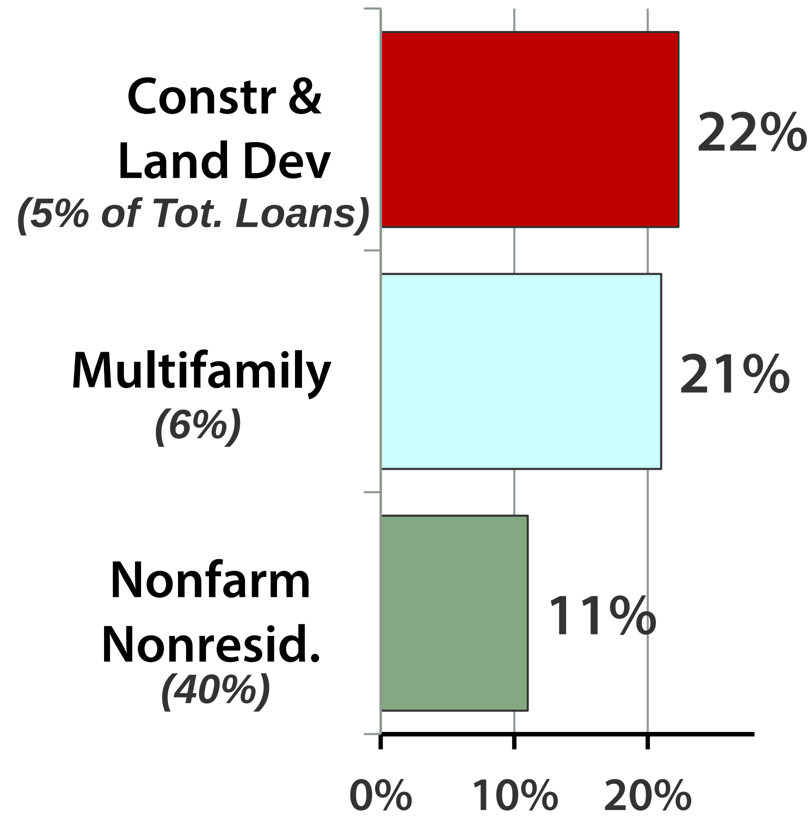
Apartment completion rate data based upon number of units
Source: CBRE-Econometric Advisors 3Q15

# (4) CRE Loan Growth Has Returned

**Commercial Real Estate 1-Year Loan Growth Rates – Nationwide Bank Aggregates**

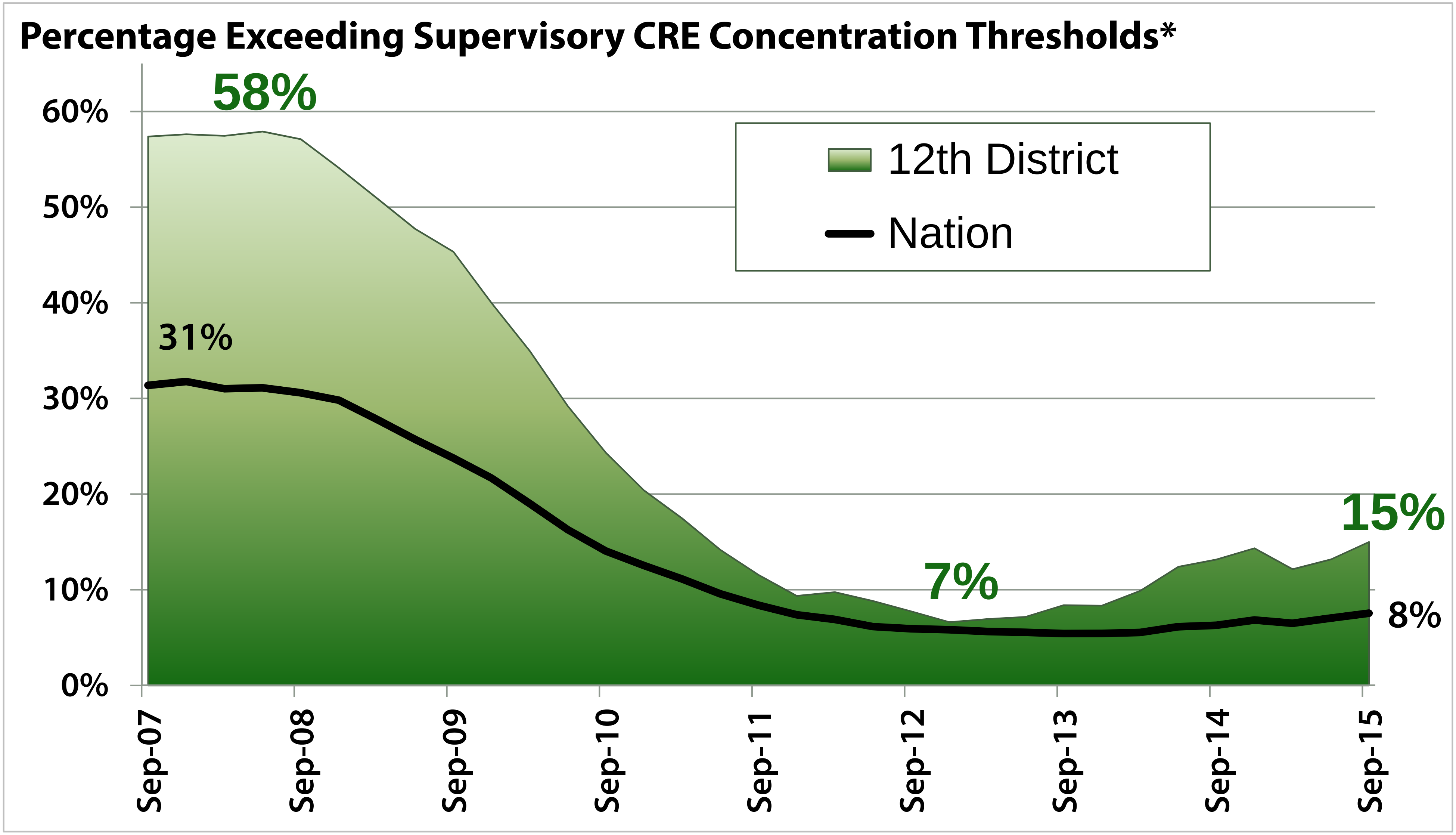



**CRE Loan 1-Year Growth by Segment, as of 9/2015**
(Aggregate. 12th District Banks under $10B )




Based on aggregate commercial bank total commercial real estate annual loan growth.
Starting 2008, growth rates exclude owner-occupied nonfarm nonresidential secured loans.
Source: Commercial Bank Call Reports; Board of Governors of the Federal Reserve System

# Percentage of Banks Exceeding Supervisory Commercial Real Estate Concentration Thresholds* Ticked Up




*Supervisory commercial real estate (CRE) thresholds include construction and land development loans (C&LD)=> 100% of total capital or total CRE loans=>300% of total capital and total CRE loan growth of=>50% during the prior 3 years. Total CRE loans include C&LD, multifamily, owner-occupied nonfarm-nonresidential mortgages and CRE purpose loans not secured by real estate.



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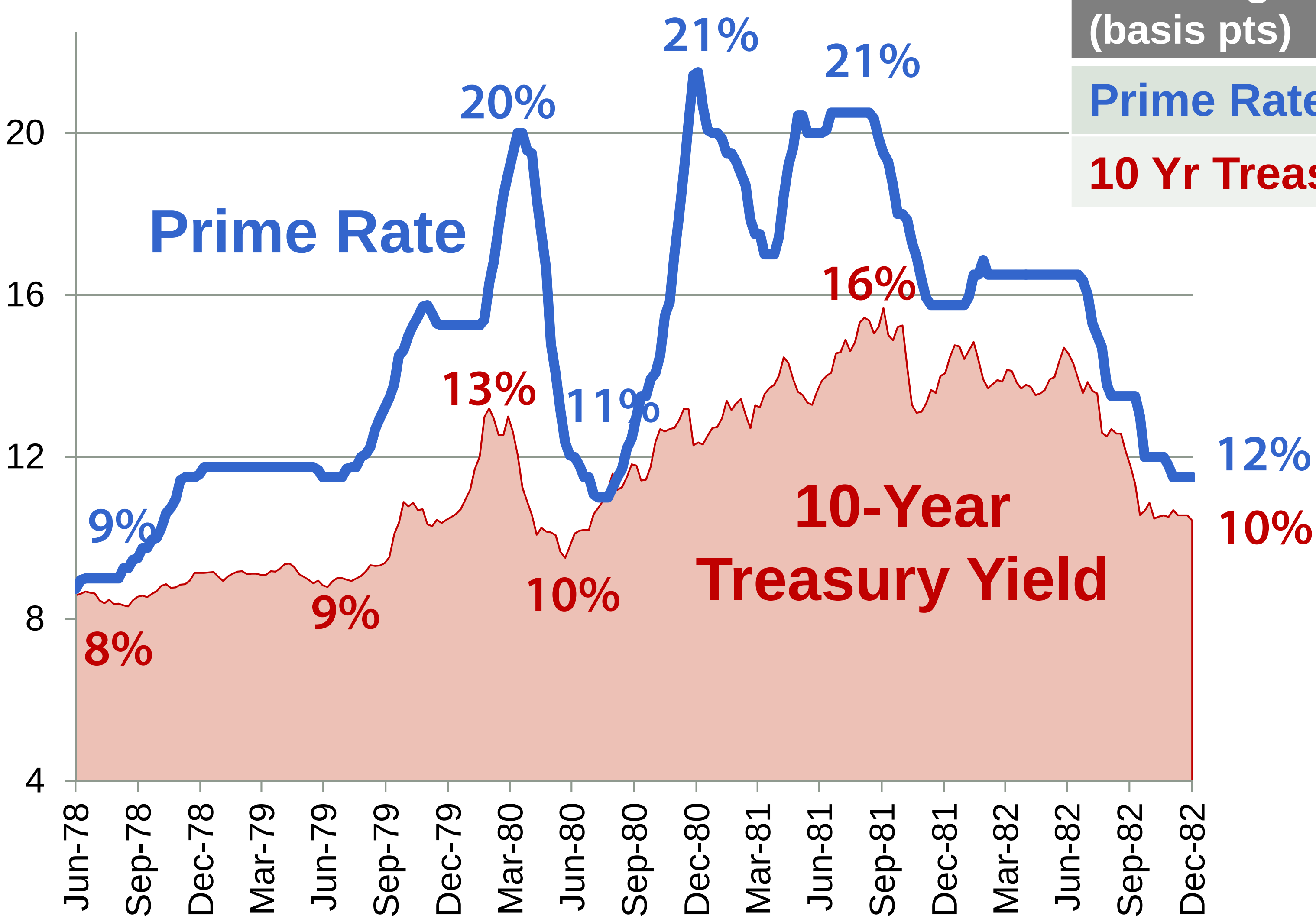
# (5) Rising Interest Rate Scenario
# We Can't Forget the Past!

## Selected Interest Rates 1978-1982




| Max chg in 1 yr (basis pts) | Up | Down |
|---|---|---|
| Prime Rate | +950 | -700 |
| 10 Yr Treasury | +438 | -454 |

*Inflation out of control – oil crisis, gov't overspending; wage/price spiral*

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# Interest Rates Could Rise More Sharply than Expected

Slow steady rate rise is most likely outcome; but there are other scenarios, e.g.:

- US reaches full employment, labor markets tighten, wage pressures mount
- Low energy costs finally trigger consumer spending
- Int'l situation improves / commodity prices rise
- Inflationary expectations rise; Fed responds by tightening monetary policy more than planned

*Not a likely scenario, but a possible one*



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# Impacts of Rate Rise

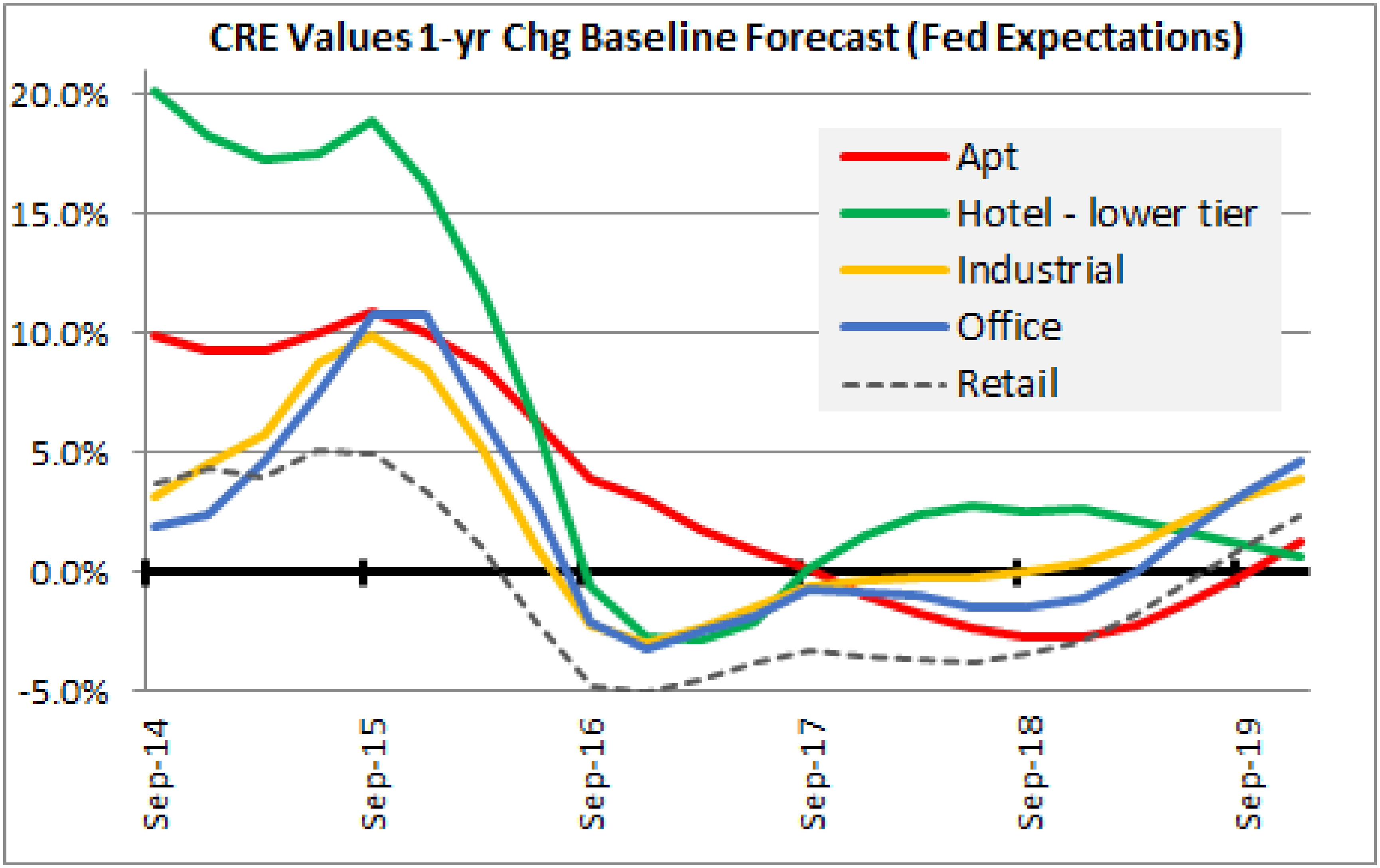
Modest rate rise (e.g. market expectations over next year)

- Cap rates hold steady, spreads to Treasury narrow
- NOIs continues to rise across sectors in most areas
  - *rents generally rising – as leases roll over, NOI rises*
  - *vacancy rates generally declining – lease revenues rise*
  - *floating rate loans to remain at or near floor*

More severe & more extended rate rises (e.g. a strong economy)

- CRE debt more expensive – costlier to get deals done
- Cap rates rise (but less than rise in market rates); property values weaken
- NOIs continue to rise, but rising costs on floating rate loans may eat into gains with DSCRs weakening
  - Office/industrial/retail sector loans impacted most, due to longer typical lease terms

# How Might CRE Values be Impacted?




**Source: CBRE-Econometric Advisors: CRE Investment Fundamentals Research; National Model**

# (6) Regulatory Steps: Interagency Statement on CRE Prudent Risk Management – Dec 2015

- Heated CRE market and lending led to statement issued jointly by FRS, OCC, FDIC
- Advises that regulators will be paying "special attention" to CRE risks at examinations
- A reminder of prudent risk management practices on CRE lending activity through economic cycles.
  - *E.g.: "Financial institutions should maintain underwriting discipline and exercise prudent risk management practices that identify, measure, monitor, and manage the risks,"*

**Board of Governors of the Federal Reserve System**
**Federal Deposit Insurance Corporation**
**Office of the Comptroller of the Currency**

**Statement on Prudent Risk Management**
**for Commercial Real Estate Lending**

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the agencies) are jointly issuing this statement to remind financial institutions of existing regulatory guidance on prudent risk management practices for commercial real estate (CRE) lending activity through economic cycles.[1]

**Recent Supervisory Findings**

The agencies have observed that many CRE asset and lending markets are experiencing substantial growth, and that increased competitive pressures are contributing significantly to historically low capitalization rates and rising property values.[2] At the same time, other indicators of CRE market conditions (such as vacancy and absorption rates) and portfolio asset quality indicators (such as non-performing loan and charge-off rates) do not currently indicate weaknesses in the quality of CRE portfolios. Influenced in part by the continuing strong demand for such credit and the reassuring trends in asset-quality metrics, many institutions' CRE concentration levels have been rising.

The agencies' examination and industry outreach activities have revealed an easing of CRE underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements. The agencies also have observed certain risk management practices at some institutions that cause concern, including a greater number of underwriting policy exceptions and insufficient monitoring of market conditions to assess the risks associated with these concentrations.

[1] For purposes of this statement, a CRE loan refers to a loan where the use of funds is to acquire, develop, construct, improve, or refinance real property and where the primary source of repayment is the sale of the real property or the revenues from third-party rent or lease payments. CRE loans do not include ordinary business loans and lines of credit in which real estate is taken as collateral. Financial institutions with concentrations in owner-occupied CRE loans also should implement appropriate risk management processes.

[2] For example, between 2011 and 2015, multi-family loans at insured depository institutions increased 45 percent and comprised 17 percent of all CRE loans held by financial institutions, and prices for multi-family properties rose to record levels while capitalization rates fell to record lows. Sources: Consolidated Reports of Condition and Income, Costar Property Price Index, and CBRE.

**High CRE banks that survived the financial crisis generally were quicker to respond to changing conditions – e.g. stopping C&LD lending**



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# CRE: Concern Mitigants

1. Cap rates low, but spreads still reasonable
2. Economic Outlook Solid; CRE Space Demand Strong
3. Current Credit Performance is Strong
4. Bank C&LD Concentrations Relatively Low

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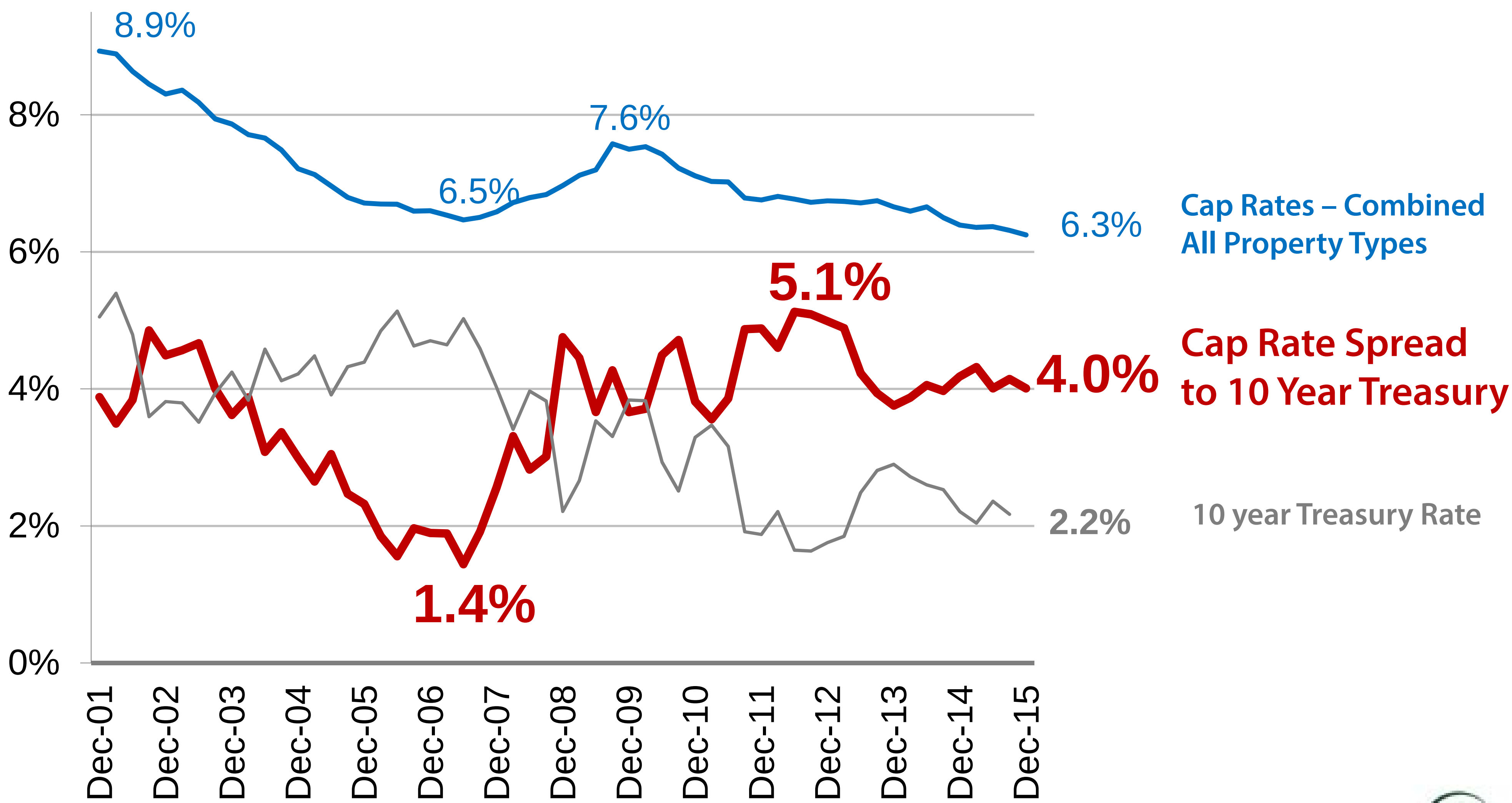
# (1) Spreads Reasonable: Generally, Cap Rate Spreads Remain Well Higher Than Pre-Crisis Levels

**Cap Rates and Spreads – All CRE Sector Aggregate – Nationwide (%)**




Source: Real Capital Analytics

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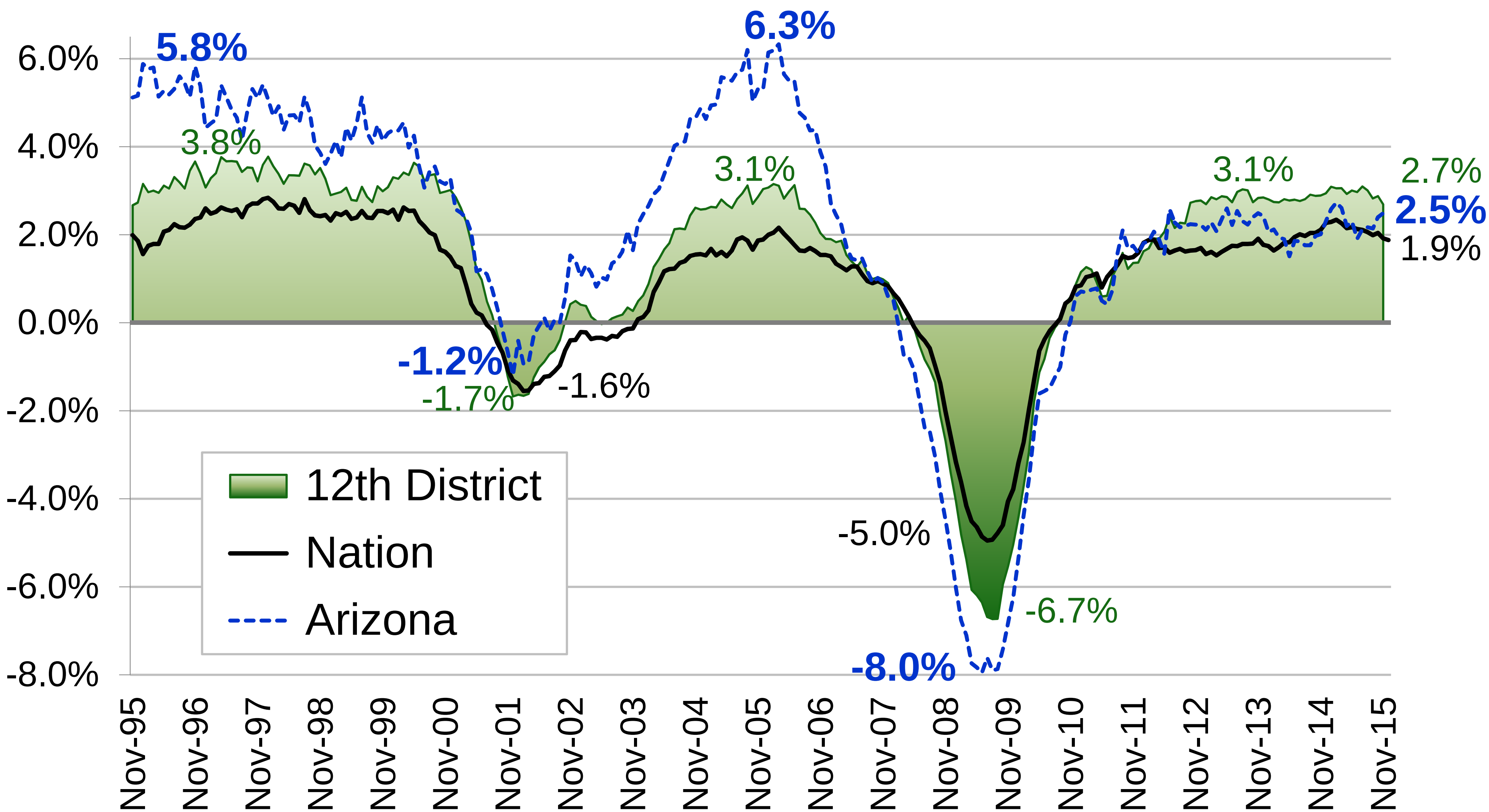
# (2) Economy Continues to Expand: District Annual Job Growth Rates Roughly Back to Typical Non-Recession Levels; AZ Growth Rate Catching Up

## Year-Over-Year Nonfarm Job Growth




Based on average nonfarm payroll levels over trailing three months; Source: Bureau of Labor Statistics via Haver Analytics.



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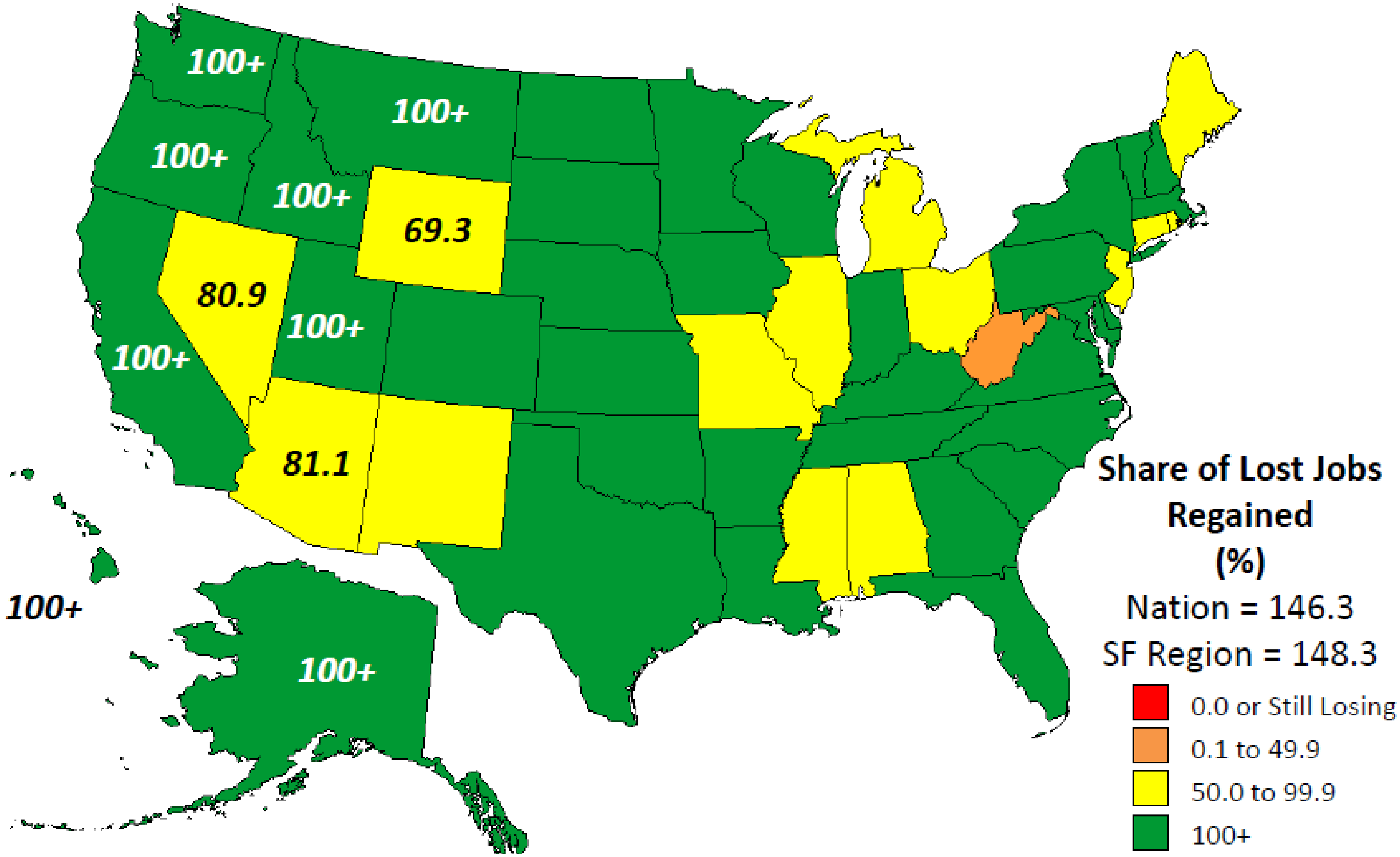
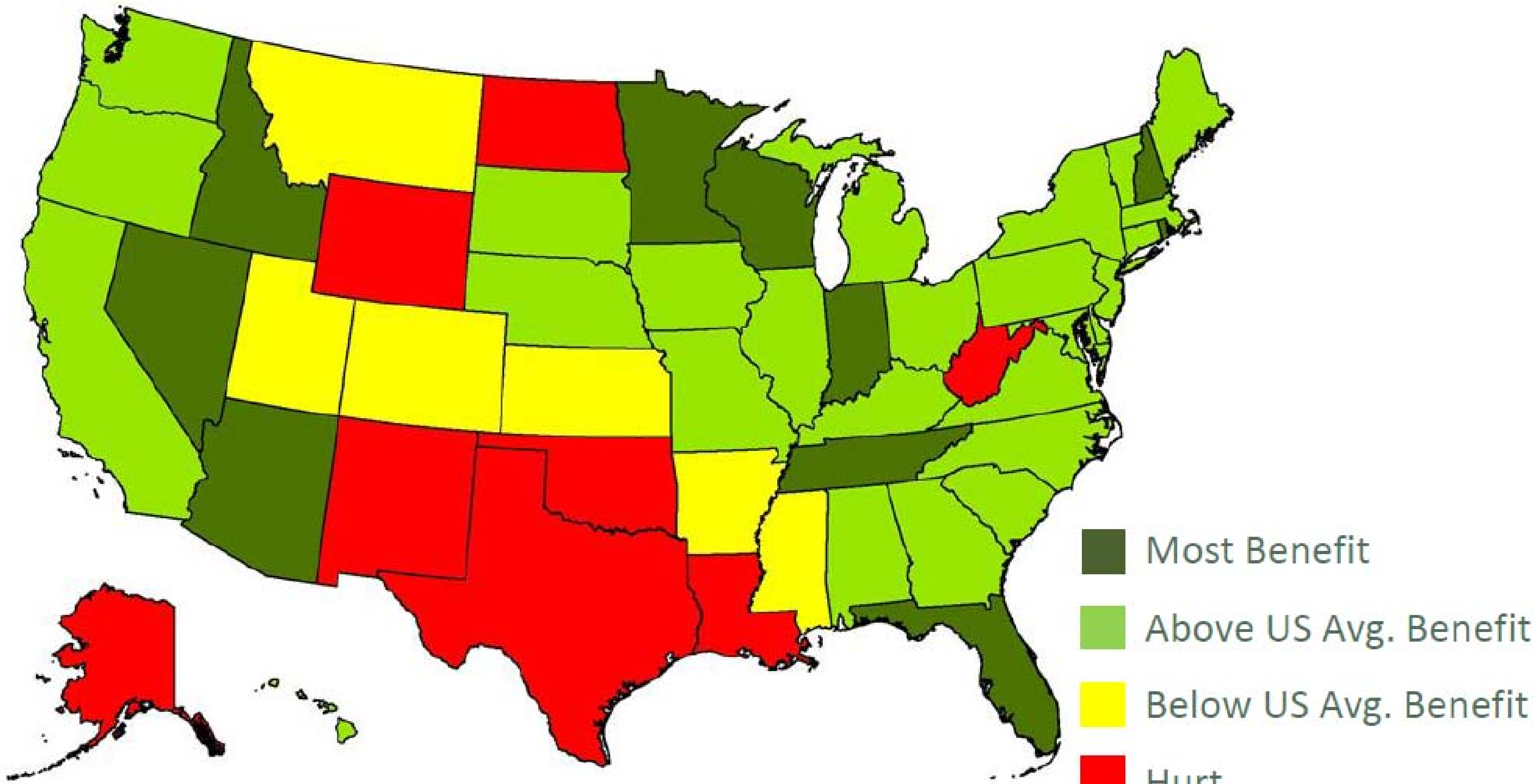
# Share of Lost Jobs that have been Regained

*AZ progressing but had furthest to go in West along with NV*




Source: FDIC, Bureau of Labor Statistics third quarter 2015 nonfarm employment data (seasonally adjusted). SF Region figure based on aggregate for AK, AZ, CA, HI, ID, MT, NV, OR, UT, WA, and WY. Map shows difference between employment levels in current period and trough period as share of difference between employment levels from peak period to trough period. The date of the pre-recession peak and trough employment levels varies by state.

# Estimated Impact of Lower Oil Prices a Net Positive for Arizona




Source: Stephen Brown and Mine Yucel, "The Shale Gas and Tight Oil Boom: U.S. States' Economic Gains and Vulnerabilities," Council on Foreign Relations (October 2013) and Stephen Brown, "Falling Oil Prices: Implications in the United States", Resources for the Future (May 2015).



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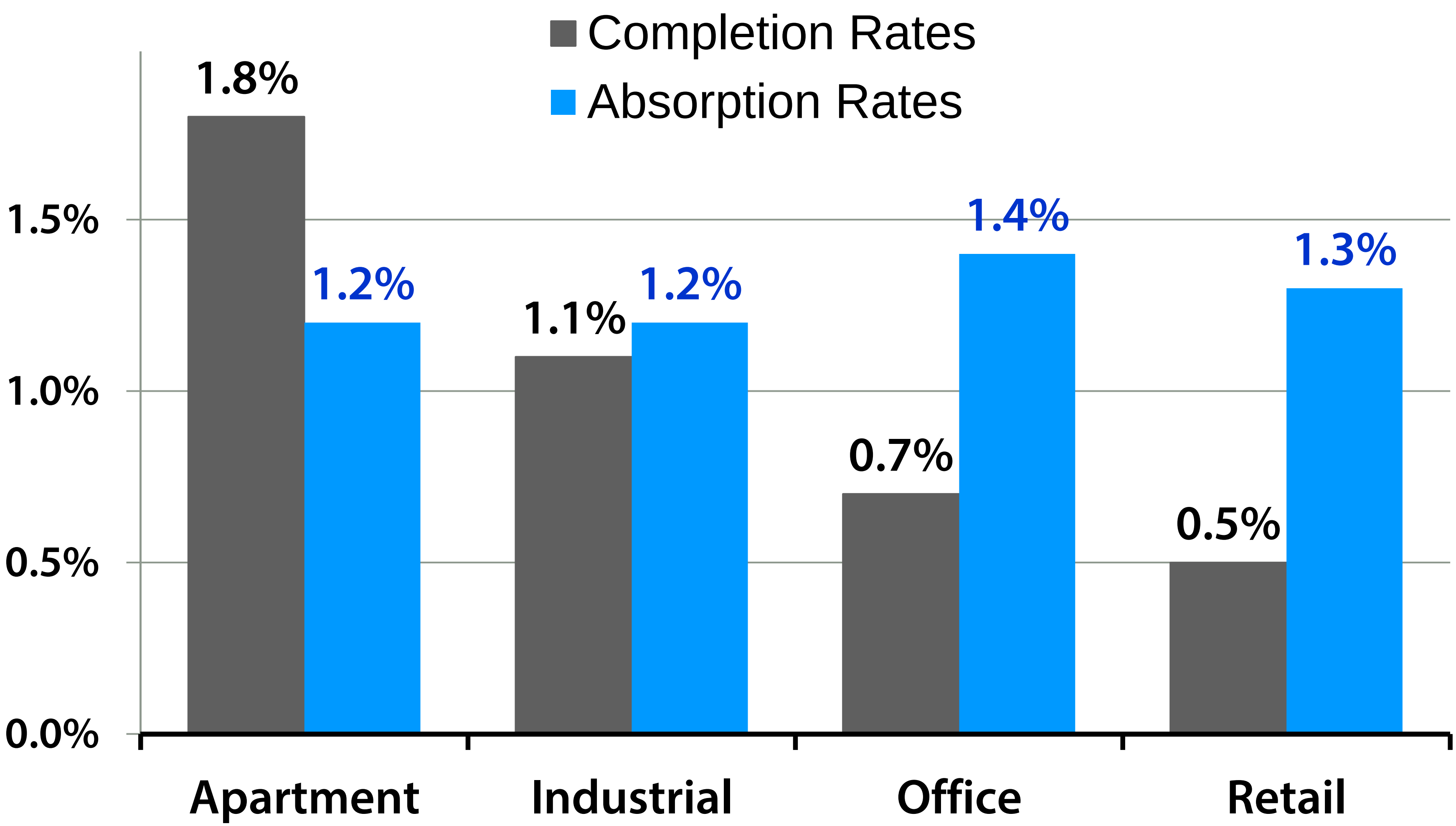
# (2) Demand Remains Strong: Net Absorption of New Space Expected to Equal or Exceed Supply in 3 of 4 Sectors

**Forecast Annual Completion Rates vs Absorption Rates, 2015-2016**

## 12th District




Based on square footage of space (or number of units for apartments) expected to be delivered and absorbed per year over 2015-2016 period to current stock; Source: CBRE-Econometric Advisors 3Q15 Forecast



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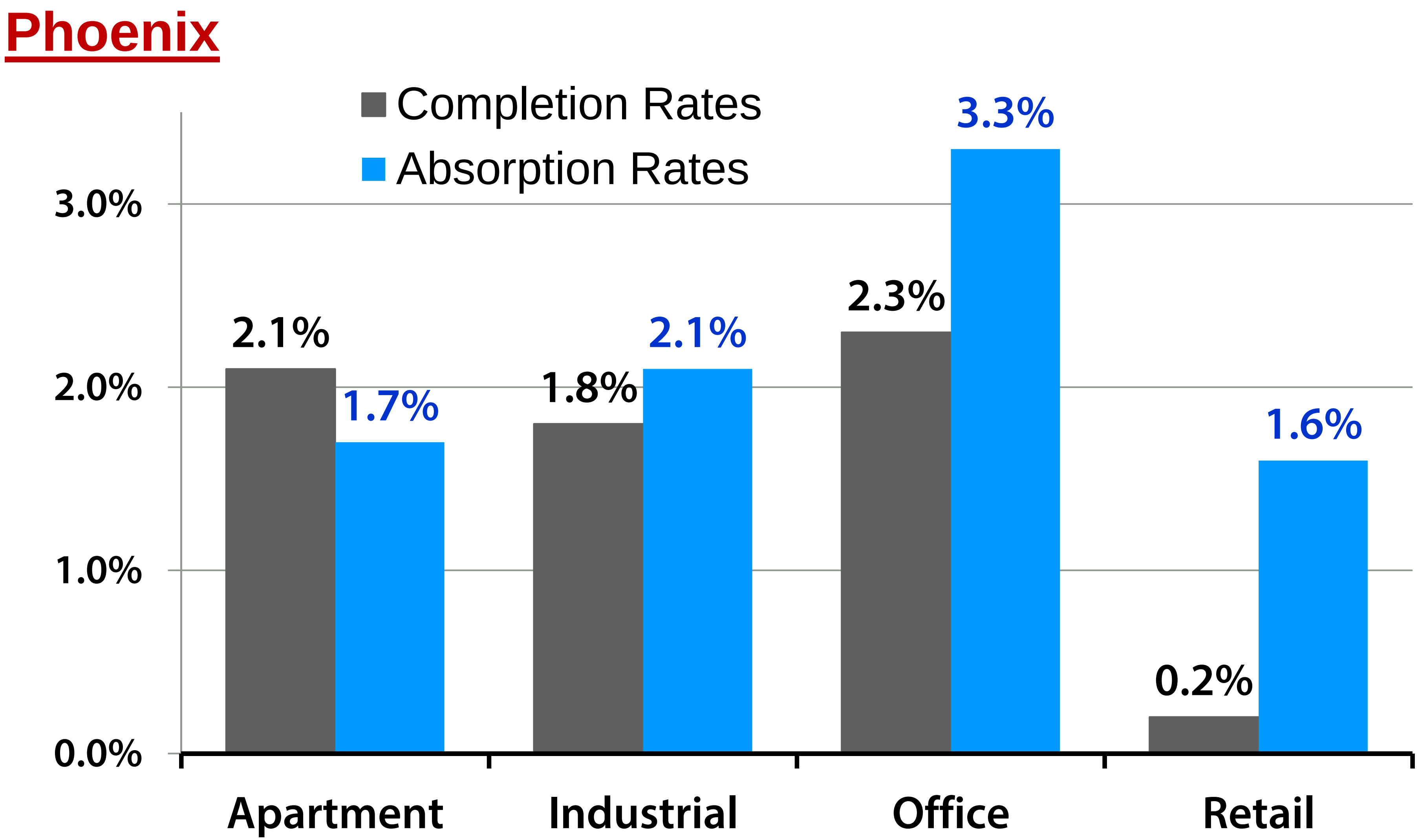
# Phoenix Supply/Demand Situation Good

**Forecast Annual Completion Rates vs Absorption Rates, 2015-2016**




Based on square footage of space (or number of units for apartments) expected to be delivered and absorbed per year over 2015-2016 period to current stock; Source: CBRE-Econometric Advisors 3Q15 Forecast

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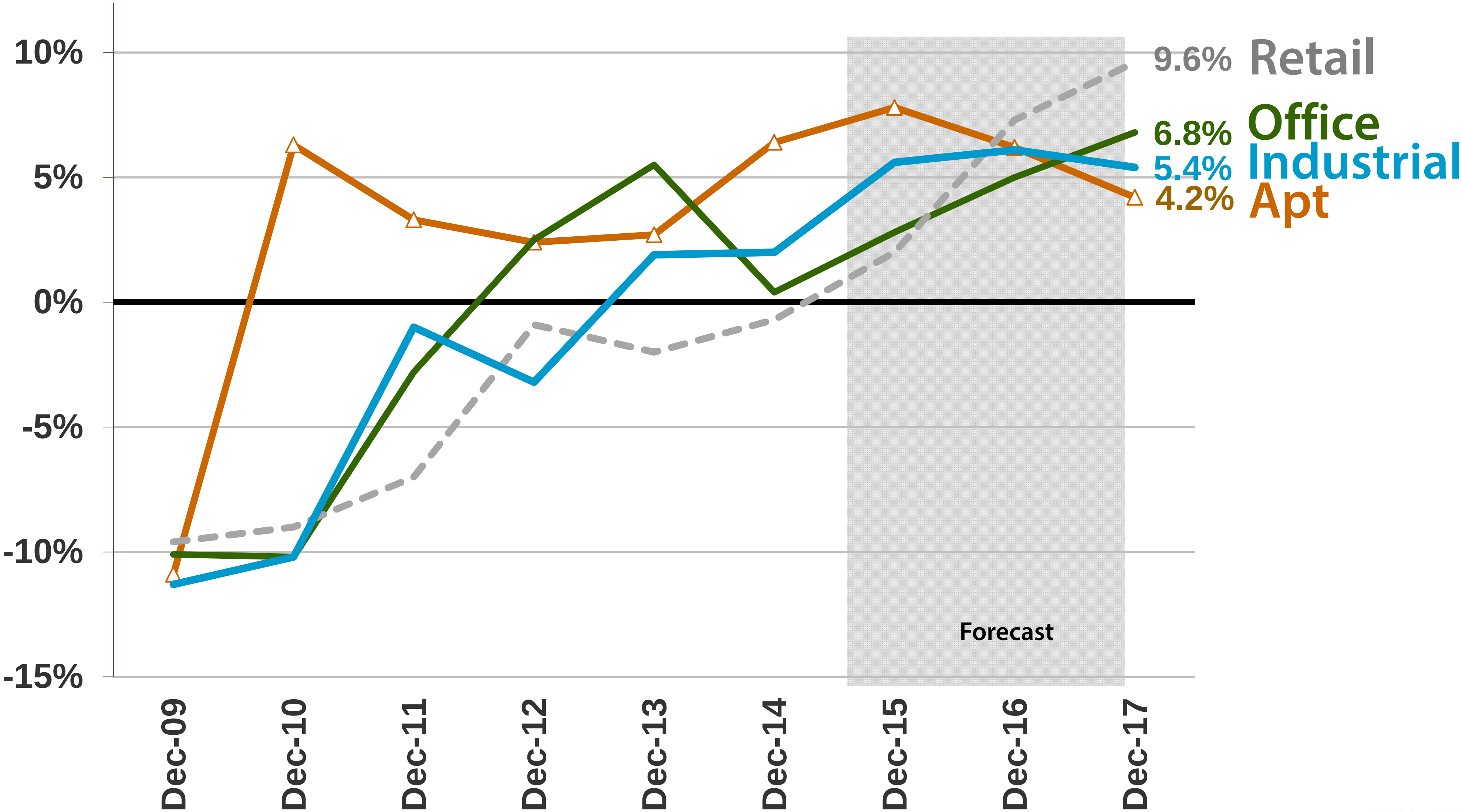
# Phoenix Rent Growth is Expected to Remain Positive Accelerating in Office and Retail Sectors

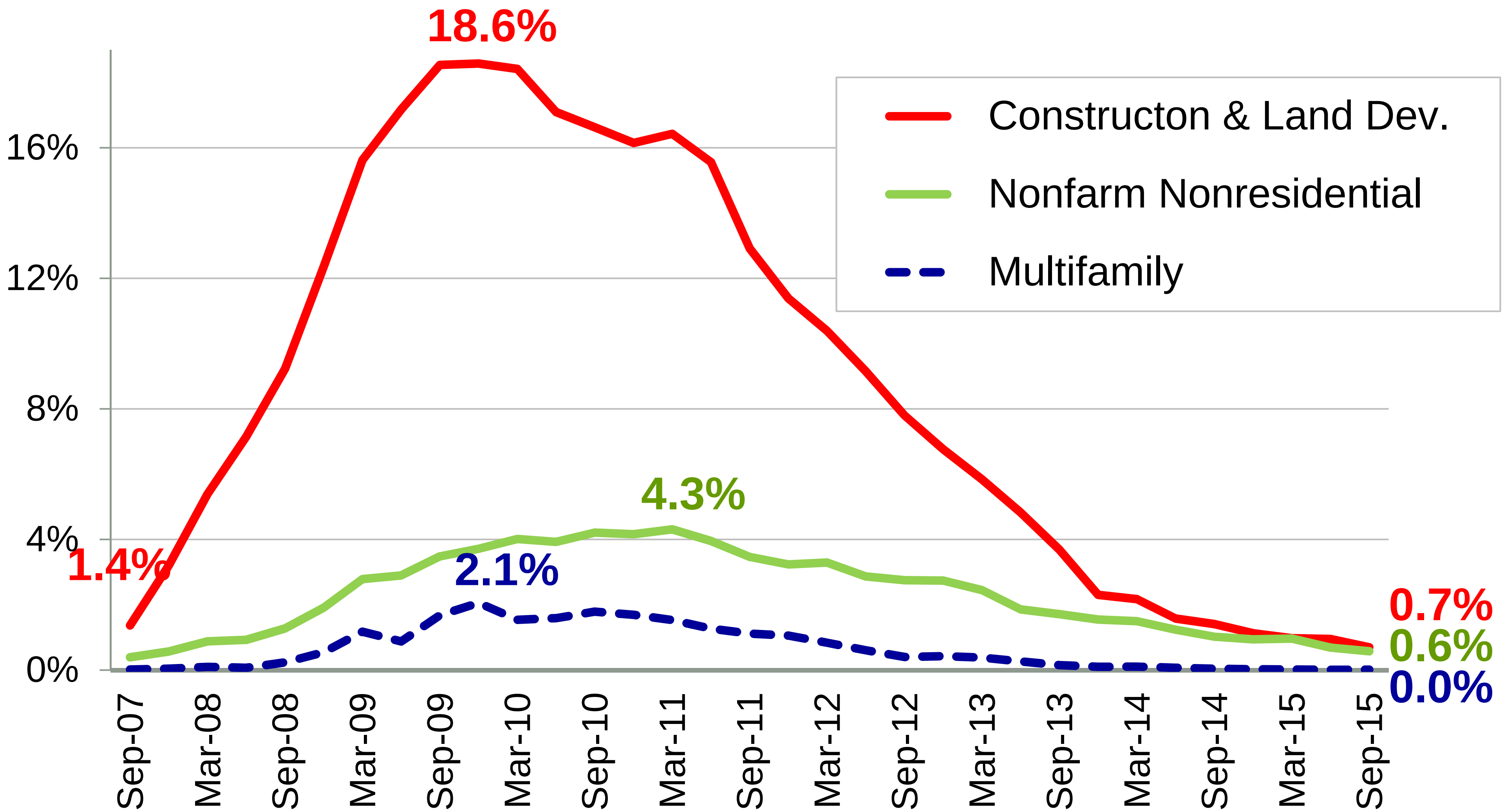
## Rent Growth Index Growth Rate (1 year) – Phoenix




Annual effective rent increases. Source: CBRE-Econometric Advisors, 3Q15 Forecast

# (3) Current Credit Performance Strong: Bank Loan Delinquency Rates Returned to Low Levels

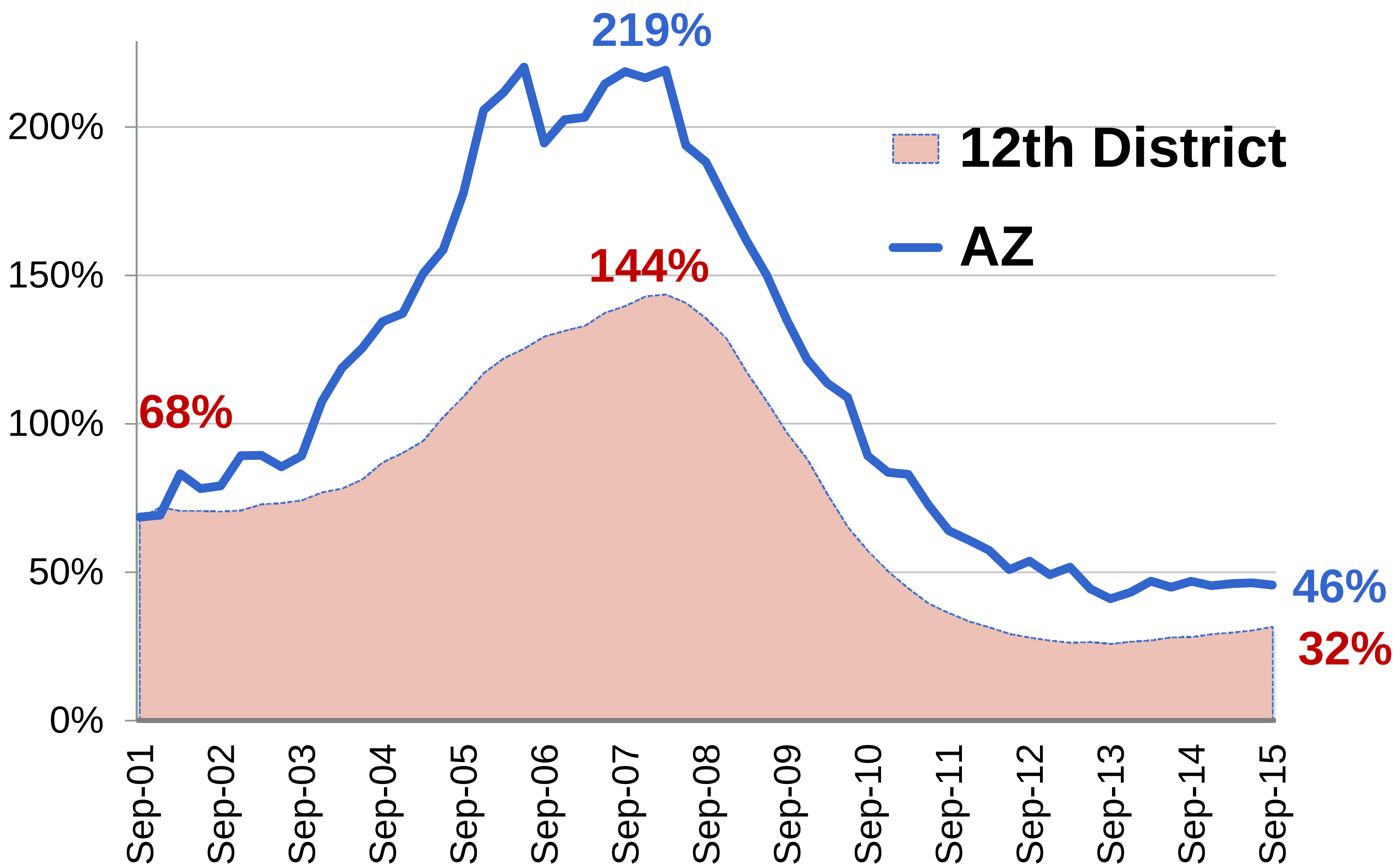
**% of Loans Past Due 30+ or Nonaccrual by Type – 12th District**




Based on 12th District commercial banks, excluding De Novos; trimmed means; C&LD = construction and land development; NFNR = nonfarm-nonresidential

# (4) C&LD Concentrations Remain Relatively Low
## By Far the Riskiest Segment Historically

**Avg. Construction & Land Development Loans / Total Capital Ratios**




Based on commercial banks, excluding De Novos; trimmed means

# CRE: Conclusions

1. CRE risks exist -- Prices, Underwriting
   - *CRE values – possibly due for a correction?*
2. Rising interest rates?
   - *Minor impact with expected slow rise in rates*
   - *Sharp rise scenario: big impact – CRE deflation / more loan defaults*
3. But… economy & banking conditions improving; bank C&LD concentrations remain low. CRE values have nearly doubled & can withstand a moderate correction

# Resources

**Federal Reserve Bank of San Francisco/Federal Reserve Board**
*FedViews:* http://www.frbsf.org/economic-research/publications/fedviews/
*FOMC Minutes / Projections:*
http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm
*First Glance 12L*: http://www.frbsf.org/banking/publications/first-glance-12l/
*Banks at a Glance*: http://www.frbsf.org/banking/publications/banks-at-a-glance/
*Supervisory Spotlight*: http://www.frbsf.org/banking/publications/supervisory-spotlight/
*Community Banking Connections*: https://www.communitybankingconnections.org/

**Federal Deposit Insurance Corporation**
*State Profiles*: https://www.fdic.gov/bank/analytical/stateprofile/
*Quarterly Banking Profile*: https://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP
*Supervisory Insights*: https://www.fdic.gov/regulations/examinations/supervisory/insights/

**Office of the Comptroller of the Currency**
*Semi-Annual Risk Perspective*: http://www.occ.gov/publications/publications-by-type/other-publications-reports/index-semiannual-risk-perspective.html
*Mortgage Metrics Report:* http://www.occ.gov/publications/publications-by-type/other-publications-reports/index-mortgage-metrics.html
Survey of Credit Underwriting Practices: http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/index-survey-credit-underwriting-practices-report.html

# Q&A / Discussion

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# Basel III High Volatility CRE (HVCRE) Rule
## [not discussed in presentation due to time constraint]

1. An HVCRE loan: credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property.

2. Requires 50% higher capital reserves (150% risk weighted asset weighting compared to 100%) – No grandfathering of existing loans

3. Generally, HVCRE status can be avoided where:
   - ADC facility finances 1-4 family properties, community development or ag land
   - Meets loan-to-value (usually <=80%) and capital contribution requirements (>=15% of "as completed" value)

4. Rule applies to all banks

5. Increases HVCRE loan costs, compliance costs

6. Many (mostly small) banks not yet reporting HVCRE accurately

7. Interagency policy group is reviewing HVCRE rules to consider if adjustments are needed