The Outlook for CRE + Bank Performance in the West

“Call the Fed” Audio Conference
April 21, 2009
2:00 - 3:15 Pacific Time

Questions/problems: send an email before or during the call:
sf.bsr.fedaudioconference@sf.frbsf.org

Gary Palmer, Banking Supervision, FRBSF

"SO ALL THIS IS BECAUSE WE TOOK OUT A HOME EQUITY LOAN TO REDO THE BATHROOM?"

Agenda – 12th District Bank Focus

1. Housing Market (e.g. Residential C&LD Loan Impact)
2. Income Property Markets (CRE Loan impact)
3. Banking Performance and Outlook & Potential Path for Banks this Cycle
4. Ways RE Market Information is used by Supervisors
5. **Q&A** – Starting with Some Oft-Asked Questions for Credit Risk Coordinator Wally Young

Many of the slides here are also updated regularly for "First Glance 12L" or "RE Lending Risks Monitor" publications on FRBSF's Public web @ http://www.frbsf.org/publications/banking/index.html

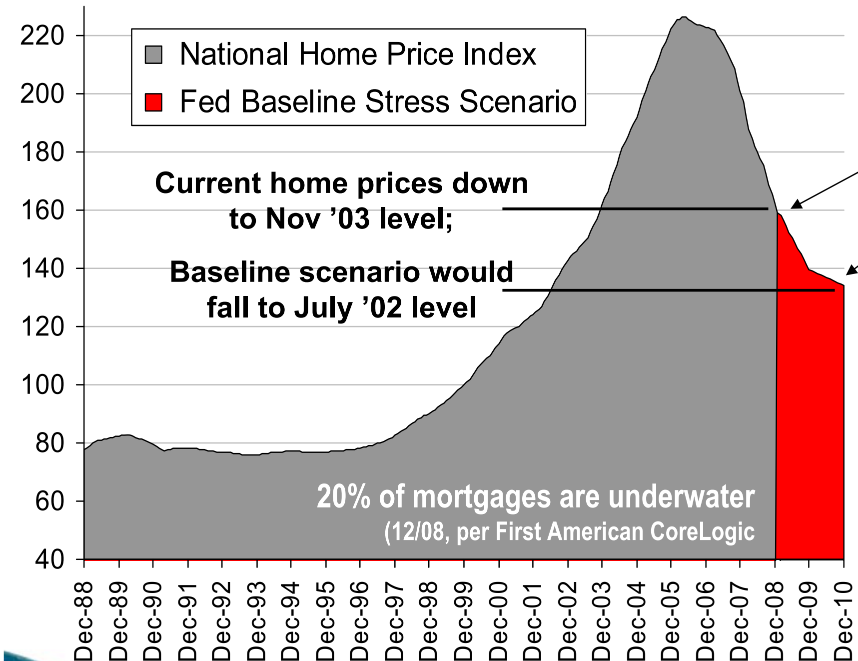
(1)
Housing Market

Construction & Land Development Lending Impact

Housing Market Collapse: Home Prices Down 30% from Peaks

Federal Gov't "Stress Test" Baseline Scenario: Another 11% to go*

Case-Shiller National Home Price Index



Peak-to-trough declines

-30% as of Jan 2009

-41% baseline stress*

Peak-to-trough declines, so far

• Phoenix	-48%
• Las Vegas	-46%
• Miami	-43%
• San Francisco	-42%
• San Diego	-40%
• Detroit	-39%
• Los Angeles	-38%
…	
• Seattle	-18%
• Portland	-16%
• Nation	-30%

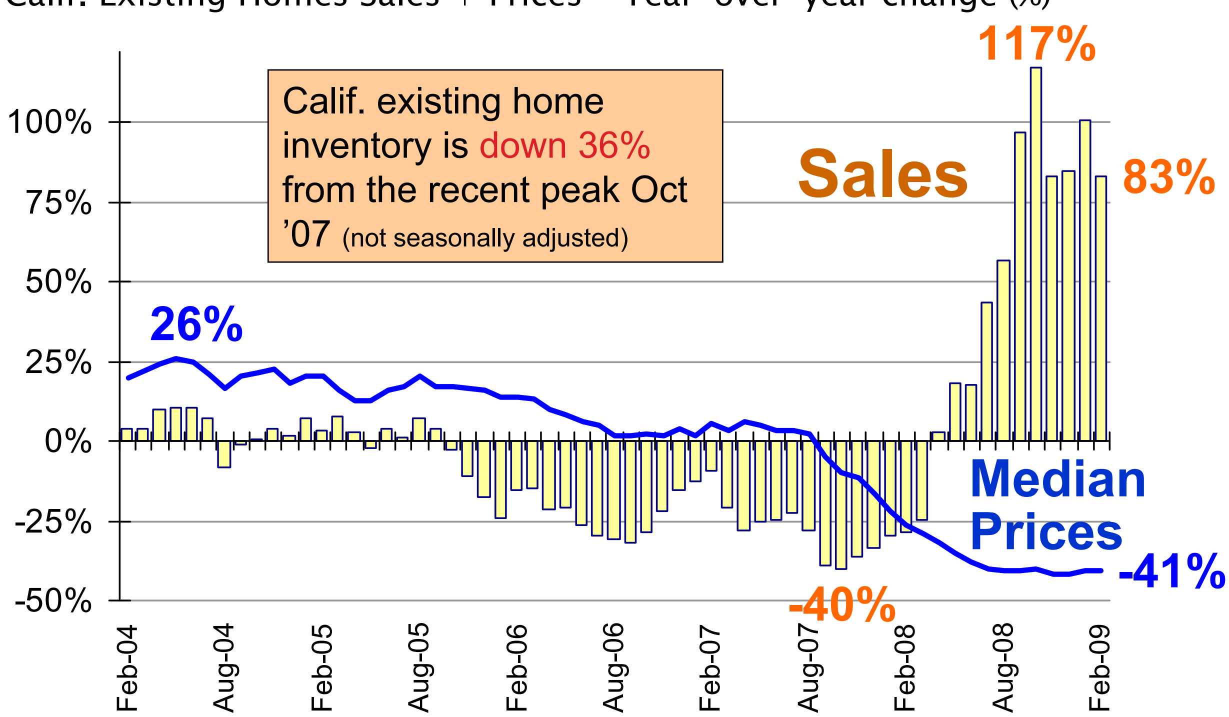
Sources: S&P/Case-Shiller Home Price Index (area chart uses Composite 10 MSA index, seasonally adjusted), Haver Analytics;

* Gov't economic scenarios for stress testing at large banks translate into peak-to-trough declines of 41% (baseline) and 48% (adverse)

Although there are Signs that the Market is Working

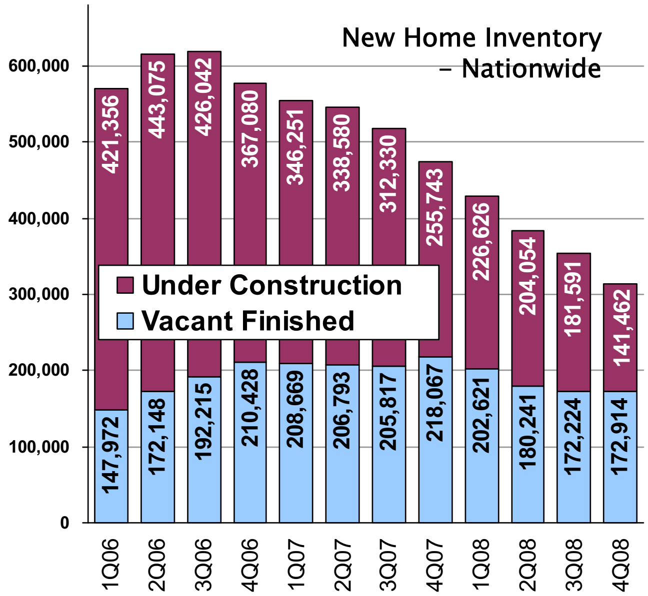
Calif. Home Sales Surging as Foreclosures Dominate Sales Activity

Calif. Existing Homes Sales + Prices - Year-over-year change (%)



Source: Calif. Assoc of Realtors – year-over-year change in existing single family detached home sales and median prices

New Homes: Inventory Continues to Drop, but Month's Supply Still Too High



New Home Inventory	4Q06	4Q08	% Chg
Vacant homes	210k	173k	-18%
Under Construction	367k	141k	-62%
Month's Supply (vacant + under construction)	9.4	11.0	

- New home inventory had dropped sharply
- Housing starts in the West are lowest in over 40 years
- Affordability has improved sharply
- Sales have improved modestly (California's $10,000 tax credit for new home buyers helps)
- However, supply of new homes remains elevated at 11 months

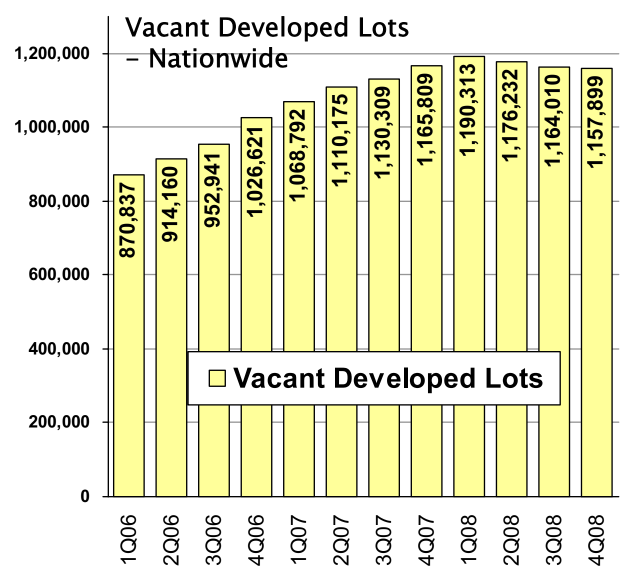
Source: Metrostudy – covers approximately 60% of the nat'l new home market; Months' supply calculations based on annual rate of sales

Land – Who Wants Some?

Vacant Developed Lot Inventory Remains Elevated

- Sharp deflation of land values
  - *According to a recent Zelman & Associates survey, **finished lot prices are down 50% from peaks** on average*
- Abnormally low sales rates for developed lots
- Developers likely to increasingly default on loans
- Land/lot foreclosures likely to rise
- Banks are reluctant to sell assets at distressed prices – PPIP could help?

Source: February 2009 Land Development Survey, Zelman & Associates



Vac Devel Lots	4Q06	4Q08	% Chg
VDLs	1.0m	1.2m	13%
Month's Supply	16.0	59.1	

Source: Metrostudy – Months' supply calculations based on annual rate of starts

Supply of Vacant Developed Lots

Months' Supply in Larger District Counties – as of 4Q08

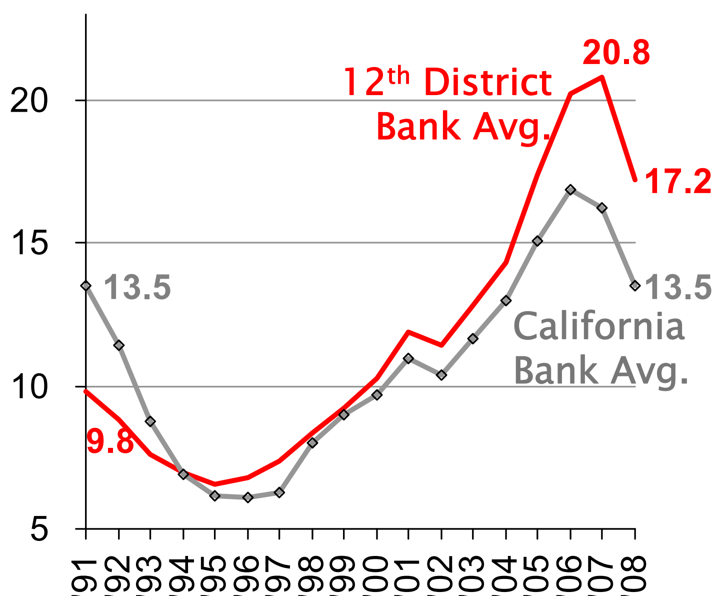
County	Largest City	VDLs	Months' Supply
Merced, CA	Merced	4,523	275
Yavapai, AZ	Prescott	8,286	268
Washington, UT	St. George	6,235	121
Utah, UT	Provo	9,357	81
Stanislaus, CA	Modesto	2,480	79
Canyon, ID	Nampa	4,274	75
Orange, CA	Santa Ana	3,806	75
Weber, UT	Odgen	3,281	70
San Joaquin, CA	Stockton	4,787	68
San Bernardino, CA	San Bernardino	8,437	61
Kern, CA	Bakersfield	6,600	56
Riverside, CA	Riverside	20,768	56
Ada, ID	Boise	7,193	55
Contra Costa, CA	Concord	5,275	54
Sacramento, CA	Sacramento	7,775	51
Clark, NV	Las Vegas	28,400	44
Maricopa, AZ	Phoenix	41,205	44
Nation		1,157,899	59

Source: Metrostudy. District 12 states not covered by vendor: AK, HI, OR, WA

Concentrations in C&LD Loans: District Banks are More Exposed Compared to the Early '90s

Underlying Assets Often have Outdated Appraisals

Construction & Land Development Loans / Total Loans (avg. %)



- *According to a recent survey, less than half the AD&C (C&LD) assets have been re-appraised since being underwritten **

* January 2009 Banker Survey, Zelman & Associates

C&LD Loans / Total Loans (%)

rank	st	avg
1	UT	30.4
2	NV	24.9
5	AZ	21.7
6	WA	20.9
7	ID	20.2
9	OR	18.3
15	CA	13.5
18	AK	13.0
31	HI	8.0

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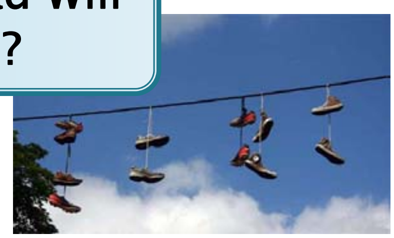
Income Property Markets

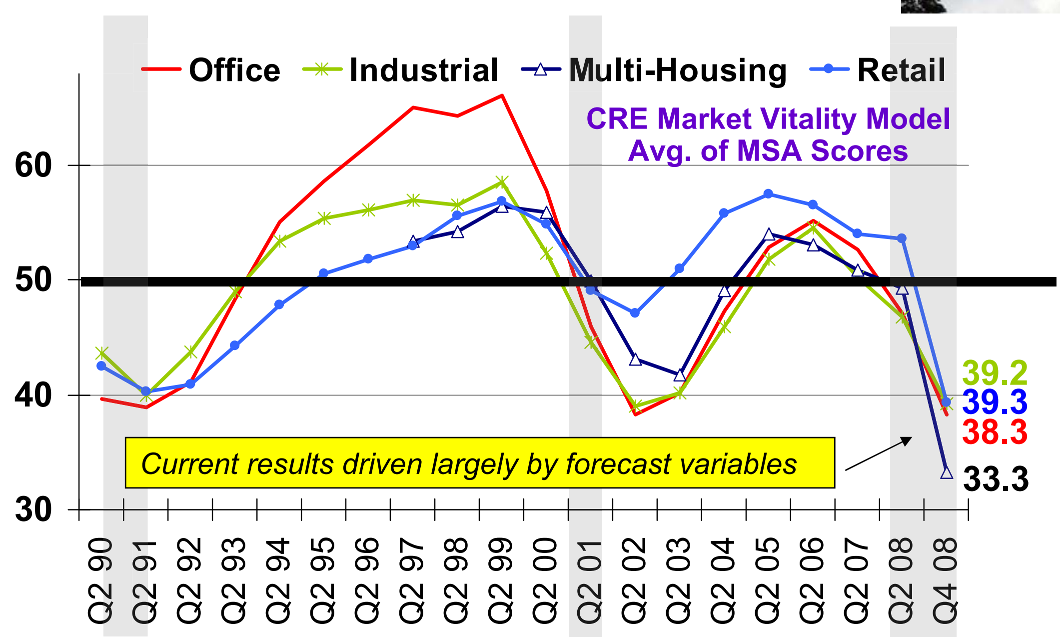
CRE Lending Impact

Other CRE (income properties): How Bad Will It Get? More Shoes Dropping?



FRBSF Model Reflects Recessions' Impacts on CRE Markets

Nat' MSA avgs - scores below 50 are below long term historical avgs.



Model Includes:
- Job growth
- Vacancy rates
- Rent growth
- Property value change
- Supply growth

Forecast
- Vacancy rates
- Rent growth
- Property value change
- New supply rate
- Absorption rate

Source: FRBSF CRE Market Vitality Model – avg scores across all MSAs, Spring '09 (data and forecasts as of 4Q08

Ranking from the Worst (Phoenix) to the Best (SF+LA)

4Q2008		CRE Market Vitality Scores				
Rank	MSA	Office	Industrial	Multi-Housing	Retail	Avg
1	Phoenix	20.6	26.0	17.6	36.0	25.0
2	Atlanta	31.9	32.0	16.3	28.6	27.2
3	Detroit	23.8	23.2	29.6	32.4	27.2
Other 12th District:						
11	Sacramento	29.2	37.0	23.8	37.3	31.8
13	Riverside	30.1	27.8	33.3	38.4	32.4
28	Las Vegas	32.1	45.5	21.4	46.1	36.3
31	Oakland	40.2	40.1	35.1	32.7	37.0
34	Tucson	36.7	46.8	33.8	32.6	37.5
43	San Diego	27.2	35.6	47.7	44.5	38.8
44	Salt Lake City	36.2	46.7	31.2	41.0	38.8
57	Portland	46.6	51.5	35.6	38.9	43.2
59	San Jose	28.2	47.8	43.6	54.3	43.5
60	Seattle	43.1	48.8	38.3	44.6	43.7
62	Orange County	28.0	50.1	48.5	50.0	44.1
68	Honolulu	60.3		45.2	39.1	48.2
69	Los Angeles	44.6	58.9	43.9	50.4	49.4
71	San Francisco	49.8	56.2	50.6	50.2	51.7

In Contrast… CRE Vitality Scores Last Year

4Q2007		CRE Market Vitality Scores				
Rank	MSA	Office	Industrial	Multi-Housing	Retail	Avg
12th District:						
21	Sacramento	43.0	46.2	43.5	47.8	45.1
28	Oakland	43.3	51.8	46.5	45.5	46.8
32	Las Vegas	35.8	50.9	44.9	62.2	48.5
33	Phoenix	44.1	45.2	49.6	56.4	48.8
37	San Diego	43.4	48.0	50.1	60.6	50.5
48	Portland	57.0	59.5	53.0	47.8	54.3
53	Riverside	53.3	57.9	60.0	62.5	58.4
54	Salt Lake City	56.5	58.2	64.4	54.7	58.4
56	Seattle	61.1	60.1	52.7	60.9	58.7
57	Honolulu	64.5		60.0	52.7	59.1
60	San Jose	53.3	58.1	61.0	66.0	59.6
63	Orange County	51.8	63.3	59.6	66.7	60.4
67	Tucson	58.7	70.2	65.1	51.9	61.5
68	San Francisco	63.6	68.0	53.8	64.9	62.6
69	Los Angeles	68.0	71.5	57.8	70.3	66.9

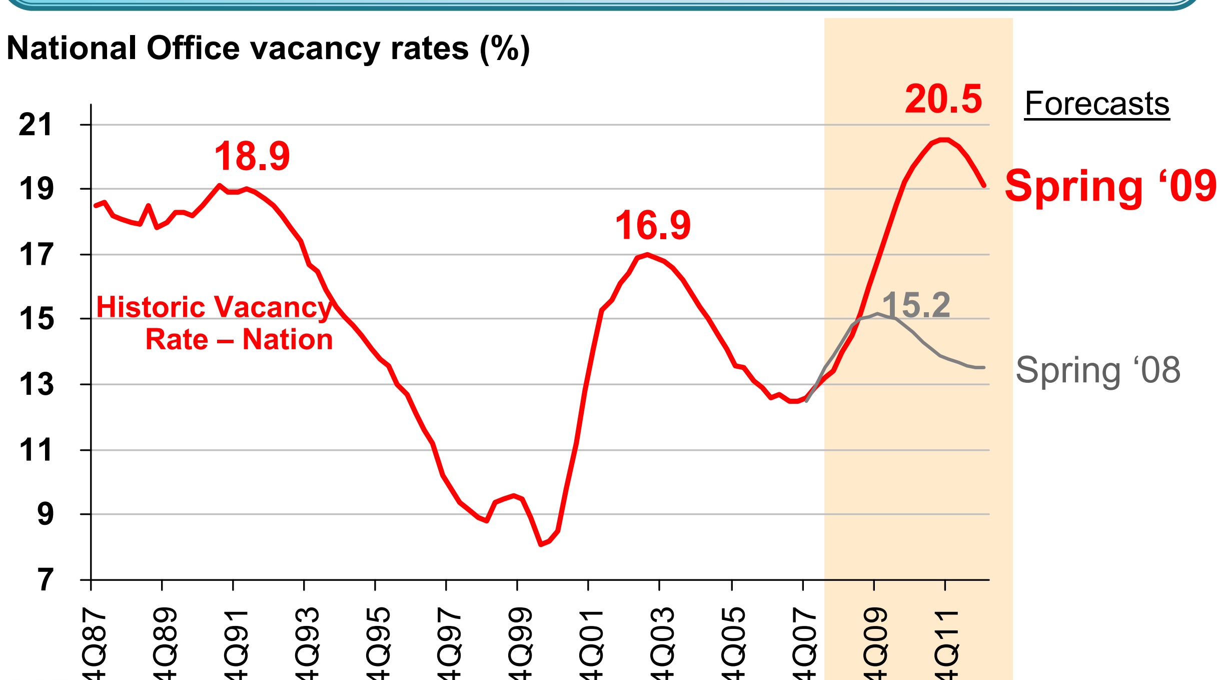
Main Drivers of Adverse Results: Job Losses & Forecasts

As reflected in CRE Market Vitality Model results for 12th District MSAs

1. **Recent Job Losses** (5.1M jobs so far) Retail: job losses & adverse forecasts reflect declines in retail sales & rising retailer bankruptcies
2. **Forecast Rent Declines** (rents in many MSAs to fall, especially office, retail, multi-housing, rent concessions)
3. **Forecast Vacancy Rates** (record-high vacancy rates are expected nationally in all 4 CRE sectors – caused by DEMAND SHOCK – not oversupply like we had in the early '90s)
4. **Forecast Property Value Declines** (1 year TWR forecast)

Example of How Forecasts Have Changed: Evolving Office Vacancy Rate Forecasts

In four quarters, forecast peak ballooned from 15.2% to 20.5%

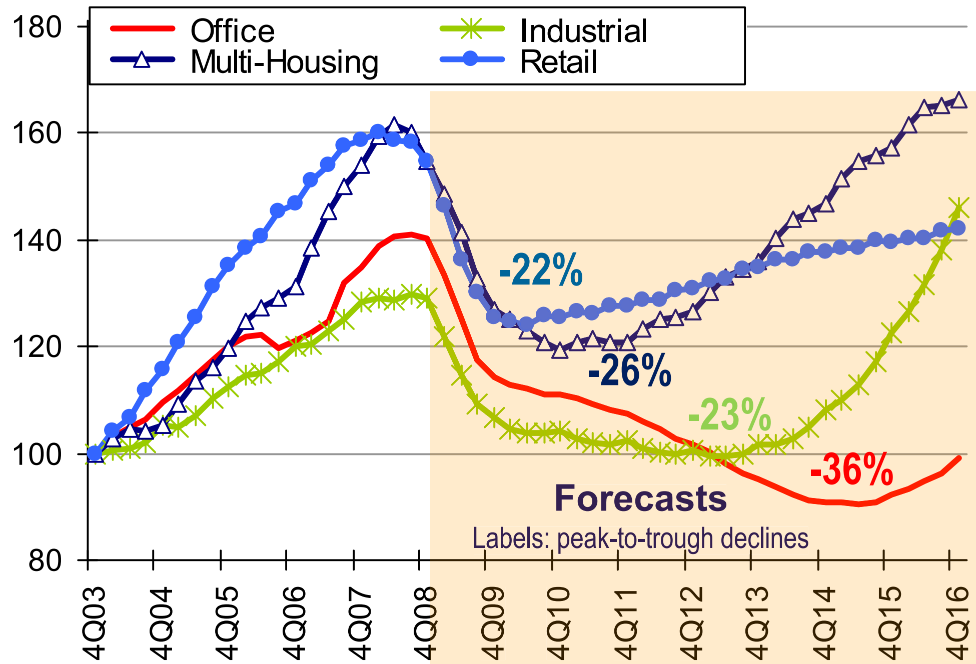


Source: Torto Wheaton Research Office Outlook

CRE Property Values to Drop Sharply

Peak-to-trough Declines of 36% Expected for Office Sector

National Data – Index 2003 = 100



Drivers:

- **CMBS market failure**
- **Deleveraging - LTVs of 60% instead of 80%**
- **High spreads**
- **Amortizing loans**
- **Cap rates rising**

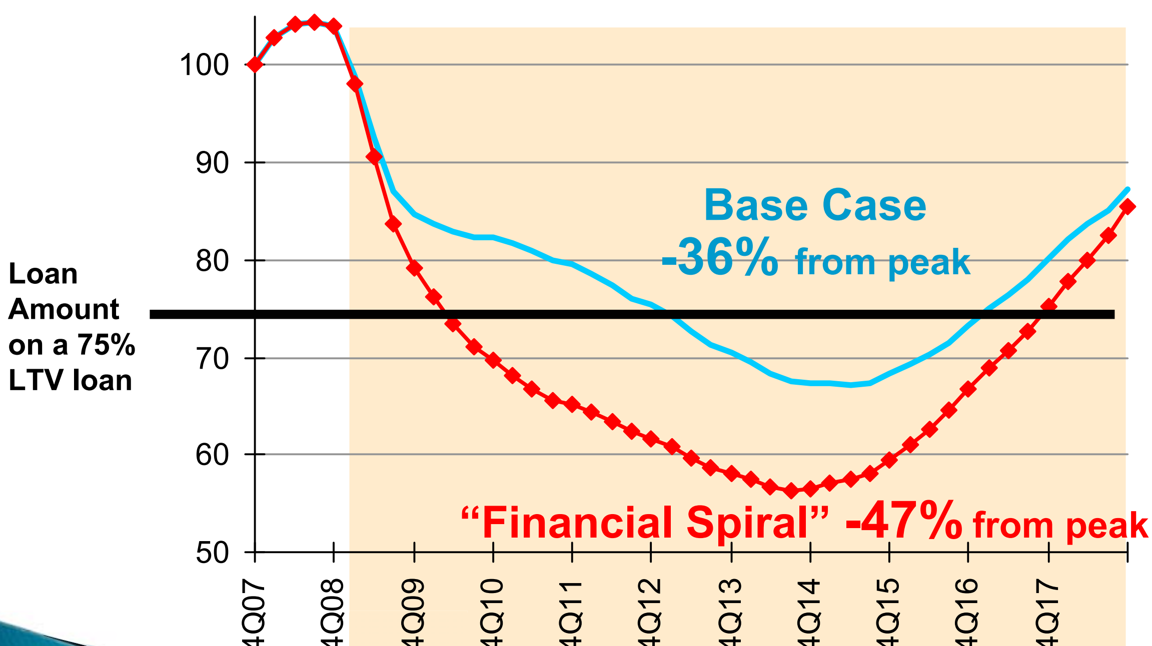
Cap rates already rising (Apt)
Real Capital Analytics

Source: Torto Wheaton Research Investment Outlook, Spring 2009 Base Case Forecast; FRBSF

Values Could Fall Even Further

LTVs could generally rise to well over 100%

TWR's Base Case + Financ'l Spiral Scenarios – <u>Office Sector;</u> Index 100=4Q07

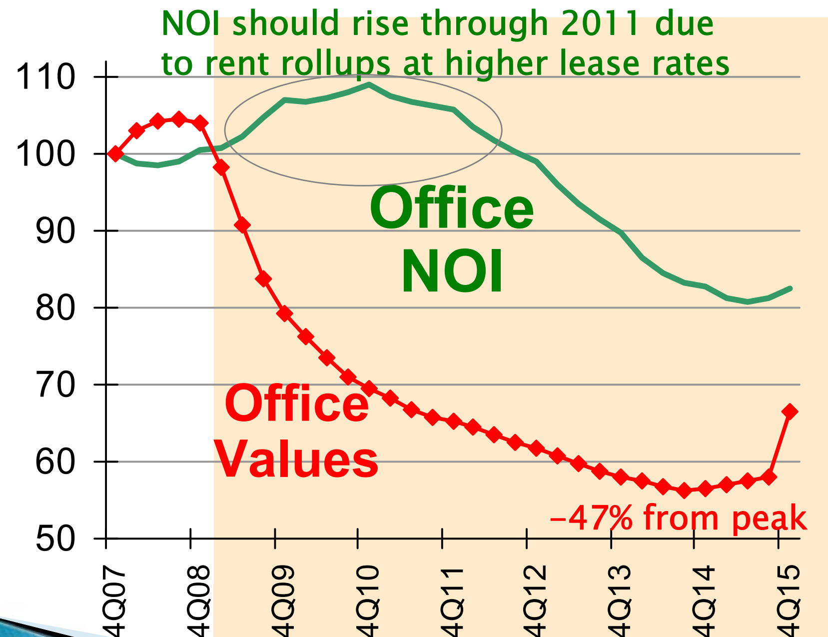


Source: Torto Wheaton Research Investment Outlook – Spring 2009; FRBSF

But, Expected Loss Rates May Not Skyrocket: Why? NOIs Forecast to Hold up or Rise in Near-Term

(due to lag between Rents and NOIs resulting from 5-7 year lease terms)

<u>Office Sector: Financial Spiral Scenario</u> – **Values & Net Operating Income** Index 4Q07 = 100



While declining values mean **high LGDs…**

Stable / rising property income means **low PDs**… for now

So, Moody's Commercial Mortgage Metrics model indicates relatively low CRE loss rates next 3 years (< 1% per year)

Source: Torto Wheaton Research Spring 2009 Office Outlook; Financial Spiral Scenario; FRBSF

How Could NOIs Go Up When Rents Go Down???

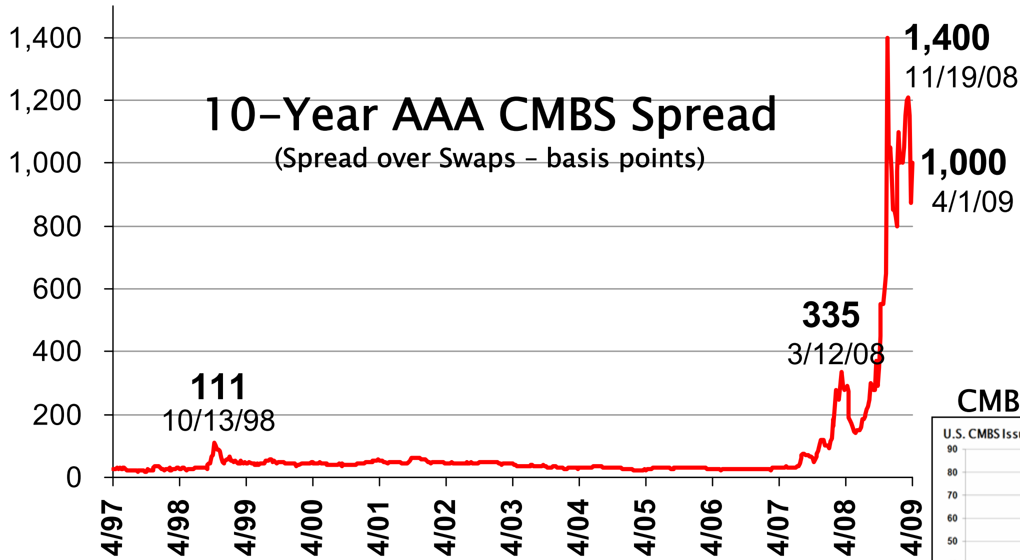
Example of NOI Bump-Up **LA Office Property – 5 year lease**	**Effective rent* rate** ($ per sq ft per year	**% Chg from Lease Date**
Lease Signed - 4Q04	$21.08	
At 2008 peak	$29.46	+40%
At Lease Renewal Date - 4Q09	$28.01	+33%

Although market rents should drop 5% in 2009, at the lease renewal date in 2009, rents should be 33% higher than they were in 2004.

* <u>Effective rents</u> incorporate estimate of concessions, like free rent periods

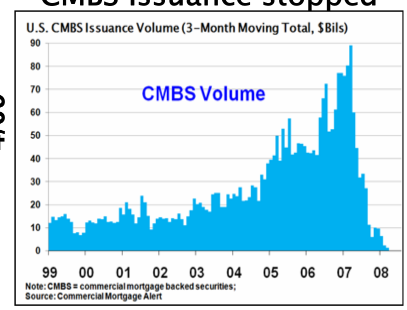
Source: Torto Wheaton Research Investment Outlook, Spring 2009; FRBSF

Yet, CMBS Spreads Remain in Stratosphere – Refinances Costly and Difficult –TALF Should Help



"[With TALF] average spreads on AAA-rated CMBS are likely to narrow to as little as 600 basis points, a level where investors taking government funding can probably still get annual returns of more than 15 percent" Alan Todd, JPMC 3/26/09 Reuters article

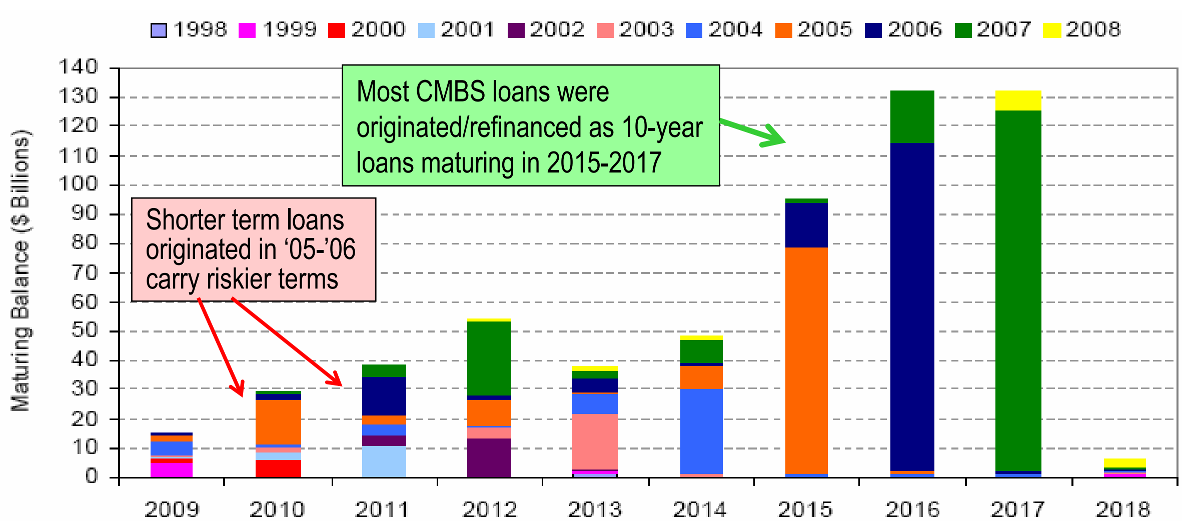
CMBS Issuance stopped



Source: Commercial Mortgage Alert

Refinance Risks Heightened Over Next 2 years; However, Most CMBS Matures Well Later

Maturing CMBS Mortgages



Sources Deutsche Bank, Trepp, Intex

(3)

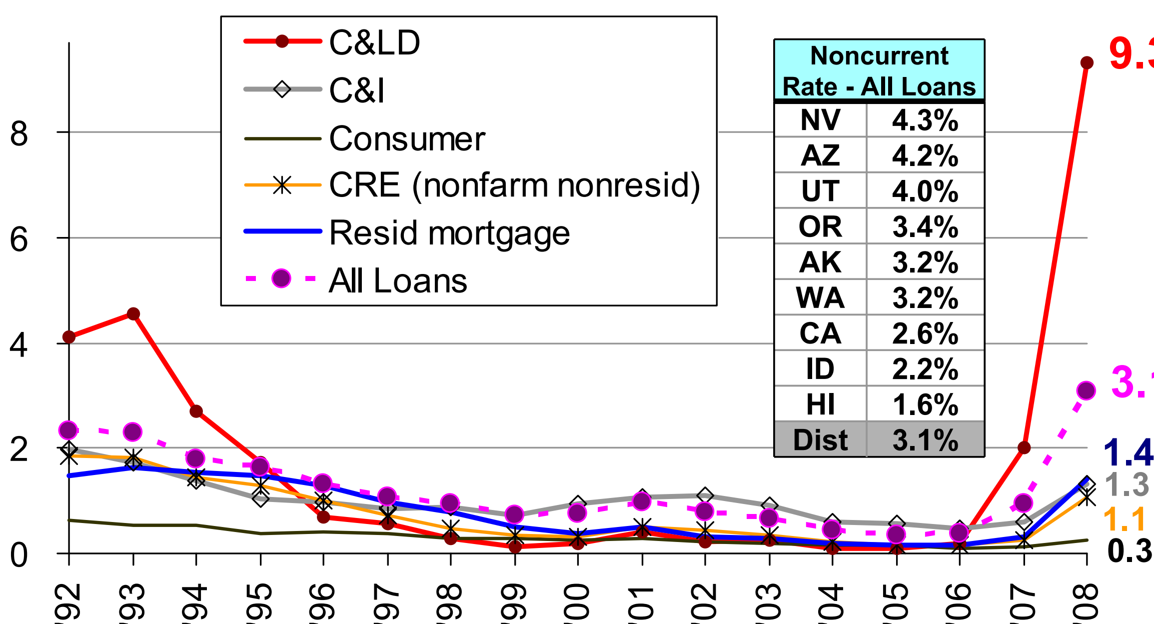
Banking Performance and Outlook

Potential Path for Banks this Cycle

Similar to Calif in Early ’90s?

District 12 Bank Avg. Noncurrent Rates at Record Highs, Driven by C&LD Loan Deterioration

Pct of loans that are 90+ day past due or on nonaccrual (%)



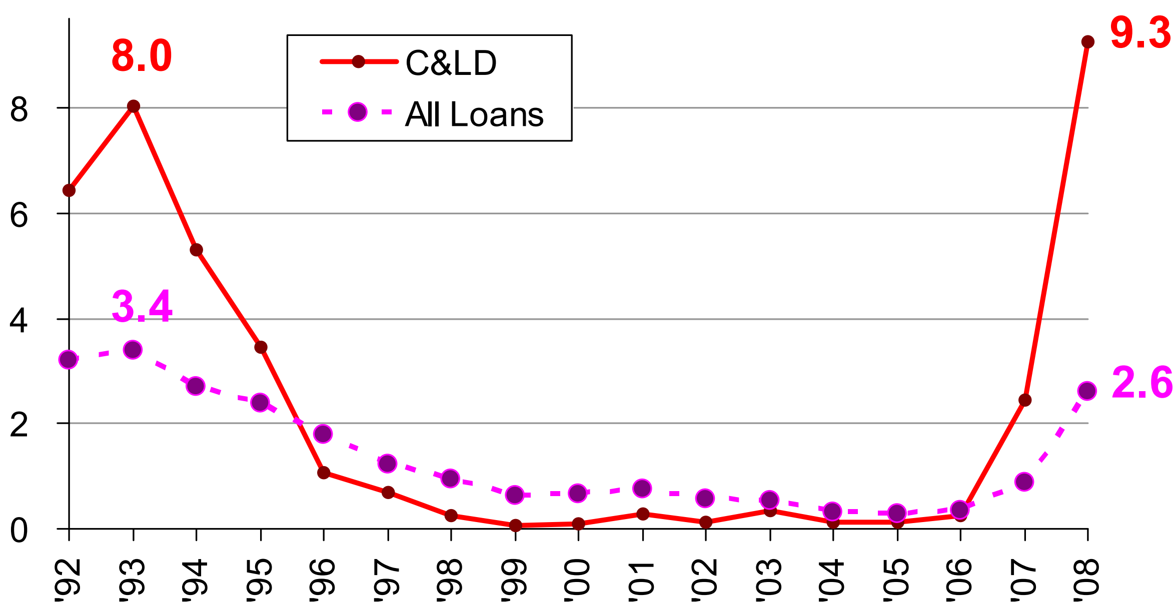
Noncurrent Rate - All Loans	
NV	4.3%
AZ	4.2%
UT	4.0%
OR	3.4%
AK	3.2%
WA	3.2%
CA	2.6%
ID	2.2%
HI	1.6%
Dist	3.1%

Adj. avgs. (10% trim) for all 12th District commercial banks, excluding De Novos; C&LD=construction & land development

Might Early '90s California Serve as a Model for this Cycle?

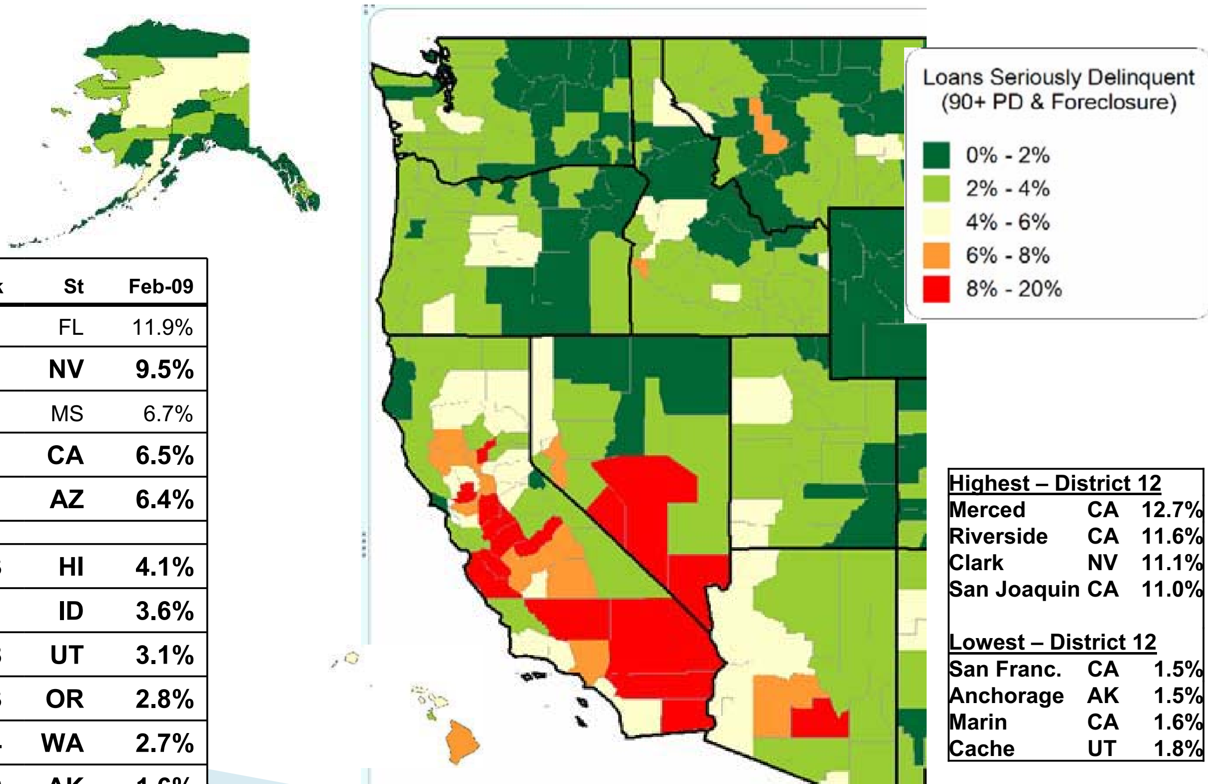
Calif. Noncurrent Rates -- Similar Now to '90s

CALIFORNIA Pct of loans that are 90+ day past due or on nonaccrual (%)



Adj. avgs. (10% trim) for CA commercial banks, excluding De Novos; C&LD=construction & land development

Serious Delinquency Rates – First Lien Mortgages As of February 2009



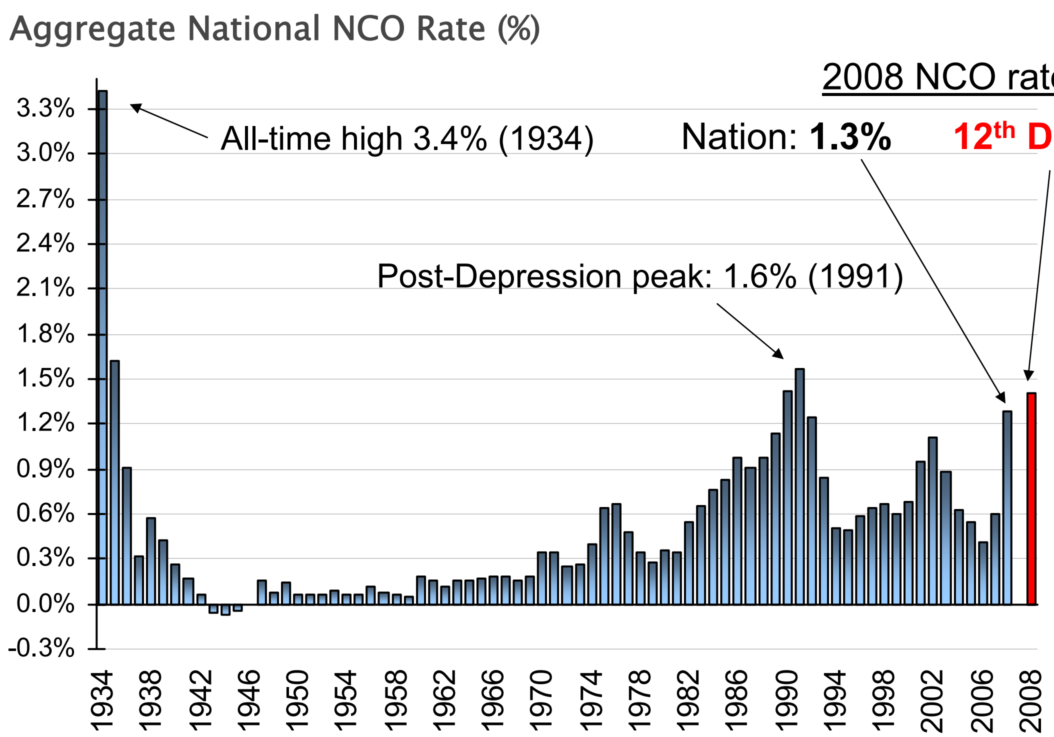
rnk	St	Feb-09
1	FL	11.9%
2	**NV**	**9.5%**
3	MS	6.7%
4	**CA**	**6.5%**
5	**AZ**	**6.4%**
23	**HI**	**4.1%**
31	**ID**	**3.6%**
38	**UT**	**3.1%**
43	**OR**	**2.8%**
44	**WA**	**2.7%**
49	**AK**	**1.6%**

Highest – District 12		
Merced	**CA**	**12.7%**
Riverside	**CA**	**11.6%**
Clark	**NV**	**11.1%**
San Joaquin	**CA**	**11.0%**

Lowest – District 12		
San Franc.	**CA**	**1.5%**
Anchorage	**AK**	**1.5%**
Marin	**CA**	**1.6%**
Cache	**UT**	**1.8%**

* 90+ PD & Foreclosure
Source: Lender Processing Services (LPS)

Nat'l Net Charge-off Rate for Banks Nearly Back to '90-'91 Levels… and Likely Rising

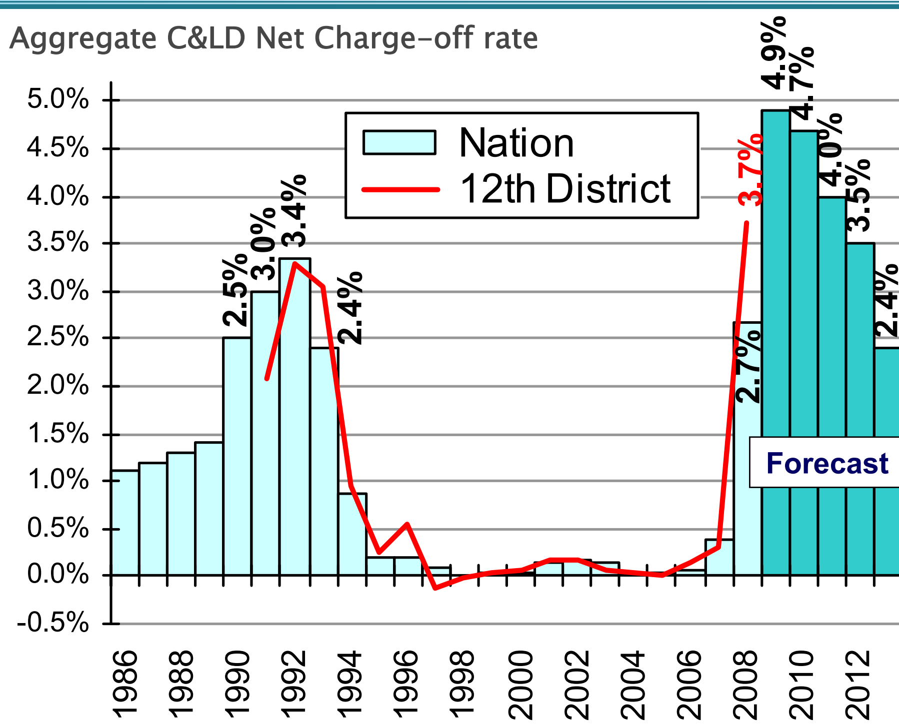


Nat'l NCO Rates 2008	
CrCard	5.5%
C&LD	2.7%
Instalm	2.3%
HEL	1.7%
Resid	1.0%
C&I	1.0%
MultiF	0.5%
CRE	0.3%
Ag	0.2%

Sources: FDIC; FRS Board of Govs

If the Entire District is Impacted Like '90s Calif, Aggregate Construction NCOs Will Exceed Prior Highs, as in this Forecast

- In this cycle,
  - More severe housing downturn
  - More overbuilding
  - Builder/developer financing is particularly difficult
  - Collapse of land values
  - Impact will be greater now because of higher concentrations

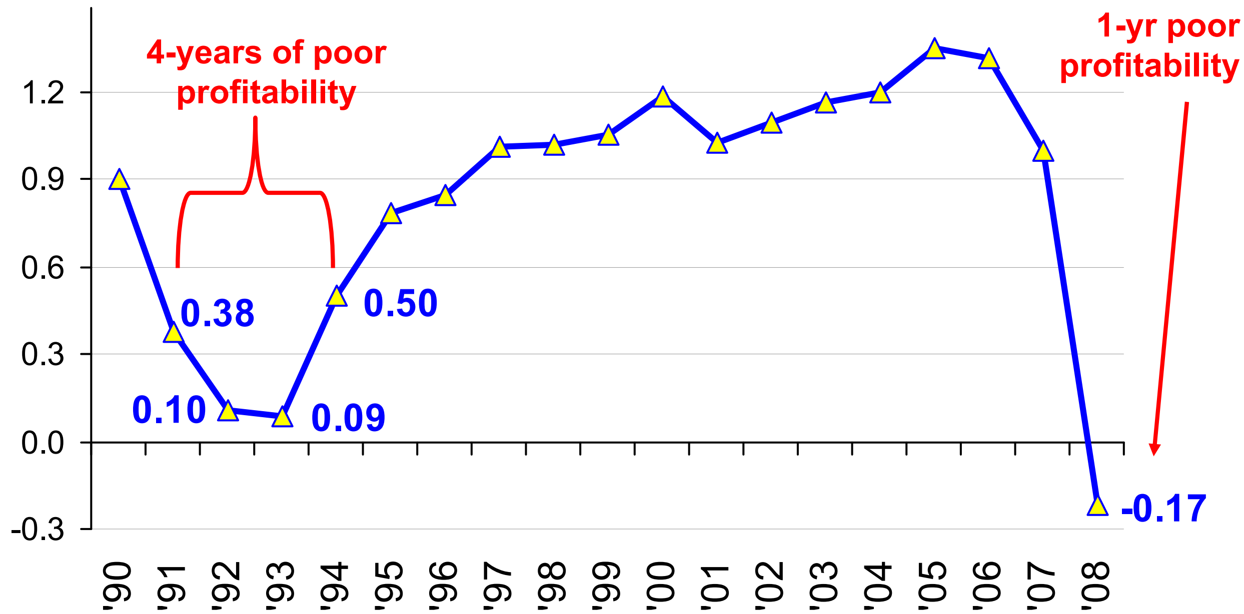


Sources: FRS Board of Govs. Summary Profile of Commercial Banks. Estimated NCO rates prior to 1991 and 2009-2013 forecasts are from Zelman & Associates.

California Bank Avg ROA was Hammered by RE Recession from '91–'94

A Historical Model that Might Repeat Itself?

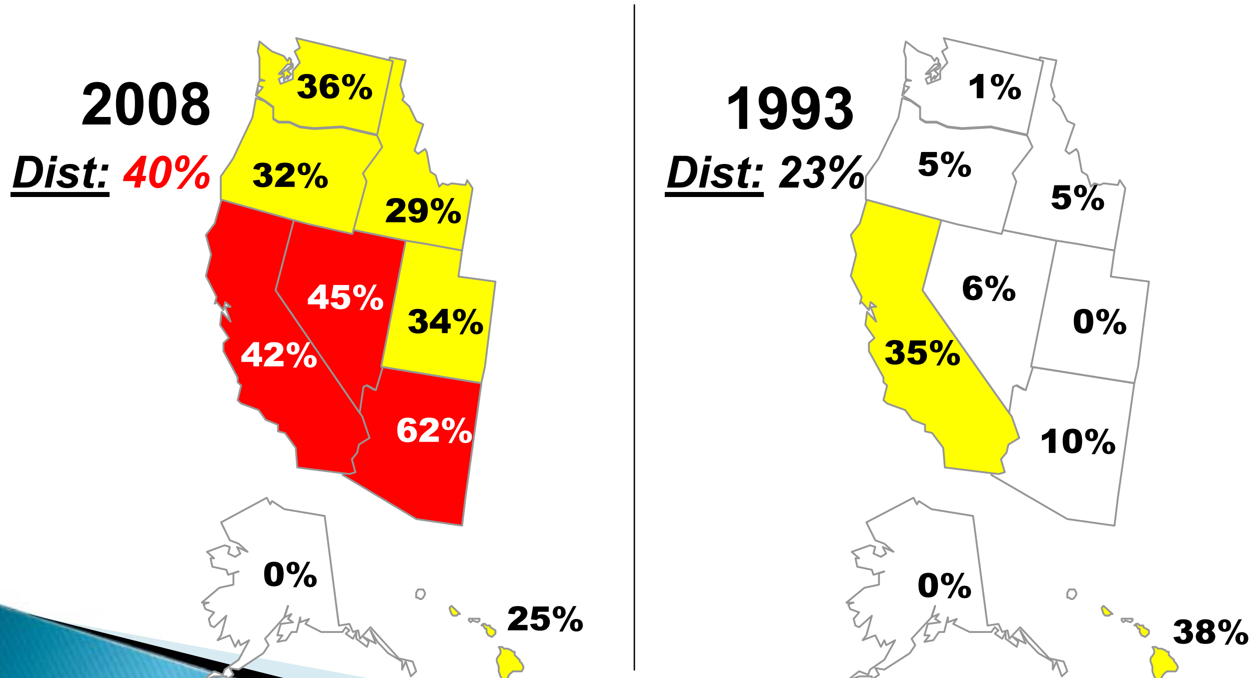
California Banks' Avg. Return on Average Assets (%)



All commercial banks excl. De Novo banks; adjusted averages (10% trim -- 5% of highest and 5% of lowest ratios are trimmed out)

Pct of District Banks Losing Money: Now + Then

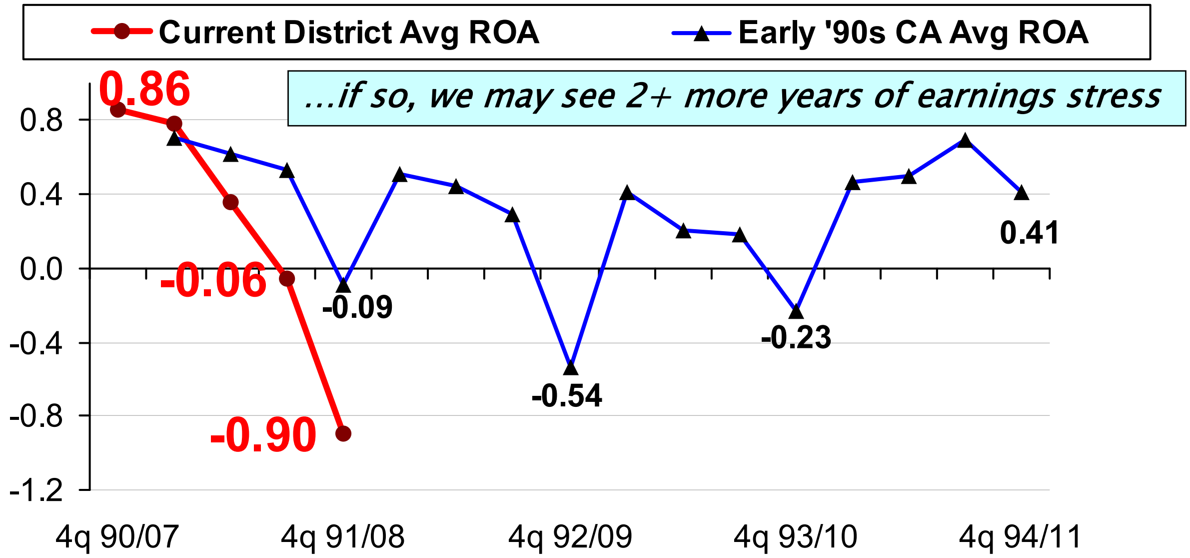
Between 1990 and 2007, the highest pct. of District banks that lost money occurred in 1993 – But 2008's percentage was sharply higher



All commercial banks excluding De Novo banks

If this Cycle Looks like the CA Bank Experience in the '90s for Dist Banks…

1-Qtr Avg. ROA (%) - Mapping 1991 to 2008, etc.



The CA bank average ROA from 4q1991 is mapped against the District bank average ROA of 4Q2008, 4Q1992 is mapped against 4Q2009, etc. During down cycles, ROA tends to be cyclical, with the strongest performance in first quarters and weakest in fourth quarters. A pattern similar to the early 1990s is possible during this down cycle.

All commercial banks excl. De Novos; adjusted averages (10% trim)

What's it mean for banks?

- The current deep recession with heavy job losses, combined with rapid deflation of RE values is a bad recipe for banks
- This down credit cycle may be similar (or worse) in magnitude + duration to CA in the early '90s with all credit areas impacted
- C&LD loan quality will remain the main credit issue for many District banks, like the early '90s

Current C&LD NCO rate of 2.7% - could rise to 4-5% per year

- Other CRE: Sharp deflation in values, growing supply/demand imbalances & refinance issues to cause rising losses, but likely well lower than C&LD

Current CRE NCO rate of 0.3% - could rise to 1-3% per yr

- Other loan categories also to suffer. In short, a challenging time for banks for the next 2-4 years – more rating downgrades

(4)

Ways that Market Information is Used by Bank Supervisors

Ways that RE Market Information is used by Supervisors
EXAMPLES

On-Site Examinations & Prep

- Examiners review local economic & market conditions prior to exam work for an environmental assessment
- Examiners compare assumptions contained within individual loans files with market data and forecasts (e.g. occupancy levels, absorption rates, rent trends, cap rates, etc.)

Portfolio / Multiple Bank Analyses

- Apply market data to determine loans to emphasize during on-site loan review – focus more resources on loans in weaker / vulnerable sectors
- Conduct stress tests; e.g. by applying results from Moody's Commercial Mortgage Metrics to bank portfolios

Q & A – part 1

Questions for Credit Risk Coordinator Wally Young

- In declining markets, how often should banks obtain updated appraisals on CRE properties?
- If CRE values fall by 35%-50% as suggested earlier, and the LTVs on many performing credits rise above 100%, will examiners classify these credits?
- What are the biggest problems examiners are seeing with the allowance for loan & lease losses?
- In what situations is it okay to extend additional interest reserves on construction or development loans?

Q & A – part 2

Ask questions on the conference call, or send an email before or during the call at:

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