



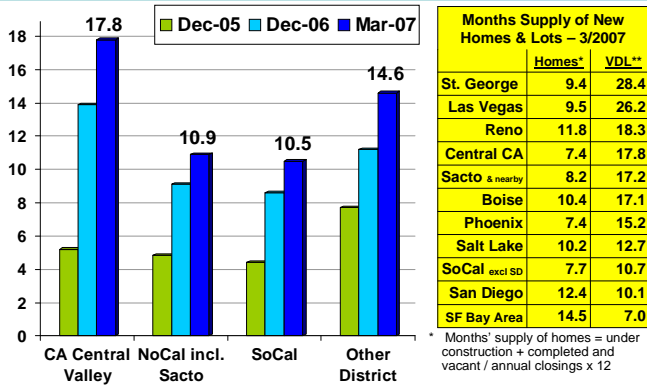
# Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

## I. Housing Slowdown: Feeling the Impact in AZ, CA and NV

Figures 1-2: Not long ago, housing markets were booming and economists' models found many Western MSAs to be highly vulnerable to price correction. According to one model, eight of the ten most "overvalued" MSAs were in CA (mostly Central) and one was in AZ<sup>1</sup>. Given current regional price trends, it looks like these models were fairly accurate. Not surprisingly, inventories of vacant developed lots<sup>2</sup> have expanded, particularly in NV and CA's Central Valley. Rising months' supply trends have been influenced both by surging vacant lots and by falling starts. In the Central Valley, vacant developed lots grew by 122% since 2005 while annual starts fell 35%. It will take many months to work down both vacant lot and new home inventories to normal levels. Home price trends have been (and likely will remain) weakest in CA, NV, and AZ; however, this follows years of tremendous appreciation, so the broad economic impact may remain fairly muted. Home appreciation remains strong (but decelerating) in most of UT and the Pacific NW.

### 1) Months' supply of vacant developed lots surged since 2005

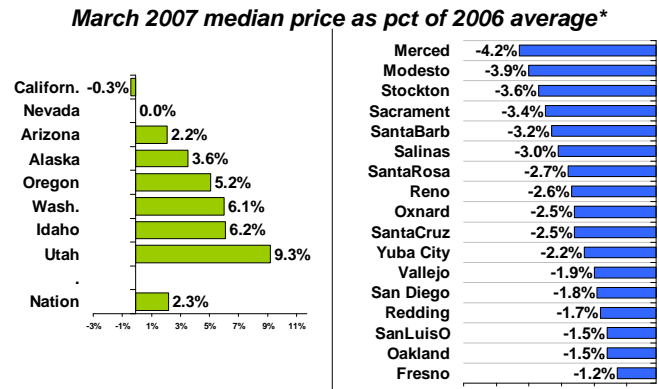


Source: Metrostudy; Other District includes major markets in AZ, ID, NV and UT

MSA	Months Supply of New Homes & Lots - 3/2007	
	Homes*	VDL**
St. George	9.4	28.4
Las Vegas	9.5	26.2
Reno	11.8	18.3
Central CA	7.4	17.8
Sacto & nearby	8.2	17.2
Boise	10.4	17.1
Phoenix	7.4	15.2
Salt Lake	10.2	12.7
SoCal excl SD	7.7	10.7
San Diego	12.4	10.1
SF Bay Area	14.5	7.0

\* Months' supply of homes = under construction + completed and vacant / annual closings x 12  
\*\* VDL = Vacant Developed Lots; Month's supply = VDL / Annual starts x 12

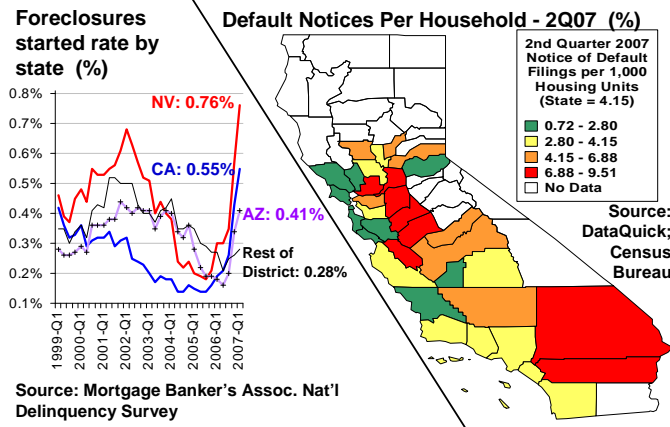
### 2) Home price trends are strong in Utah & Pacific Northwest; weak in CA's Central Valley



\* March 2007 median price of existing homes compared to the average of quarterly median prices during all of 2006; Source: Office of Federal Housing Oversight

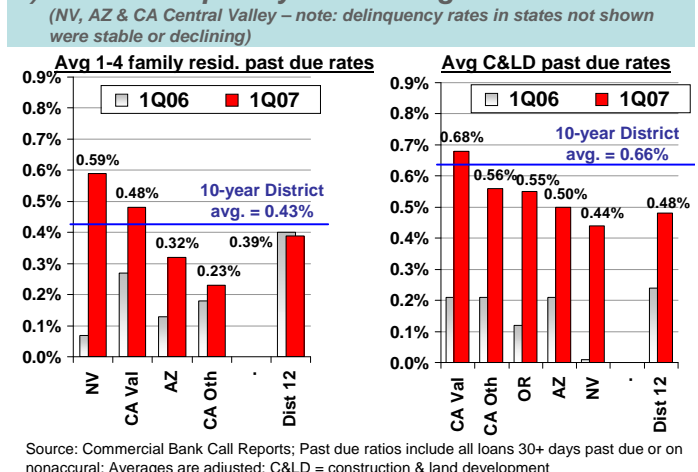
Figures 3-4: Mortgage default rates rose sharply in the past year (largely subprime related) with CA's rates generally higher with greater distance from San Francisco, San Jose or Los Angeles. At banks, delinquency rates generally moved up over the past year, led by C&LD loan<sup>3</sup> delinquencies. With reports of developer difficulties, slow home absorption rates, and lenders extending interest reserve periods, this is a lending area that needs close monitoring by banks. Fortunately, so far, C&LD loan past due rates remain modest relative to the early 1990s (CA banks' average C&LD loan past due rate peaked at a hefty 9.8% in 1994).

### 3) Mortgage defaults and foreclosure starts rising in NV, AZ, CA's Central Valley



Source: Mortgage Banker's Assoc. Nat'l Delinquency Survey

### 4) Bank delinquency rates rising in some areas



Source: Commercial Bank Call Reports; Past due ratios include all loans 30+ days past due or on nonaccrual; Averages are adjusted; C&LD = construction & land development

<sup>1</sup> Global Insights/National City valuation model, 1Q2006;

<sup>2</sup> Vacant Developed Lots: lots where underground utilities have been installed and the street in front is paved

<sup>3</sup> C&LD Loans: Construction & land development loans

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## II. Condos & Commercial Real Estate

**Figure 5:** An increasing condominium oversupply in many MSAs bears watching as the number of units under construction has surged. Developers are having difficulty selling units and many buyers (often investors) are backing out of their sales contracts. Consequently, a significant supply / demand imbalance may persist in many markets for the next year or two. This situation translates into higher than normal credit risk in condominium project financing (acquisition, conversion, construction). However, the market has started to self-correct, as we've seen an upsurge in abandoned and deferred projects in recent quarters.

**Figure 6:** Aside from the weak condo market, the major CRE property sectors continue to perform well. Rents and occupancy rates have edged up for the past three years. Forecasts call for some near-term increase in vacancy rates in most Western MSAs over the next two years as completions outpace generally slow absorption rates across property sectors. However, rent growth is expected to remain positive. Cap rates on industrial, office, and retail property transactions continued to compress through the first half of the year; however, most analysts expect them to start to climb soon (this prediction eventually will come true!) so successful CRE investing / lending may have to depend more on growing property cash flows than on declining cap rates.

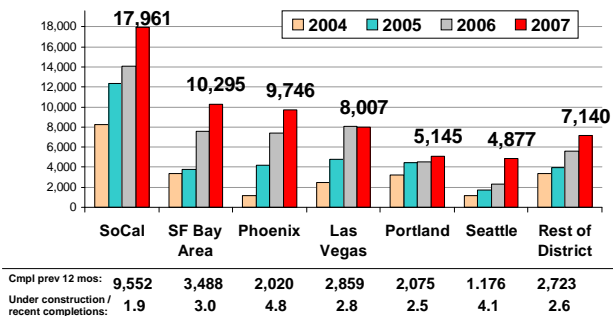
**Figure 7:** We're always searching for tools to help monitor RE credit risk, so we recently took a look at Moody's Commercial Mortgage Metrics. Users enter loan and property parameters and the model calculates loss metrics (e.g. default probabilities). We created various generic CRE loans and "placed" them across the West. The results are generally as expected: low cumulative expected loss rates with some isolated exceptions. The hotel sector is riskiest due to weak or declining cash flows and values in some MSAs (mainly due to new supply being added). The Bay Area's office rents are well down from 5 years ago, so the model predicts declining cash flows as leases roll over, and therefore higher credit risk. We haven't seen any significant CRE-related losses in hotels or the Bay Area, but the model's results are worth keeping in mind.

Bank processes to identify, measure, and monitor loan risks have increased in importance given elevated bank CRE and C&LD exposures and a soft housing market.

For more info, see recent regulatory guidance: CRE concentrations (SR 07-1), subprime lending (SR 07-12), non-traditional mortgages (SR 06-15) at <http://www.federalreserve.gov/boarddocs/srletters/>.

### 5) Condominiums under construction continue to climb despite soft residential market

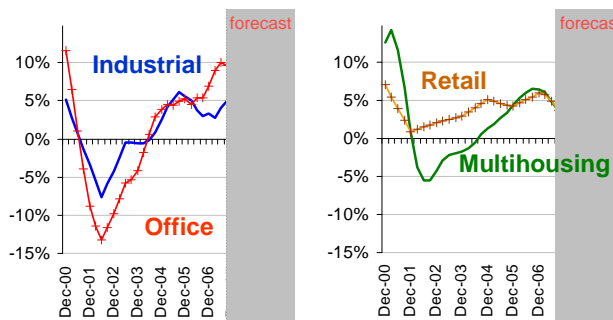
Number of condominium units under construction



Source: Dodge / TWR Pipeline; shows number of condo units under construction within 12<sup>th</sup> District MSAs as of April or May of each year

### 6) CRE fundamentals are good: Rent growth expected to slow, but remain positive

Rent appreciation rates in 12<sup>th</sup> District MSAs (1-year change in rent indices)



Source: Torto Wheaton Research, Summer 2007 Outlook – Aggregation of rent data for 15-17 MSAs in the 12<sup>th</sup> Federal Reserve District

### 7) What a credit risk model tells us about the CRE outlook (Moody's Commercial Mortgage Metrics)

Cumulative Expected Loss Rate for a fixed rate CRE loan originated 3 years ago with a 75% LTV and 1.3x DSCR

MSA	Office	Industrial	Multihousing	Retail	Hotel - Ltd Service
Honolulu	0.5	--	0.6	1.8	1.7 (full srv)
Las Vegas	1.8	0.7	0.8	1.3	--
Los Angeles	0.6	0.3	0.8	1.0	2.0
Phoenix	0.9	0.7	0.6	1.3	2.1
Portland	1.3	0.5	0.8	1.4	2.4
Salt Lake Ct	0.8	0.5	0.8	2.3	--
San Diego	1.2	0.5	0.9	1.1	2.4
San Francis.	3.3	0.6	0.5	2.5	1.4
San Jose	5.9	0.4	0.2	1.6	--
Seattle	1.1	0.6	0.6	1.5	1.8
Nation	1.0	0.7	0.8	1.5	2.4

Source: Moody's / Torto Wheaton Research CMM, Summer 2007

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