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Are commercial real estate loans going to hurt banks?

Regulators target loan standards to avoid bust

By Sue Kirchhoff
USA TODAY

Collman & Karsky Architects of Tampa has increased its staff by nearly a third since late 2004, trying to keep pace with surging demand for sleek new office, condo and retail buildings.

"The vacancy rate for office space is in the 10% range (or lower). As that approaches down to the 6% range, we're going to be seeing more speculative office buildings," says Rodney Collman, a principal at the firm, discussing local conditions. "We still have about 1,000 people a day moving into Florida. We've got a lot of housing needs."

Cover story

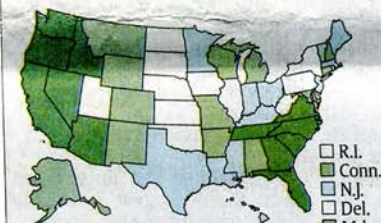
Commercial real estate has surged after several down years. That's good news for the economy and firms like Collman's. But it's worrying federal officials, who note many banks are carrying a heavier concentration of real estate loans today than they did during a heady 1980s boom — a boom that ended in a bust, forcing many lenders out of business.

In Georgia, commercial real estate loan concentration (a definition that includes housing activity) is at record levels, soaring from \$7.5 billion and 40% of bank assets in 1996 to \$34.5 billion and 61% in 2005, the Federal Deposit Insurance Corp. says. In Florida, construction and development loans grew 66% in 2005. In Wisconsin, 87% of lenders boosted commercial real estate portfolios

More loans, more construction

More banks are carrying commercial real estate loans as construction starts enjoy an upswing. Construction and development loans as a percentage of Tier 1 bank capital:

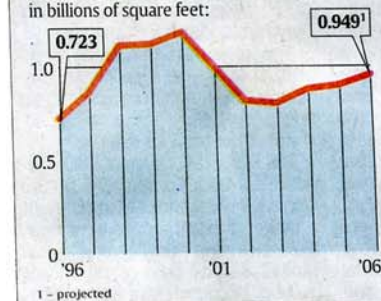
- 3.9%-20.8%
- 20.8%-37.9%
- 37.9%-65.0%
- 65.0%-187.9%



1 - Consists of trust securities, qualifying preferred stock and minority interests in consolidated subsidiaries, minus some adjustments. Source: FDIC

Construction starts

Total commercial construction starts, in billions of square feet:



Source: McGraw-Hill Construction By Karl Gelles, USA TODAY

Analysts say there's no substitute for tighter rules

in the past year.

Nationally, in the mid-'90s, 15%-20% of federally insured banks had what regulators consider a heavy load of commercial real estate loans. In 2005, it was 40%, the FDIC says.

Cover story

"For banks in the moderate-sized ranges and smaller, what we're seeing is that the amount of capital committed to commercial real estate has basically more than doubled from the year 2000 and that ... these loans today represent three times capital," says Federal Reserve Gov. Susan Schmidt Bies, a former bank official. "Back in the worst times of the '80s, it was one-and-a-half times capital."

Capital generally refers to bank equity, loan loss reserves and certain forms of debt.

Tightening loan standards

Determined to avoid a reprise of the 1980s, regulators are tightening standards for commercial real estate lending. While such loans are generally performing well and bank profits are healthy, Bies and other officials warn that the industry is entering a time in which problems are most likely to crop up. Interest rates are rising and a wave of just-completed office, condo and other buildings are coming to market, which could affect rents and prices.

Lenders are fighting the efforts, particularly smaller banks that see real estate as one of their best chances to compete effectively with huge, national lenders. Industry representatives, who have filed hundreds of comments on the plan, note that banks are better managed than during the '80s and that part of the development during that period was fueled by ill-advised federal tax cuts, later repealed.

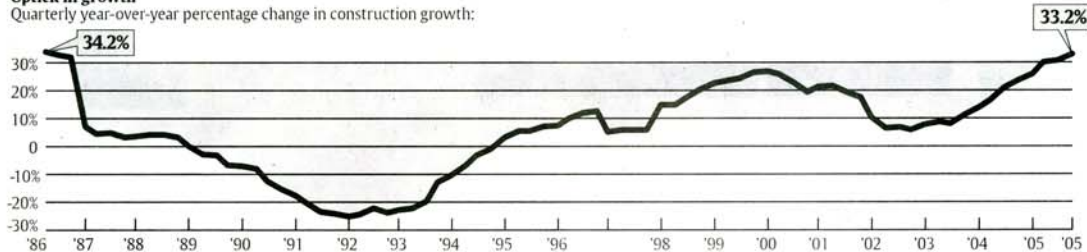
"Community banks are saying, 'If you take this line of business from us, you're running the risk of essentially putting us out of business,'" says Mark Tenhundfeld, director of the American Bankers Association Office of Regulatory Policy.

David H. Wells Jr., president and CEO of K Bank, a \$650 million commercial bank in Owings Mills, Md., says the federal effort has already affected his business. He's decided to hold back a bit due to uncertainty about the regulatory climate and signs of softening in housing.

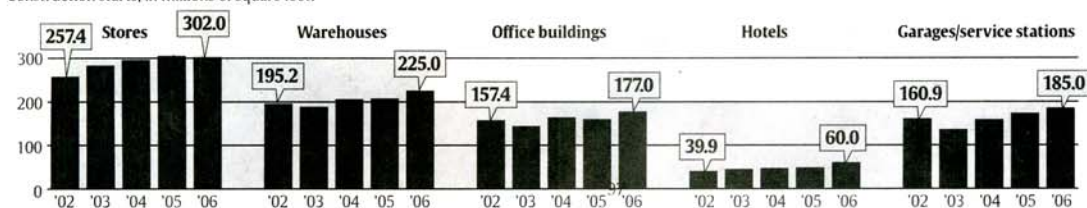
Building up commercial construction

Uptick in growth

Quarterly year-over-year percentage change in construction growth:



Construction starts, in millions of square feet:



Sources: McGraw-Hill Construction and FDIC

"What they've done is to throw a bucket of cold water over the whole business," Wells says. "We're certainly not going to get any more concentrated."

Industry analysts agree that banks are more cautious than two decades ago. But given the up-and-down nature of the real estate market, some say there's no substitute for tighter regulation of portfolios.

"The concentration in real estate exposure in the industry has always been fairly high, but right now it's at an all-time peak," says Khanh Vuong, a senior financial analyst at AM Best, which rates the financial condition of insurers and, increasingly, banks. It issued a report calling concentration a "powerful risk" to bank earnings. "Market conditions are softening."

Construction picking up

Commercial real estate slowed several years ago but has been coming back. U.S. office vacancy rates, now the lowest since the 2001 recession, will average 11% by the end of 2006. That's down from more than 14% in 2005. An estimated 31,000 hotel rooms are expected to be added in 52 markets studied in 2006, up from 3,852 in 2005, the National Association of Realtors says.

Retail building is near a record high, according to Robert Murray of McGraw-Hill Construction.

"There's been a sense that this has been a more disciplined real estate cycle, compared with 10 to 15 years ago," Murray says, with a

greater share of buildings pre-leased or sold. He adds, however, that more office buildings are under construction, which is "starting to generate some concern."

The American Institute of Architects' monthly index of billings shows activity expanding. Architecture billings are a sort of leading indicator, with changes in activity presaging by about nine months either a slowdown or speedup in construction activity.

"We've seen no signs so far that acceleration (in commercial real estate) is starting to wane," says Kermit Baker, AIA chief economist.

Michael Sullivan of OWP&P Architects in Chicago says conditions are healthy, with some firms constructing new office buildings in the suburbs. "I certainly have not heard that clients are having difficulty on the financing side," Sullivan says.

Rents for commercial real estate have been surging, according to Global Real Analytics. Warehouse rates in Las Vegas rose 13.7% from the first quarter of 2005 to the same period in 2006. Retail rents in Honolulu were up 13.4% and office rents in San Francisco's central business district were up 12.5%.

Still, Detroit and Cleveland were struggling, while some commercial real estate properties in Atlanta, Dallas, Chicago and Norfolk had lagging rents, Global Real Analytics says. Further, housing is slowing, and there are fears about a glut of condos in Florida and other areas.

Commercial real estate has been a support to community banks, which have been losing traditional business to big institutions.

In 1985, community banks had 33.6% of consumer and mortgage loans, midsize banks had 49.8%, while the nation's biggest 25 banks had 16.6%. By 2003, the community bank share was 11.6% and the midsize share 29%, while the big

banks had 59.4%, the FDIC says.

"I wouldn't describe it as alarming, I would describe it as a natural reaction" to a good economy and record home market, says Steve Fritts, director of risk management policy at the FDIC Supervision and Consumer Protection Division. But he adds that "loans may be very good loans individually, but as (concentration) has grown, banks haven't necessarily built up the management systems."

Taking account of risks

Overbuilding can force down rents. Rising interest rates may make it more difficult to sell a property or complete a project. Foreign capital and pension funds chasing investment properties, along with banks competing for business, may push prices too high and erode lending standards in some areas.

The regulators' guidance is intended to ensure that banks consider a range of factors as their real estate portfolios grow, taking account of the broader risks.

The Fed, FDIC, Office of Thrift Supervision and Comptroller of the Currency want banks to implement a range of risk management controls, including possibly beefing up capital, if they have a significant number of commercial loans. Commercial real estate is defined as loans secured by land, development and construction (including commercial and residential) and loans on existing properties like apartments, retail and offices.

They emphasize their focus is on the most volatile slice of the business: loans whose repayment depends on rental income, proceeds of a sale, or permanent financing or refinancing of the property.

The guidance for the first time has benchmarks for identifying whether a bank's portfolio may be becoming overly heavy in real es-

tate. Under one marker, banks with construction and development loans totaling 100% or more of risk-based capital would have what regulators call a potential concentration. Banks with construction, multifamily housing and commercial real estate loans at 300% or more of capital also would be potentially concentrated.

Based on the potential risk, banks would be expected to have appropriate controls such as clear risk standards, oversight by their bank board, strategic and contingency planning for downturns, and adequate capital and reserves.

Regulators emphasize the benchmarks are not a cap. They also say most banks are already well capitalized.

"In my opinion they're overreacting," says David Holmstrom, senior vice president for commercial lending at Golf Saving Bank in Seattle. The bank, initially a mortgage lender, is now active in residential and commercial real estate.

According to AM Best, under the proposed federal definition, Golf Saving Bank would have a construction lending concentration of more than 600% of capital.

Holmstrom says it's no surprise, given the nature of its business. He says the bank already has many of the management controls regulators suggest, though it would probably have to beef up its systems.

"Seattle is our primary market. The economy is in good shape; the prospects (for real estate) are in good shape, too," Holmstrom says.

Robert Lavoie, attorney for Devine Millimet who chairs the real estate practice group for the firm that is active in New England, says he has seen some softening in the Massachusetts market in the past six months to a year, particularly in the housing end.

"The bubble that burst in the 1980s was a shock for most of the lenders that lived through that. There were deals in the '80s that were surprising then and have not been repeated," Lavoie says.

The guidance could change after regulators weed through hundreds of comments. Bank officials complain the new concentration formulas mix lower-risk loans for housing with higher-risk speculative office or retail developments.

Joe Brannen, president of the Georgia Bankers Association, thinks current state and federal inspections are adequate and wants federal regulators to pull the guidelines and perform a study.

"We see no hint of overbuilding here," Brannen says.

Still, AM Best notes that more than 60% of banks in California had lending concentrations above the 300% threshold, some with commercial loans at more than 1,000% of capital.

"Banks are much better equipped in terms of managing the risk. . . . Having said that, the cyclical effect of this asset class remains," says Vuong. "You can mitigate a risk, but the risk is still there."



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