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I am pleased to be here on behalf of the Federal Reserve Board to discuss real estate lending by commercial banks and its effects on their financial condition. The Committee is, I am sure, well aware of the many problems that banks and other depository lenders have had with real estate loans in the last five years or so and is understandably concerned about the prospects of these problems continuing. In my comments I shall provide a brief overview of the trends and developments of real estate lending over this decade, and then discuss the evolution of conditions in the real estate markets and the dimensions of the problems they have presented to banks. I will also address some supervisory considerations and the effects recent actions by banks are having on the availability of bank credit.

Commercial Real Estate Lending in the 1980's

Real estate markets were generally robust over the decade of the 1980's. Growing demand produced sizable increases in property values and prompted substantial growth in construction of new commercial and residential structures. Commercial banks, thrift institutions, insurance companies and other major lenders, including foreign institutions, played important roles in this process, providing funds for the construction and sale of new properties and for the transfer of ownership of existing properties at rising values.

For the decade as a whole, real estate loans at all commercial banks almost tripled, reflecting a particularly sharp rise in commercial and construction loans, while total assets of commercial banks grew at a much slower pace. By the end of the decade, real estate loans made up about 23 percent of total bank assets, compared with less than 15 percent at the end of 1980. Commercial property and construction loans now account for roughly one-half of the $778 billion of total real estate loans held by commercial banks.

States in which the energy sector was large, particularly Texas, Oklahoma, Colorado, and Louisiana, were in the vanguard of the strong real estate expansion of the early 1980s. These strong economies stimulated sharp increases in construction of commercial and residential properties. Once underway, the construction boom maintained momentum even as the energy sector lost strength. This continued construction was encouraged by the substantial optimism that prevailed in these sunbelt states arising from their increases in population and general income levels.

The ready availability of credit bolstered this process. S&Ls in the region, seeking to overcome weak capital positions and deficient earnings aggressively extended credit for many projects. Commercial banks in the region were also active in real estate lending, as they sought to replace revenues previously earned on loans to firms in energy and related sectors. Major banks from other areas of the country and abroad also added to the supply of credit.

Other regions, as well, found real estate lending attractive areas for growth. Responding to the general expansion in economic activity and the favorable tax laws embodied in the Tax Reform Act of 1981, real estate markets gained strength. From year-end 1980 to the end of 1984, commercial real estate lending nationwide grew at a rate roughly twice the pace of total bank assets. By the mid-80s when Southwest real estate markets were beginning to slow, markets in most other parts of the country were still growing at a brisk pace. Here again, the general economic expansion and the willingness and ability of financial institutions, both domestic and foreign, to finance real estate projects on favorable terms played an important role.

By the end of the decade the pace of expansion had slowed. In the last few years, the supply of real estate has exceeded demand, with consequent effects on vacancy rates, property values and rental rates. To date, these developments have been most pronounced in the New England region, although, weak market conditions exist along much of the east coast, as demonstrated by high and rising office vacancy rates. Market conditions in some midwestern cities have also begun to show a marked loss of strength, and even the western states of California, Oregon and Washington, long the beneficiaries of strong real estate markets, have begun to report increased office vacancy rates in at least some areas.

These weakening market conditions are reflected in higher real estate losses for banks. During 1989, real estate charge-offs at commercial banks rose 54 percent from the prior year to almost $3 billion and totalled $1 billion in the first quarter of this year, alone. The Northeast (excluding the large New York City banks) has replaced the Southwest as the latest area of concern and accounted for almost one-half of the industry's first-quarter real estate losses. Nonperforming real estate loans also continue to mount, increasing by 37 percent last year and by another 8 percent to $32 billion in the first-quarter of this year. Nonperforming real estate loans now account for nearly one-half of all nonperforming loans held by U.S. commercial banks.

Reasons for the Robust Real Estate Markets

Given the problems that certain types of real estate loans have caused and the risk they still present, it is fair to ask why banks pursued this strategy and how some of the large real estate loan problems seem to have surfaced so suddenly. While there are no single or simple answers to these questions, several factors played important roles.

Disintermediation. During the 1980s, U.S. commercial banks--especially the larger ones--increasingly lost the business of their larger and stronger commercial borrowers to the commercial paper and securities markets. In the Southwest, as previously noted, this loss was compounded when demands by energy-related firms dropped as oil prices started to come down.

Generally, the proportion of bank loans to commercial and industrial (C&I) borrowers declined over the decade, relative to other bank assets. During the last five years of the 1980s, for example, these loans fell from 20 percent of assets to 17.6 percent, with the New York money center banks much more severely affected. Increased real estate lending offered a way to offset revenue losses in other parts of their loan portfolios and bolster overall earnings.

Increased fee income. Banks were also attracted to real estate loans because of the substantial fee income they could earn on these loans. Fees on real estate loans are typically higher than those on other types of corporate credits, and before accounting standards changed in 1988, many of these fees could be recorded "up-front", providing an immediate boost to earnings. In other cases, the fees provided, in addition to immediate income, an ongoing source of revenues.

<u>Strong demand.</u> Demand for residential structures and for additional office, retail, and industrial properties rose rapidly in various areas in the middle part of the decade. Office space in the early 1980s, for example, was far below that needed for the decade. Looking back to the 1970s, developers and many others, including lenders, had the view that inflation would work to make almost all projects profitable. In the face of the relative shortage, developers moved decisively to put in place added structures. Supply soon began to catch up with demand, and during the last half of the decade 40% more office space was built than absorbed.

Tax law treatment introduced with the 1981 law and kept in place until the reform of 1986 also contributed to the building boom by subsidizing the cost of real property. Some analysts estimate that before the new law, more than half of the return to taxable investors came from tax benefits, rather than from higher economic values. Increased demand from abroad for U.S. real estate holdings also supported property values and helped to encourage new construction.

Effect of Strong Lender Competition on Credit Availability and Lending Terms.

The perceived need to find new business, the ability to generate real estate loans, and the appeal of larger fee income combined to encourage aggressive real estate lending. These factors, plus generally overly optimistic market assessments, produced favorable borrowing conditions for developers. It also led, in many cases, to more liberal underwriting standards. Some banks failed to assess realistically the economic soundness of specific projects and cashflow projections.

Construction loans that historically had been made on the basis of pre-leased space and pre-arranged permanent financing were now made without those features and largely on the basis of past relationships and on the appraised value of the underlying property. Borrower equity in projects was often minimal, and appraisals supporting the loans were sometimes based on revenue projections that did not materialize. With steady or, indeed, robust economic growth and rising real estate prices, lenders felt pressured to match "prevailing" market terms and unduly relied on the projected value of collateral as protection against loss. Some expanded nationwide, extending credit in markets in which they lacked experience.

Many lenders also seem to have focused on the strength of specific projects without giving appropriate consideration of total market conditions. Although the latest projects they were financing may have been successful, many were so only because they drew tenants from existing buildings and created problems elsewhere. Office gluts and generally lower operating costs in the southwest and other regions of the country have enticed some companies to relocate from high-cost areas, further weakening real estate markets that were already beginning to slow. Such a pattern may help cities like San Antonio and Houston revive, but only increases pressures on higher cost cities like Stamford, which already has the nation's highest metropolitan area office vacancy rate at 30 percent.

The expanded investment powers for thrifts may also have changed the nature, as well as the level, of competition. In addition to simply increasing the supply of credit available for real estate construction, these changes introduced new competitors that at least initially were inexperienced in commercial real estate lending and unable to adequately evaluate the risks. Thrifts holding equity interests had different incentives than typical lenders and often focused on the potential gains from their ownership roles and extended credits they might otherwise have denied. As long as market conditions were favorable, these actions influenced market terms.

The result of these developments has been overbuilt real estate markets in which financial institutions have been forced to finance buildings beyond the time they originally envisioned, to accept significant concessions on rents, and to face vacancy rates much higher than planned. In these circumstances, the value of the bank's collateral--often only the real estate itself--has been reevaluated on the basis of existing market conditions and has led to significant write-downs of many loans.

Bank supervision

As bank supervisors, the Federal Reserve and the other federal and state banking agencies have the responsibility to review the activities of financial institutions and to enforce sound lending and operating procedures. Doing that requires sufficient resources to attract and retain qualified personnel and the institutional will to enforce the standards set. The atmosphere of deregulation in the early 1980s led to budgetary pressures at some agencies and, in some instances, to less supervisory oversight. These effects were most severe regarding the supervision of thrifts.

Of course, adequate resources and resolve are not all that we need. Even under ideal conditions, concentrations in certain types of credits will occur because of the process we have. Bank regulatory agencies generally try to minimize their influence on credit allocation decisions and, as a general rule, do not impose limits on the different types of loans banks should make. We do, however, evaluate the policies and activities of individual banks, but try to avoid substituting our credit judgments for theirs in lending decisions, unless the need to intervene is clear. I would stress that we clearly recognize our role in protecting the federal safety net and minimizing risks that insured deposits present to taxpayers. Balancing those concerns with the objective of avoiding unnecessary interference in bank lending activities is a constant challenge to bank supervisors.

This supervisory approach recognizes that the long term interests of the economy are best served when lending decisions are made by private institutions, not government agencies. As private institutions, their own capital is first at risk, and they are more familiar with and better able to determine the credit needs of their customers than are bank examiners and other supervisory personnel.

The Federal Reserve has long had the view that a strong supervisory process is built upon a program of frequent on-site examinations that, in turn, is centered on an evaluation of asset quality. Accordingly, a key function of the examiners is to evaluate credits and ensure that banks reflect assets at appropriate values in their financial statements. While we leave credit decisions to banks, the effects of their decisions must be promptly and accurately reflected so that management receives the information it needs to respond prudently.

Recently, there has been specific interest in the procedures examiners use to evaluate real estate credits. I would say a few words about them. As with any loan, examiners first check to determine if the loan is current; that is, that the borrower has made all required payments. Examiners will then review the credit file, which should include financial statements of the borrower, a description of relevant terms of the loan, and full documentation on any collateral or guarantees the bank holds to cover its risk. Real estate loans are typically collateralized, at least in part, by the project being financed, and a current appraisal of the value of that property should be included in the file or otherwise available at the bank. The file should also include information supporting the value of any other collateral the borrower has provided.

Examiners will criticize any loan for which documentation is out-dated or incomplete or for which the borrower's ability to pay is otherwise uncertain. Real estate appraisals should be based on current market conditions and should demonstrate that the project is economically viable. Even current loans, or portions thereof, are subject to criticism if the current or likely cashflow provided by the project is insufficient to service the loan fully. That may happen, for example, if current payments are being made from an interest reserve created from proceeds of the bank loan, and the assumptions on which the loan was made no longer reflect market conditions. Indeed, any appraisals that are not realistic are ordinarily discounted and could lead the examiner to criticize the loan.

While examiners urge adherence to sound banking practices, there are practical limits to the achievement of this objective. Maintaining diversification is a good case in point. To a greater or lesser extent, all financial institutions will be affected by local conditions that may broadly affect their activities. With roughly one-quarter of U.S. bank assets devoted to financing real estate, local conditions will almost certainly affect that part of their business.

Many of the real estate losses banks have recently experienced have been identified by rigorous supervisory reviews, or of bank management's preparation for one. Some banks have been hit hard by these examinations, others have come through quite well. Most banks, though, are acknowledging that the real estate markets have changed and have reviewed and tightened their lending procedures. The effect is painful now, but it will be beneficial for the long-term. It will also reduce the risk they present to the federal safety net.

Availability of bank credit

Under present conditions, the Federal Reserve has been concerned that creditworthy borrowers continue to have adequate access to bank credit and has monitored credit markets closely. In that connection, the Chairman of the Federal Reserve, along with the Chairman of the FDIC and the Comptroller of the Currency, met in May with bank representatives to stress the importance to the economy of continued lending and to clarify that supervisory actions are not intended to prevent new loans.

In subsequent testimony Chairman Greenspan and I both indicated that while lenders had tightened their standards there did not appear to be a broad-based squeeze on credit, but noted that the Federal Reserve was monitoring the situation closely. More recently, evidence is building that conditions have become weaker. It is difficult to determine what part of the slowdown derives from higher credit standards, versus less loan demand. As the Chairman stated in his testimony of July 18, though, lending standards seem to have tightened too much. The Federal Reserve has recently taken some steps to offset the effect of these tighter lending standards.

Syndications

Questions have been raised regarding the use of loan syndications in funding real estate assets. In this regard, it should be noted that banking organizations rarely syndicate real estate loans in the same sense as they do in other types of loans, including highly leveraged transactions. Real estate loans involving more than one lender typically involve participations where _one_ lender originates the loan and sells or assigns parts of it to one or more institutions. In true syndications, _several_ institutions originate the loan, and any one of them can then participate out its own interest.

In either form, there is generally a lead lender that has the responsibility to administer the loan and to ensure that the other lenders receive sufficient information to make independent credit decisions--both before the loan is bought and throughout the period it is outstanding. Indeed, other borrowers have the responsibility to make independent decisions about the credit worthiness of the borrower and should not rely solely on the representations of the seller. Typically, the sales agreements include provisions that require participating lenders to attest to having made such independent reviews.

Conclusion

Unfortunately, real estate loans are only one of the significant risks banks in this country face. Loans to highly leveraged borrowers and to developing countries cannot be ignored. The current slowdown in real estate markets will have a dampening effect on economic activity that will be felt unevenly nationwide.

The problems that financial institutions are experiencing at this time merely illustrate the risks and uncertainties inherent in lending funds. Strong bank management and an active and sound supervisory process will help prevent many problems. Many others, though, will still exist. It is critical that banks have sufficient equity capital to support the risks they take--both to ensure their own survival and to protect the federal safety net. Ensuring adequate bank capital is an important objective of supervision and remains an important priority of the Federal Reserve.