December 3, 2009

Jobs and the potential commercial real estate problem: Still keeping us up at night

In the season of good cheer, it is certainly gratifying to know that some in the economic forecasting business are actually feeling cheerier:

> Reaffirming last month's call that the Great Recession is over, NABE [National Association for Business Economics] panelists have marked up their predictions for economic growth in 2010 and expect performance to exceed its long-term trend. "While the recovery has been jobless so far, that should soon change. Within the next few months, companies should be adding instead of cutting jobs," said NABE President Lynn Reaser, chief economist at Point Loma Nazarene University.

While we at the Atlanta Fed agree that the recession has likely ended, we wish we could feel as optimistic about the current jobs outlook. We've catalogued those concerns before—here, for example—but we continue to look for reasons to believe that our pessimism is unwarranted.

As was noted in a recent speech by Federal Reserve Chairman Ben Bernanke, weak bank lending remains one potentially significant headwind impeding the jobs recovery:

> "… reduced bank lending may well slow the recovery by damping consumer spending, especially on durable goods, and by restricting the ability of some firms to finance their operations."

Among the factors restricting lending, "… with loan losses still high and difficult to predict in the current environment, and with further uncertainty attending how regulatory capital standards may change, banks are being especially conservative in taking on more risk," Chairman Bernanke said.

One area where bank loan losses are potentially high and uncertain is commercial real estate (CRE). As highlighted in a macroblog post from October, if the CRE problem falls disproportionately on financial institutions that also finance small business activity, we will be all the more worried that "the post-recession employment boost [small] firms typically provide may be less robust than in previous recoveries."

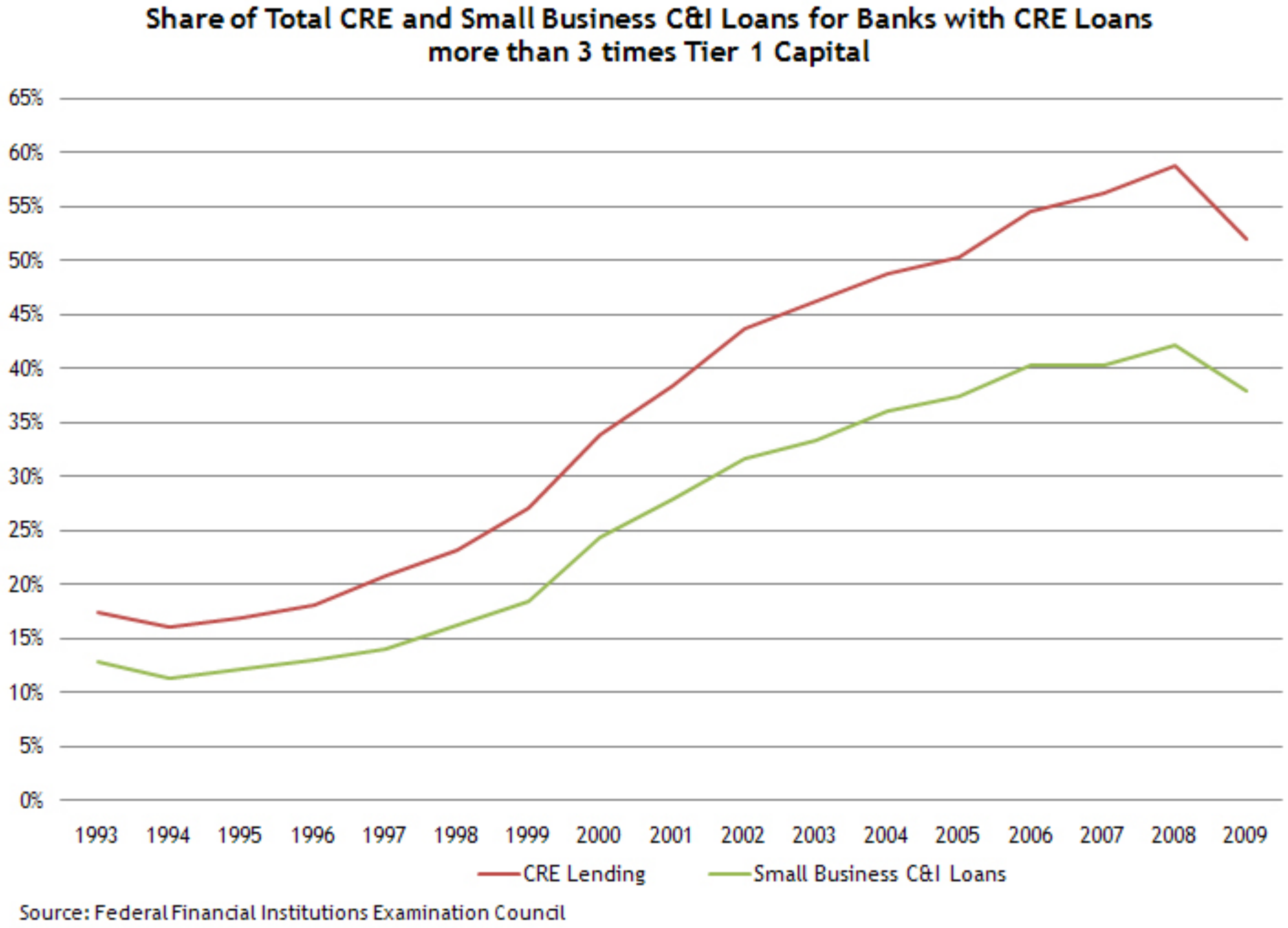
In fact, as Atlanta Fed President Lockhart noted in a speech last month, as of mid-2009 the banks with high exposure to CRE (relative to tier 1 capital) accounted for about 40 percent of commercial and industrial (C&I) loans to small businesses.

Underneath that statistic are a couple of additional facts that also have our attention:

1. Over time, CRE loans have become increasingly concentrated in those banks whose CRE lending activity is high relative to their available capital. As of June 2009, banks with CRE loan books more than three times their Tier 1 capital level accounted for 52 percent of the $1.6 trillion of CRE loans in bank portfolios. Though this is lower than the 2008 peak of 59 percent, it compares to just 17 percent in 1993.

2. Small businesses that rely on bank loans for credit are much more likely to be affected by a bank's CRE exposure than in the past. In 1993, banks with CRE loan books more than three times their Tier 1 capital accounted for just 11 percent of total small business C&I loans. But this share increased to 42 percent in 2008 and stood at 38 percent in June 2009 (of a total of $281 billion of C&I loans to small businesses).

The following chart summarizes these two observations.



Thus, both commercial real estate loans and small business C&I loans are much more concentrated in banks with relatively lower levels of capital than has been the case in the past. Combined with our previous observation that a relatively high fraction of small business loans sit in banks with significant exposures to commercial real estate, these facts do not strike us as a case for optimism regarding the near-term outlook for growth in small business borrowing.

Perhaps today's job summit will result in additional ideas to counter what we see as a serious drag on job creation in the near term. And, of course, tomorrow's employment report could show signs of improvement in labor markets. That would be good news.

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