July 10, 2013

## Why Housing Rebound May Continue at a Slower Rate Than Hoped For

Perhaps it's because I've worked with bank examiners for many years, but I often question financial news that seems too optimistic. On July 1, 2013, the U.S. Census Bureau reported that overall construction spending increased in May. Private residential construction, which generally leads the economy, grew 24.4 percent from May 2012 to May 2013. Beyond being cautious with one data point, I think that there are several reasons why housing's rebound may be slower than hoped.

To be clear, residential real estate conditions have been improving, albeit from record low levels of activity. Sales of both new and existing houses have been trending up recently, but remain near historically low levels. Additionally, the quantity of new and existing homes readily available for sale is low. Homebuilders in the Sixth Federal Reserve District (which includes Alabama, Florida, and Georgia and parts of Louisiana, Mississippi, and Tennessee) recently reported that new home sales and construction have been ahead of year-earlier levels and that buyer traffic remains strong (see this *SouthPoint* post). Builders noted, however, that access to financing and a shortage of developed lots continued to constrain construction activity. In conjunction with the recent construction spending data release, it is this last point that I aim to dig into a bit deeper in this blog post.

Since the housing bust, construction and development (C&D) lending has been in sharp decline in terms of aggregate dollars and as a percent of total bank assets. Using year-end data, we find that C&D loans peaked in 2007 at $629.4 billion. As of 2012, they stood at $203.8 billion. As of March 2013, C&D loans accounted for 1.4 percent of bank assets, unchanged from December 2012 and the lowest level since at least 1991. The decline in C&D lending is broad based given that similar trends are seen for banks under and over $1 billion in total assets. With the recent reports of growing construction spending, will bank lending practices dampen construction growth going forward?

Banks represent a significant funding source for homebuilders, especially nonpublic homebuilders. Using data from 1991 to 2012, there appears to be a strong, positive relationship between bank construction lending and private residential construction put in place—see the chart. Of course, it's impossible to tell from this chart whether construction activity is responding to changes in credit supply or credit supply is responding to changes in construction demand. However, banks have been extremely tight with credit in the aftermath of the financial crisis, and there aren't many signs that banks plan to change course any time soon. So it may be reasonable to assume that a continued reduction in bank C&D lending is likely to limit future gains in construction activity.

### ABOUT

*Real Estate Research* provided analysis of topical research and current issues in the fields of housing and real estate economics. Authors for the blog included the Atlanta Fed's Jessica Dill, Kristopher Gerardi, Carl Hudson, and analysts, as well as the Boston Fed's Christopher Foote and Paul Willen.

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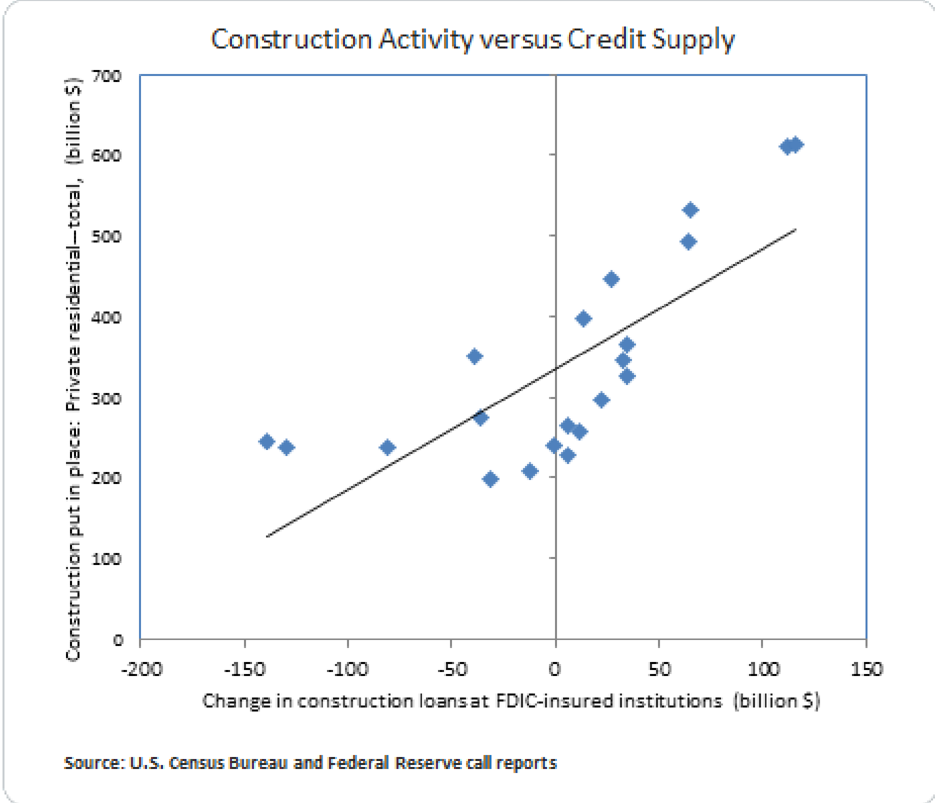


**A case for optimism**
In conversations with banks of various sizes, two things are often repeated. First, bankers indicate there is little appetite for growth in C&D lending and second, banks of various sizes want to increase commercial and industrial lending (C&I). For many banks, a move from C&D lending to C&I lending is easier said than done—the skillsets needed for C&I lending differ from those associated with C&D. Acquiring C&I expertise is a challenge particularly for smaller banks. So what's a community bank going to do?

An old adage is to do what you know best. For many community banks that would be C&D lending. Given the reports of lot shortages and house inventory being low, it would seem that profitable opportunities for C&D lending exist. There is nothing wrong with C&D loans appropriately underwritten and subject to reasonable risk management. A key question is when banks start moving back to C&D lending, will they be able to resist the shortcuts of the last cycle? Let's hope that banks can successfully navigate a return to C&D lending so that the housing market can continue to recover.

By *Carl Hudson, Director, Center for Real Estate Analytics in the Atlanta Fed's research department*

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