

Comment on James R. Barth and R. Dan Brumbaugh, Jr.'s "Turmoil Among Depository Institutions: Implications for the U.S. Real Estate Market"

William B. Brueggeman
Southern Methodist University

The paper by Barth and Brumbaugh does an excellent job of developing a framework in which the crisis facing federally insured depositories and its implications for real estate lending can be better understood. In this comment, I will amplify on major points to round out their framework and attempt to extend the implications for depository institutions and real estate lending beyond those offered by the authors.

On the deposit side, an important trend pointed out by the authors is the competition between federally insured depositories and private intermediaries. As their data show, from 1980 to the present, funds available for investment in financial assets more than tripled from \$4 billion to over \$12.4 billion, yet the share of these assets held by federally insured depositories declined from 58 percent to 39 percent. In other words, while asset growth at these institutions has increased in absolute terms, their share relative to private intermediaries has declined.

There are at least two developments that will continue to drive this trend: the increasing importance of private and public pension plans and the growing sophistication of electronic and information technology. Pension fund growth will continue because of underlying demographics in the United States and the deferral of federal taxation on income earned on pension assets until beneficiaries retire. The phenomenal growth in sophistication of electronic and information technology has made, and will continue to make, *direct* investment of these funds possible without intermediation through depository institutions. It has also given nondepository private intermediaries the opportunity to offer households alternatives to traditional deposit plans, the most important of which are money market-type funds. Depository-type intermediaries have countered with deposit choices that include money market-type plans, but the new technology has decoupled households from traditional forms of savings forever. Technological developments will continue to

confront banks and savings institutions with new forms of competition and alternatives to traditional forms of intermediation.

On the asset side of the balance sheet, another very important trend that should be emphasized is the substantial growth in the commercial paper market. Advances in information technology have streamlined the credit rating process and now allow corporate issuers to reach a broad spectrum of buyers directly or via investment banks. As a result, increasing numbers of large corporate borrowers with superior credit ratings are bypassing commercial banks and directly accessing capital at a lower cost. This direct-access market has tripled in size from about \$175 billion in 1983 to over \$530 billion at the end of 1991 (see *Federal Reserve Bulletin* 1992, especially table 1.32). The net result of growth of the commercial paper market has been erosion of the traditional, prime rate-based commercial and industrial loan market at commercial banks. Banks must now compete with one another for a smaller, riskier pool of corporate borrowers.

Technology has also made possible growth in asset-backed securitization. Asset-backed security markets now include everything from mortgages to credit card-based consumer receivables. The development of this market has enabled loan originators to offer a variety of products directly to pension, money market, and mutual funds. While some depositories participate in this market, a sizable volume of these securities are issued directly by originators or through investment banks. The growth of residential mortgage-backed securities includes pass-throughs and collateralized mortgage obligations issued through vehicles such as real estate mortgage investment conduits and real estate investment trusts from diverse originators, including mortgage bankers and investment banks as well as depository and contractual intermediaries. At the end of 1991, these pools totaled about \$1.27 trillion, up over 60 percent from \$811 billion in 1988 (see *Federal Reserve Bulletin* 1992, especially table 1.54). Mortgage securitization will continue to play a significant role in insulating the *residential* mortgage market from much of the fallout caused by the turmoil facing depository intermediaries. More will be said about this later.

In summary, during the 1980s depository intermediaries faced more competition on both the deposit side and the asset side of the balance sheet than ever before. This underlying trend, coupled with the deregulation of lending restrictions that affected savings and loan associations in the early 1980s, helped set the stage for competition *between* depository-type intermediaries. The interaction of the underlying trends in capital markets and deregulation resulted in

banks' engaging in higher risk lending activities. In addition to commercial real estate loans, these activities included loans to developing countries and loans to complete highly leveraged transactions involving mergers and firms taken private. Savings and loan institutions (S & Ls) also engaged in high-risk commercial real estate lending. The resultant cost and the failures of volume banks and S & Ls are well documented by the authors.

Commercial real estate lending activity by commercial banks deserves some additional analysis, however. Typically, these loans range in maturity from 5 to 10 years and are made at floating interest rates. As a result, these assets have historically represented something of an interest rate and maturity mismatch compared with bank liabilities. Further, because of the floating interest rates, these loans were less than attractive to real estate developers due to interest rate risk, particularly from 1981 to 1983, a period characterized by high interest rate volatility. For these reasons, construction and commercial real estate loans were an important, though not a major asset category at banks prior to 1981–83. Nonetheless, as the authors point out, from 1980 to 1992 (first quarter) commercial real estate loans, as a percentage of total assets, doubled from 5.9 percent to 10.8 percent.¹ How did this significant increase in loan holdings occur in light of their previous relative unattractiveness to both lenders and borrowers?

The answer lies partially in an important development in *financial technology* that occurred during this period—the explosion in the interest rate swap market. Access to the interest rate swap market effectively allowed banks to make longer term loans at floating rates to developers who swapped their variable payments with counter-parties for fixed payments. As developers and counter-parties engaged in a sequential series of swaps, banks continued to receive the payments needed to cover variable interest costs on a base of short-term deposits, while simultaneously providing borrowers with fixed interest rates for longer effective loan periods. The role of this swap market in the expansion in commercial real estate lending cannot be overemphasized in trying to understand the current condition of depository institutions.

Growth in commercial real estate lending at commercial banks can also be attributed to competition for market share with savings and loan associations. Information and electronic technology enabled

¹This category includes land development and construction loans as well as mortgages on commercial and multifamily properties.

U.S. money-center banks to expand loan syndication activity to include foreign investors, particularly Japanese banks and insurance companies, as well as regional U.S. banks. This syndication activity enabled U.S. money-center banks to diversify loans and spread default risk.

Barth and Brumbaugh correctly document the extent to which depository institutions are exposed to the commercial real estate market. Their estimates of the total cost of future takeovers of banks and S & Ls are certainly plausible. Additional support for their estimates can be seen in recent Federal Deposit Insurance Corporation (FDIC) data, which show that as of the end of the second quarter of 1992, delinquency rates on commercial real estate loans at commercial banks are in the range of 8.2 percent. When real estate owned (REO) by banks as a result of voluntary and involuntary foreclosures is included, this ratio increases to over 13.5 percent (Federal Deposit Insurance Corporation 1992). Banks are currently insulated to some degree from poorly performing loan portfolios because of recent declines in interest rates. This decline is providing banks with gains from the sale of fixed-income securities and a healthy spread relative to their cost of funds. During this favorable period, banks should be systematically reducing their exposure to the commercial real estate market by selling and securitizing commercial mortgages. This strategy may be preferable to waiting for rents on commercial properties and delinquency rates to improve. The risk that banks are currently taking may worsen if the interest rate spread narrows before commercial real estate markets correct.

What does the current financial condition of depository institutions imply for future real estate lending, both on commercial and residential properties? While the answer to this question depends considerably on the long-term outlook for U.S. economic growth, an area of major uncertainty at this time, a few observations can be offered. As for the commercial real estate market, there will be little demand for new commercial construction lending because of vastly oversupplied property markets. I estimate that the market value of commercial properties in the United States has declined, or will decline, by at least 30 percent because of this oversupply. Assuming that real economic growth resumes at an annual rate of 2.5 percent, commercial property markets may require eight to nine years to correct—that is, to achieve normal vacancy levels. Consequently, the outlook for commercial mortgage financing will be more loan workouts and administration and little new lending. In that regard, the so-called “credit crunch” in commercial real estate is really an old term misapplied to the current difficulty that real estate

developers are having getting refinancings approved as loans on commercial properties mature. This crunch is due not so much to a shortage of available bank credit as much as to increasing default risk on loans in the commercial real estate sector. Market conditions have deteriorated so significantly that when lenders reevaluate these loans they find that default risk has increased substantially since the initial loan was originated. Consequently, they are demanding more equity or refusing to roll loans over. This type of crunch should not be confused with the 1981–1983 credit crunch, which resulted from the contraction in credit availability at banks and was a product of Federal Reserve policy designed to reduce the rate of inflation. During that period, vacancy rates on commercial properties ranged from 2 percent to 5 percent in most large cities, and default risk was much lower.

As for residential markets, growth in financing will be much more dependent on the rate at which long-term economic growth resumes and on population demographics, including divorces, marriages, immigration, and household formations. However, this sector will fare much better than commercial real estate. The residential market is clearly less risky than the commercial real estate market in most urban areas. Delinquency rates on residential loans at banks have risen from 2.4 percent to 4.6 percent, but this rise is a reflection of the recent economic recession and low employment growth rather than vastly oversupplied markets. Hence, despite the recent turmoil experienced by federally insured depositories, the market for residential financing should improve as economic recovery commences. Securitization activity in this market, as has been pointed out, is very well developed, and consequently residential housing finance is not nearly as dependent on financial intermediaries as the commercial mortgage market.

As for residential finance at depository intermediaries, risk-based capital ratios included in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) will clearly benefit residential financing. As Barth and Brumbaugh point out, current guidelines indicate that depository institutions will be required to hold full capital backing for commercial real estate loans, as compared with 50 percent backing for residential mortgage loans and 20 percent backing for mortgage-backed securities. Further, proposed FDIC regulations, currently in the comment period, are likely to set more stringent guidelines for loan-to-value ratios for commercial construction and permanent loans. Under these proposed guidelines, it appears that permanent residential loans will continue to be available at 95 percent of value. One potential area of concern for residential lending may lie in the area of residential land

development and builder financing, which could cause a bottleneck in housing production.

Both the FIRREA and FDIC provisions are attempts to promulgate regulations that will differentiate risk between loan categories. Risk-based capital ratios will clearly raise the capital cost associated with holding commercial versus residential mortgages. The net result will be higher interest rates for commercial real estate loans relative to residential loans, or more off-balance-sheet activity by banks, or both. The off-balance-sheet activity would likely include originating, securitizing, and servicing commercial real estate loans. The extent of this activity would depend on the yield demanded by investors (on commercial mortgage-backed securities) versus the risk-based capital cost to banks of originating and holding such loans in their portfolios.

In summary, as Barth and Brumbaugh point out, depository institutions will continue to undergo a period of substantial turmoil. It is clear that activities of the Resolution Trust Corporation and the FDIC are far from over and that the total cost of failed institutions will be substantial. Depository institutions are likely to continue to lose ground in the competition for funds as pension funds increase in size and as nondepository intermediaries continue to make financial innovations facilitated by information and electronic technology. These developments, coupled with risk-based capital rules and other regulations, will affect commercial real estate to a far greater extent than residential financing. However, the impact of these rules on the commercial market will not be significant in the near term, as this market is greatly oversupplied and the need for new financing will be minimal. The availability of financing for residential housing should not be materially affected because of the vast increase in mortgage securitization, which has kept pace with technology, provided access to a broader range of capital sources, and lessened the dependence of housing finance on depository intermediaries. As for residential finance and depository intermediaries, risk-based capital ratios will tend to make residential financings more desirable. As a result, housing finance should continue to fare well for the foreseeable future.

Author

William B. Brueggeman holds the Corrigan Chair in Real Estate at the E.L. Cox School of Business at Southern Methodist University.

References

Federal Deposit Insurance Corporation. 1992. *The FDIC Quarterly Banking Profile*. Washington, DC. (September).

Federal Reserve Bulletin. 1992. 85 (August).

