A.M. BEST

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Commercial Real Estate and Construction Loans Held By U.S. Banks Climb; Posing Powerful Risk to Earnings

A.M. Best has initiated analysis and coverage of the U.S. banking industry. This article is the latest installment in a regular series of research papers and analytical methodologies that highlight trends in the U.S. banking industry.

Among the significant findings in U.S. bank 2005 filings was the continued climb in the most volatile segment of real estate financing. The industry's commercial real estate loans increased by 9.5% in 2005, continuing the trends of the past several years' growth rates of 10.3% in 2004 and 8.7% in 2003. Similarly, growth in construction and development loans registered 9.8% in 2005, 10.5% in 2004 and 9.3% in 2003. As a percentage of total net loans, commercial real estate loans still remained around 15.2% to 15.6% in the past four years. However, construction and development loans have been inching steadily upward to 6.7% of total net loans in 2005, compared with 5.6% in 2004, 5.1% in 2003 and 4.9% in 2002. U.S. bank regulators have responded to these trends by proposing in January 2006 new guidance on commercial real estate (CRE) exposure.

With a plethora of anecdotal evidence

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Level of Real Estate Income Concentration / **Stress Test: 25% Decline in Total Real Estate Income**

(in USD billions)	2003	% Growth	2004	% Growth	2005	Stress Test Case	Revised % Growth From 2004	% Change from Actual 2005
Total Real Estate Income	$169.9	3.4%	$175.6	30.4%	$228.9	$171.7	-2.2%	-25.0%
Net Interest & Non-Interest Income	$484.6	2.7%	$497.6	8.7%	$540.7	$483.5	-2.8%	-10.6%
Real Estate Income as % of Total Income	35.1%		35.3%		42.3%	35.5%		
Net Operating Income	$112.3	4.4%	$117.2	11.5%	$130.7	$73.5	-37.3%	-43.8%

Level of Real Estate Asset Concentration / **Stress Test: 20% & 10% Declines in Construction and Comm'l Real Estate Loan Values**

(in USD billions)	2003	% Growth	2004	% Growth	2005	Stress Test Case	Revised % Growth From 2004	% Change from Actual 2005
Construction Loans	$272.2	23.8%	$336.9	33.2%	$448.7	$359.0	6.5%	-20.0%
Commercial Real Estate Loans	$833.8	10.4%	$920.9	9.9%	$1,012.2	$911.0	-1.1%	-10.0%
Total Real Estate Loans	$1,106.0	13.7%	$1,257.8	16.1%	$1,460.9	$1,269.9	1.0%	-13.1%
Total Assets	$9,075.3	11.4%	$10,105.6	7.6%	$10,877.1	$10,686.1	5.7%	-1.8%
Real Estate Loans as % of Total Assets	12.2%		12.4%		13.4%	11.9%		
Total Loans	$5,348.7	12.9%	$6,036.8	10.0%	$6,638.7	$6,447.7	6.8%	-2.9%
Real Estate Loans as % of Total Loans	20.7%		20.8%		22.0%	19.7%		
Tangible Equity & Loan Loss Reserves	$723.2	11.9%	$809.0	6.3%	$859.6	$813.9*	0.6%	-5.3%
Real Estate Loans as % of Equity	152.9%		155.5%		170.0%	156.0%		

* Assuming a retained earnings rate of 60%, causing equity to decline by 60% of the reduction in net operating income; and including full chargeoff for the amount of asset value reduction.

Source: FDIC

pointing to a softening commercial real estate market, the potential adverse impact of increasing exposure by banks in this segment is not just on asset values, but also on earnings and capital levels. The concentration in the industry's real estate income is the most alarming element. Total real estate income, consisting of all gross interest income and fees, jumped 30.4% in dollar terms from 2004 to 2005, accounting for a staggering 42.3% of total banking revenues. Total banking revenues is defined as all noninterest income and net interest income, rather than gross interest income, because in the event of a loss in real estate income, banks still would have to carry the funding cost of the troubled loan assets, i.e., the related interest expense. Loss of revenues is assumed to result from nonaccruing loans, besides the loan impairment arising from full resolution or termination of actual loan facilities which are charged off against capital. The industry's capital levels grew proportionally to total asset growth during the past several years, but tangible capital (equity plus reserves less goodwill and intangible assets) was lagging asset growth in 2005. At year end 2005, the ratio of CRE asset classes to tangible capital grew to 170.0% from 155.5% in 2004 and 152.9% in 2003.

While specific situations vary for each bank, when real estate market conditions turn downward, an aggregate increase in industrywide exposure like the current trend is likely to lead to an adverse impact on the industry at large. Under a stress scenario of a 25% decline from the year-end 2005 real estate income level (**see table**), there would be a corresponding 10.6% decline in total banking revenues and a 37.3% hit to the industry's aggregate net operating income. Combined with a stress scenario of a 10% and 20% decline in the respective loan values of commercial real estate and construction and development (**see table**), the industry might see a decline in capital levels for the first time in many years. The impact of declines in loan values on capital is assumed to be associated with actual charge-off of the impaired assets against capital.

These stress tests are a simple aggregation of industry exposures from the call reports and historical loss rates based on the last real estate market downturn in the late 1980s and early 1990s. Without detailed data on the more vulnerable segments of banks' portfolios and underwriting criteria that vary from bank to bank, the assumptions are necessarily broad. As Comptroller of the Currency John C. Dugan indicated in his April 6, 2006, speech to the industry: "[A particular bank] can have concentrations in commercial real estate loans, but only if [it has] the risk management and capital [it needs] to address the increased risk." The current state of the real estate market can be argued to have sounder fundamentals than the last real estate crisis. However, the trend toward increasing exposures by banks in these especially risky areas of construction lending and CRE, combined with a similar pattern of concentration in certain regions of the United States as during the last downturn, merit exploring the accompanying potential adverse impact on the industry's earnings, asset values and capital levels.

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