

Box 3

RISKS STEMMING FROM THE US COMMERCIAL PROPERTY SECTOR

The risks to financial stability stemming from US property markets have been well documented in previous issues of the Financial Stability Review (FSR) and elsewhere. While risks from the residential property sector have abated somewhat amid signs of a stabilisation in the market, conditions in the commercial property sector have continued to deteriorate. Rising delinquencies on commercial property loans and related securities may result in substantial further losses for US, and possibly, European banks in the near term. This box highlights the exposure of medium-sized US banks to the commercial property sector, and describes the channels through which a downturn in the sector may drag on the US economic recovery and spill over to the euro area.

After early 2007, delinquencies on commercial property loans had risen to almost 9% by the end of 2009, from close to 1% in the years preceding the crisis.¹ According to estimates published by the Congressional Oversight Panel, about USD 1.4 trillion in commercial property loans will reach the end of their terms between 2010 and 2014.² The primary focus of concern is on loans that were originated at the peak of the market and which will mature in the coming years. Sharp falls in property values over past years – Moody’s commercial property price index had at the time of writing fallen by more than 40% from its peak in October 2007 – imply that as loans reach maturity, refinancing difficulties may emerge, since the value of the collateral may in many cases no longer be sufficient to cover the outstanding loan amount. This could

1 End-2009 data is the latest available. Such delinquencies can occur either during the term of a loan or at its maturity.

2 See Congressional Oversight Panel, “February Oversight Report – Commercial real estate losses and the risk to financial stability”, February 2010.

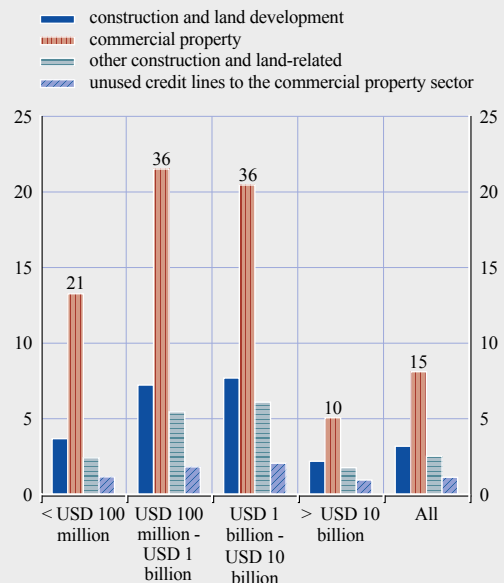
lead to a wave of further defaults. Refinancing is particularly problematic as the functioning of the market for commercial mortgage backed securities (CMBSs) remains impaired; the issuance of CMBSs has remained very weak since 2008. As a result, banks will face difficulties in managing the risks contained in their commercial property loan portfolios via securitisation. Further increases in the defaults on commercial property loans may lead to additional foreclosures on commercial properties, thus adding to the supply of properties on the market, which could, in turn, continue to exert downward pressure on commercial property values.

Loans to the commercial property sector, including loans related to construction and land development, are distributed disproportionately across the balance sheets of small and medium-sized banks. For smaller banks, commercial property loans as a percentage of total assets are significantly greater than for their larger peers, although large banks have greater holdings of CMBSs (see the chart). Exposure to the commercial property sector, however, generally decreased, as a percentage of total assets, over the first quarter of 2010. Write-downs on commercial property remained low, but those relating to construction and land development (CLD) loans were considerably higher, given their more speculative nature. Commercial property and CLD loans constitute more than 50% of total loans extended by medium-sized banks. This has serious implications for the banks in question, should the difficulties facing the commercial property sector persist or worsen. The impact of stresses in the commercial property sector is compounded by the poor diversification of banks' loan books. Furthermore, the capital adequacy of those commercial banks with assets between USD 100 million and USD 10 billion may become compromised, as commercial property loans exceed their Tier 1 core risk-weighted capital, in aggregate terms, by more than 350%.

While the direct systemic risks from medium-sized institutions may not be so material, disproportionately large exposures to commercial property could weaken their ability to provide credit to the economy.³ This could have consequences for small businesses that are less likely than large firms to have access to capital markets and that, instead, rely more heavily on bank financing.⁴ In March 2010, according to Federal Deposit Insurance Corporation data, banks with assets below USD 1 billion accounted for more than 40% of small business loans.⁵ Restrictions on small firms' access to finance may hold back the economic recovery as these firms are very

Outstanding commercial property and development loans at US commercial banks

(as at 31 Mar. 2010; percentage of total assets)



Source: Federal Deposit Insurance Corp.
Note: Individual figures refer to total exposure.

3 Furthermore, while not systemically relevant as individual institutions, a wave of correlated bankruptcies among small and medium-sized banks may have systemic consequences. Such bankruptcies would coincide with impaired cash-flows underlying CMBSs, which may have adverse consequences for the capital charges of larger banks holding these assets.

4 See G. Udell, "How will a credit crunch affect small business finance?", *Federal Reserve Bank of San Francisco Economic Letter*, No 2009-09, March 2009.

5 Total loans secured by non-farm non-residential properties of USD 1 million or less.

important for job creation.⁶ In this recession, almost 40% of the net job losses to date have resulted from labour shedding by small businesses (with fewer than 50 employees). Continued weakness in labour market prospects could contribute to, for example, rising office vacancy rates, as the need for commercial space falls, which may further suppress property values and reinforce the negative feedback loop between real economic activity and bank credit.

Aside from the negative consequences for the US and global economic recovery, there are also direct channels through which risks from commercial property could spill over to the euro area or other regions. It has been estimated that European banks exposure to US-originated CMBSs and commercial property loans is in excess of €100 billion; given the rise in delinquencies and losses for this sector, this represents a risk to the euro area financial system and is a source of concern.

⁶ For example, during the recovery that followed the 2001 recession, employment by small firms (with fewer than 50 employees) recovered earlier than employment by larger businesses and accounted for a significant share of job growth in the first years of the upturn.