GOLFING, TIGER AND COMMUNITY BANK LENDING

by Steve Brown

If you watched the U.S. Open golf tournament over the weekend, you had to be amazed by Tiger Woods. After ending Saturday in 1st place, he began Sunday in abysmal fashion, blowing up on the first 2 holes. With a bum knee, he then hung in there until the very last hole, where in true Tiger fashion; he sunk a long putt to tie for 1st place again. Whether you love golf or not you had to be impressed by the will and determination of this guy. Community banks can take a page from Tiger, as we all struggle hole by hole through one of the roughest courses in decades.

It is official - the soft housing market is spilling over into commercial real estate. Bankers report office, retail and industrial sectors are weakening, as vacancy rates rise and property prices soften. Prices for commercial properties are projected to fall as much as 20% nationwide, so expect property values to begin to soften as well. Slower economic activity is putting strains on the sector, exacerbating conditions even further. At the end of 1Q, nationwide CRE vacancy rates (calculated as a 4Q moving average) had moved to 12.8% for office, 9.1% for industrial, 7.7% for retail and 5.9% for apartments/multifamily.

A difficult chip shot for community banks right now is that while delinquencies have ticked higher in recent months, they still remain in line when compared historically. In fact, seasonally-adjusted CRE delinquencies were 3.5% in March, well below the 1991 peak (closer to 12%). That doesn't mean we should get complacent, however. Pressure remains and CRE delinquencies have about doubled this year. As of March, delinquencies were rising and matched the level set in 1996.

The next hole in CRE is a short Par 3. Securitization has been nearly shut down and borrowers are paying market rates once again. The latest FRB lender survey finds 78% of banks have tightened their lending standards on CRE. Less funding supply has helped push spreads on CRE loans wider, supported better bank profits on new transactions and simplified loan structures. Unfortunately for the fundamentals of the sector, higher borrowing costs have also begun to push cap rates higher, which ended the 1Q at 6.31% nationwide.

The sand trap on this hole could be commercial construction. This sector is expected to slow down in the last half of the year, as tighter underwriting standards, slow economic growth and a lack of borrower options begin to shelve certain projects. A drop in supply will help longer-term fundamentals, however. In commercial construction, the game will be projects tied to energy, water, college sports and stronger schools.

As we prepare to tee off on the hole sponsored by the office sector, we see some risks ahead. Fundamentals are weakening, tenant demand is slowing, consolidation is hampering things and technology is reducing demand for commercial space in many areas of the country. While office cap rates have been falling since 2000, the expectation going forward is for an upward shift from the 1Q level of 5.6%.

The next hole has been sponsored by retail. Here, a slowdown in consumer spending is pushing vacancy rates higher (up 8% from the same time last year). That has led retail chains to close underperforming stores and sector bankruptcies are also higher. In addition, spiking gasoline prices are keeping shoppers away. Look for this confluence of events to weigh on malls and shopping centers, while discount stores/warehouse clubs gain.

The 18th hole is sponsored by the industrial sector. Here we find things relatively healthy, however import growth has slowed, businesses are cutting back and vacancy rates are beginning to rise modestly. It is also true that industrial price appreciation is slowing, so continue to monitor events in your region.

As we head to the clubhouse following our most recent round of play, we remind readers that tournaments tend to run over multiple days. We urge community bankers who may be feeling down or stressed because of the economy to take a page directly from Tiger Woods Ã¢Â€" concentrate on every move before you make it, never give up, watch the hazards and continue to make consistent shots. This is a tough course to play, but community bankers are prepared (and many are darn good golfers too).

BANK NEWS

FDIC

Formed on June 16th in 1933 under the Roosevelt Administration, the FDIC turns 75 years old today.

Mortgage Insurance

The FHA will waive their 90-day waiting policy for mortgage insurance to foreclosed home buyers in an attempt to encourage purchases.

Discount Window

On Wednesday, the Fed lent $8.5B to investment banks, nearly 10% higher than a week prior. These loans are on the rise for the 1st time since late March.

Ratings Reform

The SEC has proposed tighter rules for credit rating agencies. To prevent conflicts of interest, firms would be required to have sufficient information on underlying assets when issuing ratings. In addition, agencies would need to create symbols to clearly distinguish between complex structured products and traditional bonds, unless a report is issued disclosing the rating differences.

Regulatory Warning

In a speech given just moments ago, FDIC Chair Shelia Bair said commercial real estate loans are a "supervisory concern."