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Economics Group

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CRE Credit: Fed Concerns, Tighter Standards & Less Demand

Fed officials have continued to sound caution over the elevated level of CRE pricing. However, the slower pace of foreign investment and tightening CRE lending standards should help reduce regulators' concerns.

Fed Echoes Risks in CRE

As commercial property prices continue to rise higher, financial regulators have voiced concerns about potential imbalances forming in the commercial real estate (CRE) sector. Such worries were echoed last week in the Federal Reserve's Monetary Policy Report to Congress, which highlighted CRE prices as an area of "growing concern." While the statement noted that CRE debt remains modest relative to the size of the overall economy, it also reported the run-up in prices "may leave some smaller banks vulnerable to sizable CRE price decline."[1]

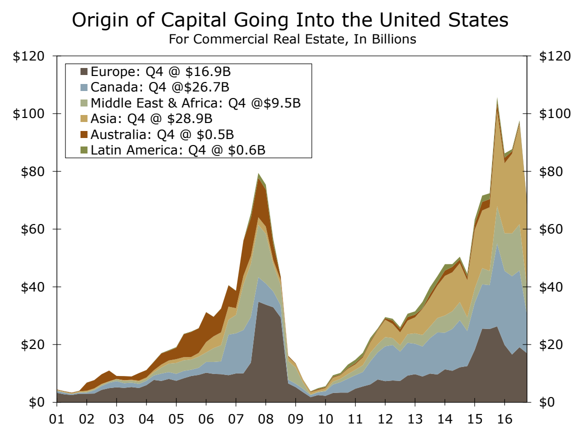
Prices Higher but Asset Price Growth Is Moderating

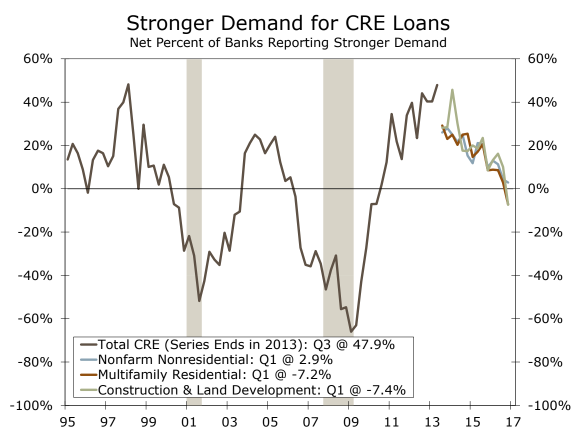
Indeed, CRE prices continued to trend higher in 2016, with overall commercial property prices increasing 7.4 percent over the course of the year and a staggering 90 percent since 2010, according to data from Moody's/RCA. The sharp increase in valuations is largely due to the surge in cross-border transaction volume witnessed over the past five years (top chart). Regional markets and sectors preferred by international investors have seen the largest price gains. For example, the apartment sector reported a double-digit 12 percent price increase in 2016. That said, the pace of asset price growth is moderating as cross-border transactions and, in kind, overall transaction volume have slowed over the past year.

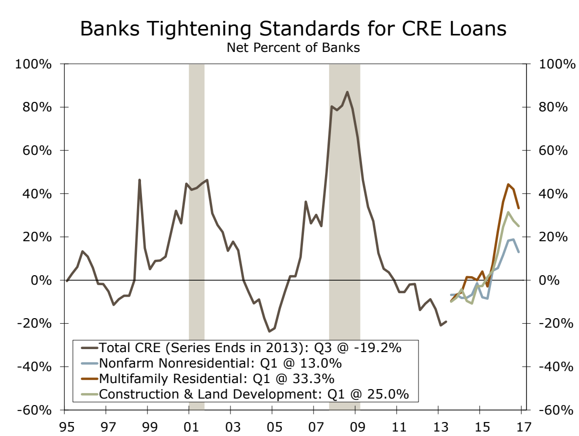
CRE Credit Availability and Demand Wane

The slowdown in transaction volumes coincides with survey measures reporting weaker demand for CRE loans. According to the Federal Reserve's January Senior Loan Officer Opinion Survey, CRE loan demand has fallen. Lenders reported weaker demand for multifamily and construction loans on net in the fourth quarter, while nonfarm nonresidential loan demand was relatively unchanged (middle chart).

On the supply side, lending standards for CRE loans continued to tighten across the board in the fourth quarter, marking the sixth-consecutive quarter of net tightening (bottom chart). The Fed survey noted particularly "significant" tightening for loans secured by multifamily properties and construction land development loans, with a net 33.3 percent and 25.0 percent of firms, respectively, tightening standards. Meanwhile, a more moderate 13 percent of banks reported tightening standards for nonfarm nonresidential property loans. The survey data suggest that bank lenders are proving themselves more cautious/selective, consistent with indications that the sector is at a mature stage in the current cycle. The slower pace of foreign investment in U.S. CRE, and tighter lending standards for CRE loans, should provide some relief to Fed officials that have sounded caution over credit risks associated with the elevated level of CRE pricing.







Source: Real Capital Analytics, Federal Reserve Board and Wells Fargo Securities

[1] **https://www.federalreserve.gov/monetarypolicy/files/20170214_mprfullreport.pdf**

For further information on our CRE outlook, please see *Commercial Real Estate Chartbook: Q4*, *available* on our website.

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