Bank Capital, Nonbank Finance, and Real Estate Activity

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This research project investigated whether banks' loan losses reduced activity in real estate markets in recent years. It might seem obvious that banks' woes would cause problems for their traditional borrowers and for those dependent on those borrowers. To date, however, there is little, if any, systematic evidence that activity in real estate markets--as measured by permits, contracts, construction, mortgage originations, sales, and so on--was affected by banks' problems.

The unusually large loan losses suffered by banks in the early 1990s reduced their net worth, or capital. Banks' capital cushions the deposit insurance fund, protecting it and ultimately the taxpayer against banks' becoming insolvent. At the same time that banks were losing capital, government regulators were becoming more insistent that banks maintain more capital. As a consequence, banks were in effect pressured by regulators to reduce their lending in order to restore their capital-to-asset ratios. To make sure we appropriately measured the effects of banks' problems on real estate markets, we also had to take into account the effects of conditions in local economies and real estate markets, like unemployment rates, vacancy rates, and real estate returns. Here we investigated whether, apart from conditions in their local real estate markets and local economies, troubled banks made fewer <u>loans</u> to the real estate sector. We found that banks did make fewer real estate loans, both commercial and residential, when they were under capital pressure.

The project then investigated whether <u>activity</u> in real estate markets were affected by the reduced availability of real estate credit from banks. One possibility is that secondary markets for real estate loans, especially the market for single-family mortgages generated by federal agencies like Ginnie Mae, Fannie Mae, and Freddie Mac, insulated the residential real estate market from the banks' capital problems. Local economic conditions, and particularly conditions in local real estate markets, also affected real estate market activity: Our results indicate that local unemployment rates, local real estate loan delinquency rates, and local income growth did affect various aspects of real estate market activity. In addition, we document that banks' capital problems reduced activity not only in commercial real estate, where secondary markets are presumably less well developed, but also, and somewhat surprisingly, in residential real estate. Thus, the health of commercial banks remains important to the health of the entire real estate industry.