Real Estate: A Vital Sector Poised for Change

Remarks by
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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

I appreciate the opportunity to participate in this year's UMKC real estate forum, and I look forward to our discussion. The real estate sector is a vital part of our economy. For a policymaker, following developments in real estate is essential. As of year-end 2019, it accounted for a quarter of household assets and 40 percent of business assets. The construction industry alone employs more than 5 percent of the nation's workforce, and housing is the second-largest component of personal consumption, topped only by healthcare. As such, fluctuations in the value of real estate can affect household consumption, business activity and the health and stability of our financial system.

The pandemic has disrupted all aspects of the economy, including real estate. The sharp drop in activity last spring, as consumers pulled back and restrictions impeded business, coincided with a jump in the unemployment rate from 50-year lows to levels not seen since the Great Depression. Since then, the economy has bounced back, supported by a tremendous amount of fiscal support and very accommodative monetary policy. But the recovery so far has been both incomplete and uneven, as close to 10 million jobs have yet to return, and some sectors struggle even as others have reported record years. As I will discuss, this unevenness has also been apparent within real estate, as the residential sector has boomed even as non-residential has lagged.

As vaccination progresses and the virus is brought under control, we could see a further robust recovery in economic activity, likely by the second half of this year. That said, even as we recover, it seems clear that we are not going back to where we started. The pandemic will likely result in, or at least accelerate, structural changes in the economy, and, as you are well aware, real estate seems poised to be on the forefront of these changes.

In my remarks today, I will review how real estate markets have weathered the pandemic so far. I'll also note some of the long-term structural challenges confronting the sector, closing with a review of the implications for real estate finance and the health and stability of the financial system more generally. As always, all of my views are wholly my own.

Near-term developments

As discussed earlier, one of the defining features of our current economy is its unevenness, a feature that carries over to the real estate sector. On the positive side, single-family housing is booming. Existing sales, prices, and starts all rose sharply during the second half of 2020 and look poised to remain strong for some time. In the Kansas City metropolitan area, permits for new single-family homes in the fourth quarter of 2020 were up by 33 percent from one year earlier, somewhat higher than national increase of 25 percent. Housing has been supported by record-low mortgage rates and an apparent increased demand for living space, as households adjust to pandemic restrictions and many people work from home.

For multifamily housing, the picture is more mixed. Compared to a year earlier, rents in the fourth quarter were down sharply in the center of many large metropolitan areas, pulling down average apartment rents by about 4 percent on a national basis. But in many medium and smaller metropolitan areas, especially in suburban locations, rents have held firm and even increased. In the Kansas City metropolitan area, apartment rents have fallen modestly in the city proper but have increased in almost all suburban markets. Vacancies have varied similarly: up considerably in the center of many large metropolitan areas but holding firm and even declining elsewhere. However, vacancy rates may be misleadingly low, held down by the eviction

moratorium. The Census Bureau estimates that more than one in six renters—more than three times the typical rate—were behind on rent at the end of January.[1]

Conditions for non-residential real estate have varied as well. Despite an uptick in vacancies, office rents were about unchanged over the year. More concerning, however, are hotel and retail properties. Tenants in these sectors have experienced declining demand as the pandemic led to a sharp drop in travel, reduced dining out, and a large shift in shopping from in-person to online. As a result, hotel occupancy has dropped and retail vacancies have jumped, pushing rents down.

The longer-term real outlook

Looking further out, I think it is likely that the pandemic will cause, or at least hasten, some significant structural changes in real estate. One development that has attracted considerable attention is the rise of remote work. Many companies have discovered that they can perform well, with employees remaining highly productive, in a remote stance. As a result, a majority of surveyed executives expressed a willingness to allow their office employees to work remotely some of the time once the health crisis has passed.[2] However, most executives who favor the option to work remotely also stress the importance of regularly working on-site in order to foster collaboration and to build company culture. Most surveyed office employees also expressed a desire to work remotely some of the time after the virus fades as a concern, with a sizeable minority saying they would like to do so all of the time.[3]

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[1] Parrott, Jim and Mark Zandi. 2021. "Averting an Eviction Crisis." Moody's Analytics.
[2] PwC. 2021. "It's Time to Reimagine Where and How Work Will Get Done: PwC's U.S. Remote Work Survey, January 12, 2021." PwC, January 12.
[3] PwC. 2021. "It's Time to Reimagine Where and How Work Will Get Done: PwC's U.S. Remote Work Survey, January 12, 2021." PwC, January 12.

In addition to affecting the overall demand for office space, it seems likely that an increase in remote working could significantly affect the geography of economic activity. Assuming that employers and employees coalesce to a hybrid model, the most meaningful impact of a rise in remote work could be a reduction in commuting time, which could affect where workers want to live and where businesses decide to locate. Estimates suggest that if employees in occupations amenable to remote working on average worked from home two days per week, the decline in daily commuting volume would cut one-way travel time on many highway segments by 20 percent or more.[4] Saved time would likely be greatest in large metropolitan areas, where traffic congestion has been worst and travel times highest.

Less frequent commutes and faster speeds would likely make many workers willing to live further away from their place of employment, and could increase the desirability of living in the outlying suburbs of metropolitan areas, where large tracts of lightly-settled land are available for development. The current boom in single-family construction likely rests in part on this increased willingness to live farther from work, with households anticipating increased remote working following the end of the pandemic.

Turning to the location of workplaces, less frequent commutes and faster speeds may lead some companies to shift their offices from suburban locations to central ones. In particular, less commuting would diminish some of the current advantages of suburban offices. Fewer commutes lessen the advantage of locating closer to residential neighborhoods. Fewer workers coming in on any given day also lessens the advantage of plentiful parking at suburban workplaces.

[4] Rappaport, Jordan. 2021. "Hybrid Officing Will Shift Where People and Businesses Decide to Locate." Federal Reserve Bank of Kansas City, *Economic Bulletin*, February 3.

The cost advantage of suburban compared to downtown offices may also diminish. To the extent that an individual company cuts back on leased office space, rent would become a smaller share of its total business expenses. Moreover, as many companies cut back on leased office space, the corresponding decrease in total demand would put downward pressure on office rents regardless of location, also cutting down on rent as a share of total business expenses. The decrease in office rents as a share of business expenses lessens the incentive to avoid locations with premium rents, such as downtowns.

Of course, we are in the early stages of seeing how these trends play out, and much remains uncertain. However, from a broader perspective any significant change in the location of economic activity, regardless of its specific form, has the potential to significantly affect the valuations of residential and commercial real estate. These revaluations, in turn, have important financial stability implications, to which I turn next.

Implication for financial stability

Over the past several decades we have learned that the financial stability implications of real estate can hardly be understated. Most recently, many accounts trace the roots of the 2008 financial crisis to excesses in residential real estate financing. In addition, the lessons from disruptions to commercial real estate financing in the aftermath of the financial crisis are equally important today. While the strains on real estate finance currently appear contained, this relative health has been importantly supported by the extraordinary policy response to the pandemic. If support fades ahead of a sustained recovery, stresses could become more prominent, especially against a backdrop of disruptive structural change.

Going into the pandemic, the residential market was in a much better place than it had been prior to the financial crisis, in part due to regulatory changes adopted after that crisis. Strengthened underwriting standards contributed to a decline in the share of non-prime mortgage balances and, overall, households had been deleveraging for most of the last decade. As a result, the U.S. household debt service ratio—debt service payments as a share of personal disposable income—had declined considerably. At the same time, household net-worth increased, driven largely by stock market and real estate gains. The way housing is financed has also changed, with non-banks increasing origination share, while the largest banks and private label securitization pulled back.

The onset of COVID-19 led to an immediate slowdown in origination activity as the pandemic temporarily dampened real estate showings, interior appraisals, and in-person closings. However, a sharp decline in mortgage rates, following the Fed's forceful monetary policy response to the pandemic, has helped revive the market, increasing demand for both purchases and refinancing.

While origination activity has bounced back to record levels, other parts of the residential mortgage market may require careful monitoring. In particular, delinquencies remain low due to the extraordinary policy measures undertaken during the pandemic. For example, the CARES Act passed last spring included temporary payment forbearance on federally backed mortgages. The share of mortgages in forbearance peaked at 8.8 percent in June 2020 but has since moderated to 5.2 percent in January 2021; the unpaid principal balance on these mortgages is estimated to be $548 billion.[5] The uptake in forbearance temporarily reduces transition rates into delinquency but creates the potential for a future wave of foreclosures when borrowers exit

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[5] Based on observations using Black Knight's McDash Flash data. Monthly reports available at https://www.blackknightinc.com/data-reports/

forbearance. Currently, mortgage debt levels relative to home valuations are not elevated and the estimated share of households with negative equity is low. These considerations not only dampen default rates but also reduce losses for lenders if borrowers were to default, thereby lowering risks of spillovers to broader financial markets.

The pandemic has also highlighted vulnerabilities associated with non-depository mortgage companies—in short, nonbanks that originate and service mortgages. As I mentioned earlier, nonbanks have more than doubled their market share over the previous decade and currently originate over 60 percent of new mortgages. Nonbanks typically rely on short-term funding and are subject to making servicing advances on delinquent borrowers. Therefore, significant increases in nonpayment can impose capital and liquidity strains for these nonbanks, which happened in the early days of the pandemic. Measures enacted by federal agencies to lessen the burden of advances on loan forbearances and a quick policy-aided rebound in origination activity helped relieve the strains on nonbanks. Nevertheless, the viability of nonbank mortgage originators and servicers is critical for providing mortgage credit access, especially in underserved communities where nonbanks have a significant presence.

Strains in the commercial real estate market could also pose significant threats to financial stability. Past experience shows that severe downturns in the commercial property market can destabilize the banking system, and regulators have taken numerous steps to address these risks. In particular, commercial real estate concentrations at smaller banks declined below the levels seen prior to the 2008 financial crisis and capital levels increased significantly. Still, balance sheet holdings have increased the past few years with commercial real estate loans making up more than one-quarter of all assets held at smaller community banks at the end of 2019.

To date, however, credit performance has held up reasonably well. So far, delinquency rates on bank loans secured by commercial properties have recorded modest increases and are significantly lower than what was anticipated by bankers, regulators and market analysts in the early days of the pandemic. Both direct and indirect measures have helped to support the flow of credit. For example, direct measures such as regulatory encouragement for banks to work constructively with borrowers and the expansion of the Term Asset-Backed Loan Facility (TALF 2020) to include certain commercial mortgage backed-securities (CMBS) provided support for portfolio and securitized commercial real estate lending.

Additionally, the extraordinary measures taken by the Federal Reserve and the Treasury helped both lenders and borrowers in this market. On the borrower side, enhanced unemployment insurance as well as funds made available to businesses through the Main Street Lending facility and the Paycheck Protection Program aided commercial property tenants to keep rental payments flowing. On the lender side, these extraordinary measures provided capital and liquidity support to banks and other lenders to help them voluntarily offer forbearance to distressed borrowers and to supply additional credit to this market. As such, forbearance has been a significant contributor to improved metrics of CRE loan performance. Still, market analysts predict that a significant volume of commercial loans currently in modification programs may ultimately default. [6]

Given this backdrop, a worrying scenario is that the economic impact of the pandemic outlasts the policy support programs currently in place. Should that occur, many renters and businesses could find themselves unable to meet their obligations, forcing banks to realize losses on existing loans and weighing on credit growth and broader economic activity.

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[6] Stovall, Nathan. 2021, "Deferrals plunge, credit migration minimal heading into ominous winter." S&P Global Market Intelligence, Research & Analysis. January 5.

Conclusion

Developments in real estate have important implications for the broad economic recovery, both in terms of growth and employment, as well as for financial stability. Just as with the aggregate economy, the effect of the pandemic on real estate has been uneven as the boom in single-family residential housing has been accompanied by higher vacancy rates in most segments of commercial real estate. While it is important to acknowledge the role of policy in supporting the real estate market, it is also important to be aware of the forthcoming challenges when this support is withdrawn, especially against the backdrop of longer-term structural changes to the outlook.