

# Real Estate Outlook

## United States

First Half 2011  
Economic Analysis

- **The economy is slowing down**, with a modest rate of employment growth. Forecasts for 2012 and 2013 indicate that economic expansion will be slightly below potential
- **Residential market remains weak**. For residential investment to be positive, we would need excess housing inventory to clear and stronger economic growth
- **CRE market recovery is not yet clear**: higher long-term interest rates, as expected for 2012, could harm cap rates forcing CRE prices to adjust further
- **The quality of the mortgage portfolio is improving**, which is one of the first steps to full mortgage financing recovery

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Closing date: June, 30, 2011

## Editorial

Housing indicators remain fragile, confirming a prolonged and slow recovery process in the residential sector. The housing meltdown coupled with a protracted period of weakness could have significant structural social, demographic and economic consequences over several years or even decades.

Several studies indicate that a housing crisis which affects availability, affordability and quality, could lead to lower levels of educational attainment, which would reduce income growth and social mobility. Similarly, the recession had significant effects on the behavior of younger workers such as postponing family expansion and delaying the purchase of a new home which in turn feeds back into the housing weakness by slowing the pace of household formation. This implies lower home sales and mortgage demand, at a time when excess inventories are high, thereby exerting further pressure on home prices. In addition, people near retirement or already retired that experienced significant real estate wealth losses have been forced to remain in or return to an already weak labor market. If these trends do not reverse rapidly, potential economic growth and living standards will decline.

In fact, some studies suggest that the elevated unemployment rate reflects the impact of declining home prices on labor mobility. If borrowers who become underwater are unwilling to move to avoid incurring losses in their homes, labor mobility diminishes and unemployment rises. However, empirical evidence suggests that the biggest impact of falling home prices is on in-county rather than out-of-state moves. Considering that a decline in local moves has little impact on labor mismatch, it seems that the housing meltdown has had limited effects on labor mobility and unemployment. In fact, data confirms that areas with significant home price declines experience higher mobility.

The recession has also prompted a downsize in housing. In fact, the latest data suggests that we are undergoing the steepest adjustment in housing size since the government began collecting data 50 years ago. Nevertheless, longitudinal studies indicate that although average square feet of living space declines during recessions, the long-term trend is positive. In fact, during the last four decades, average square foot per capita has increased by around 80%. This evidence holds regardless of the size of the city. Moreover, housing characteristics and quality continue improving over time. For example, between 1987 and 2009, the number of new homes with four or more bedrooms increased threefold, while the average household size remained unchanged. Therefore, once the economy fully recovers, housing size is likely to rebound.

Although the time it takes to build a house has basically remained unchanged for the last 40 years, a prolonged period of reduced margins could incentivize builders to boost productivity through alternative construction technologies and methods including solar panels, geothermal energy, "smart" windows, walls and roofs. The benefits could be substantial. For example, in the last 30 years the big-three U.S. automakers increased per-vehicle productivity by 50%. High maintenance costs, changes in consumer preferences and new regulations could accelerate environmentally responsible and resource-efficient construction, resulting in superior standards and more affordable homes.

Sincerely,

Nathaniel Karp

BBVA U.S. Chief Economist

## 1. Economic Outlook

### The economy is slowing down, with a modest rate of employment growth. Forecasts for 2012 and 2013 indicate that economic expansion will be slightly below potential

During the first six months of 2011, economic indicators showed that economic growth was slowing slightly. Indeed, in the first quarter of the year, the U.S. economy grew by just 1.8% quarter over quarter (QoQ) annualized on a seasonally adjusted basis compared to 3.1% in the previous quarter. This slowdown was primarily due to cuts in both public consumption expenditures and gross investments, which subtracted 1.1 percentage points (pp) from economic growth. These two indicators dropped by 7.9% in real terms QoQ. The drop was mainly contributed to some sharp cuts in defense spending, which shrank 11.7% QoQ. However, we expect the government sector to contribute positively to economic growth in the second half of the year. Personal consumption expenditures (PCE), private inventory investment and non-residential fixed investments positively contributed to the economic growth in the first quarter.

During the second half of 2011, consumption is expected to continue as the main driver of economic activity. Although the economy will continue to suffer from ongoing deleveraging due to high unemployment and strict credit conditions, a steady increase in personal income, government support programs and tax incentives will support personal spending.

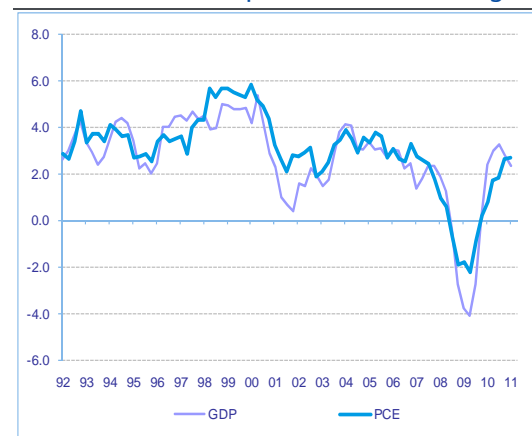
### Weak job creation raises doubts about the strength of the economic recovery, and is not contributing significantly to a reduction in unemployment levels

Labor market conditions are improving, but slowly. During the second half of 2010 and the first six months of 2011, slightly more than 1 million jobs were created in the U.S. economy. This job creation has not been sufficient to counteract the high level of unemployment, which remains at 9.2%. The negative effects of these high levels of joblessness are further enhanced by the decrease in the participation rate, which stood at 64.1% at the end of the first half of 2011; more than half a percentage point below the rate a year earlier.

Labor market indicators for the first half of 2011 – initial jobless claims, unemployment and wages – show only a slight improvement and are far from suggesting companies are ready to undertake rapid hiring. These trends point to an imbalance between demand for labor and the skills of the unemployed. In this scenario, the unemployment rate will decline more slowly than in previous economic recoveries.

Chart 1

Real GDP and Consumption (PCE) YoY % change



Source: BEA and BBVA Research

Chart 2

Nonfarm Payrolls, MoM change (thousands)



Source: BLS and BBVA Research

At the end of 2Q11, the International Energy Agency (IEA) announced that it would release 60 million barrels of oil worldwide, which has eased the oil markets. The IAE highlighted that this increase in supply is intended to offset the disruptions in supply due to civil unrest in Libya. Furthermore, Saudi Arabia previously announced that it would act against OPEC guidelines and boost crude oil output by 1.4 million barrels a day. These events have led to a drop in oil prices, which have been driven down further by the global economic slowdown. This price adjustment mitigated inflationary risks in the first half of the year.

### Monetary policy will remain flexible until the beginning of 2012, when the Federal Reserve will begin to increase its interest rates

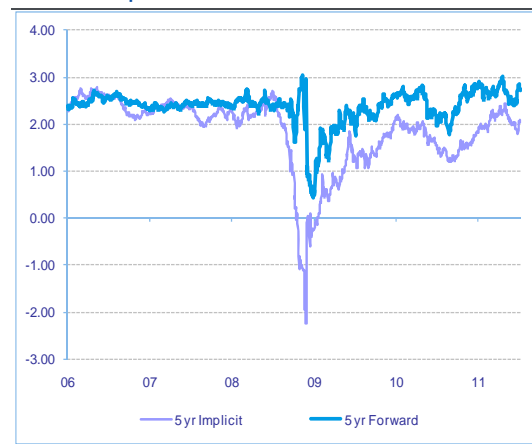
The Federal Reserve's Large-Scale Assets Purchase (LSAP) program in the first half of 2011 contributed significantly to eliminate the risk of deflation; with headline inflation and core inflation currently well above zero. From the Fed's perspective LSAP was a success as it diverted the economy away from deflation and the irrelevance of interest rates. Consumer confidence has increased in the form of growing retail sales, lower volatility and ameliorated corporate spreads.

We continue to believe that the Fed will maintain the current target Fed Funds rate unchanged throughout the remainder of 2011. While we expect the Federal Reserve to complete its current large-scale asset purchase program at the end of 2Q11, we believe that the reinvestment of principal from maturing assets will continue until financial and economic conditions warrant a change in policy, probably through August or September. The cessation of principal reinvestment is one of the first steps of their exit strategy. Assuming that the inflation rate remains within the Fed's comfort zone and longer-term inflation expectations are stable, the Fed will delete the wording "extended period" from the statement a couple of meetings before the first rate hike. Our baseline scenario assumes the first rate hike will occur in March 2012.

Overall, our forecasts indicate 3.0% growth in the U.S. economy in 2011, but downside risks are greater than the upside potential. The inflation rate will increase to 2.8% in 2011 while core inflation remains below 2%. The Fed will be in no rush to raise interest rates in an environment with substantial resource slack, limited core inflationary pressures and stable long-term inflation expectations. The timing of policy actions, particularly balance sheet normalization, will depend on the evolution of data during the summer.

Chart 3

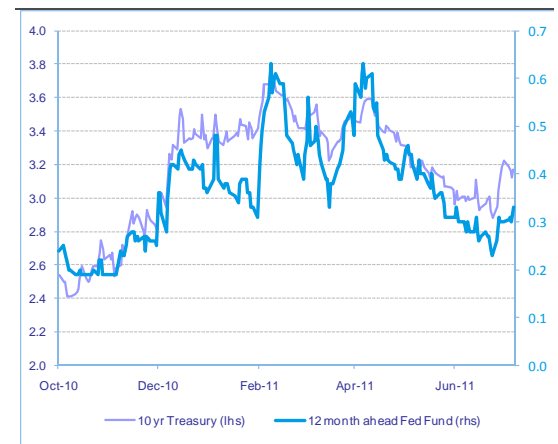
#### Inflation Expectations. (%)



Source: Reserve Federal and Harver

Chart 4

#### 10 Year Treasuries and Fed Funds Futures (%)



Source: Datastream and BBVA Research

## 2. Residential Real Estate

### **Residential market remains weak. For residential investment to be positive, we need excess housing inventory to clear and stronger economic growth**

All residential market indicators remained weak in the first half of 2011. Compared to the same period last year, residential property sales have declined 5% while prices have slipped around 7%. On the positive side, the inventory of homes for sale has shrunk slightly to slightly more than 5%. That said, there is still a "shadow" inventory of homes currently in foreclosure and others which are now in the financial entities portfolio. Residential construction is also suffering from these weak sales figures with 7% fewer homes being started in the first six months of the year and the number of building projects declining 12%. This triggered a 5% drop in real residential investment, eroding nearly 0.3 percentage points off GDP growth.

The number of households rose by more than 750,000 units between the second quarter of 2010 and the first quarter of 2011, and the job market generated more than 1.1 million net jobs nationwide. However, demand for residential property during the period remained weak and was mostly focused on the rental market, where the number of properties inventory rose 2.8% year over year (YoY).

The outlook for the second half of 2011 is not much brighter. Home sales are projected to remain steady, prices will continue to decline, albeit at a slower pace, and the stock of unsold homes will adjust timidly. New home start figures are expected to recover slightly, making residential investment annual growth positive for the first time since the second half of 2006.

For 2012, according to our estimates, the recovery of the residential market and housing investment will be more visible. Housing prices will stabilize as both economic activity and household confidence expectations improve.

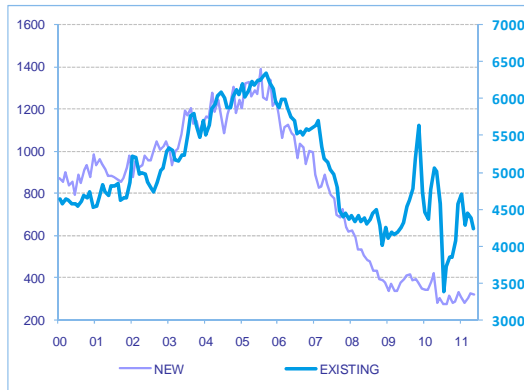
### **Home sales did not respond to improved demand factors. Instead, it was the rental market which profited from the increased number of households and higher employment figures**

In the first quarter of 2011, the average home sales rose to slightly more than 5.4 million units in annualized terms, which was a decline of more than 5% compared to the first half of 2010. However, compared to the figures for the second half of 2010, when the government tax incentives ended, property sales for the first quarter of 2011 period rose nearly 14%.

Sales improved specifically in the existing home segment, where total sales increased by 14.7%. This improvement was boosted by the large number of distressed properties coming on the market. According to the National Association of Realtors (NAR), homes in foreclosure and short sales by financial entities comprised more than 30% of existing home sales in the first quarter of 2011. In this regard, the improved quality of financial entities' property portfolios and lower default levels on new mortgages are helping financial entities place their distressed real estate assets on the market without significantly eroding their key financial ratios.

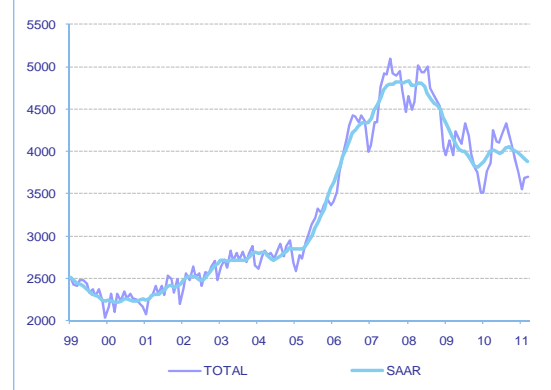
New home sales remained stable at around 300,000 units per year in the second half of 2010 and the first four months of 2011. This figure is lower than in previous housing recessions where minimum sales averaged slightly less than 400,000 units a year. Given this lower pace of new home sales, developers are holding lower inventories for this type of property.

Chart 1  
**Single Family Home Sales. Thousands**



Source: National Association of Realtors and Census Bureau

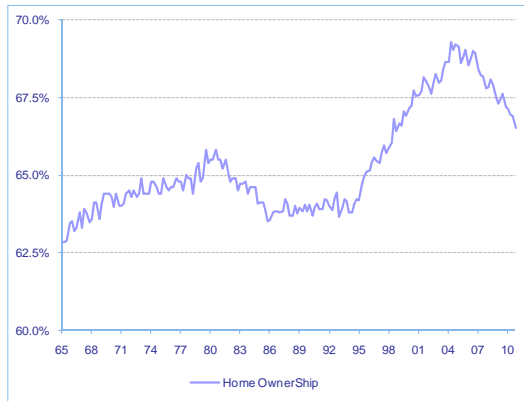
Chart 2  
**Houses on Sale. Thousands**



Source: National Association of Realtors and Census Bureau

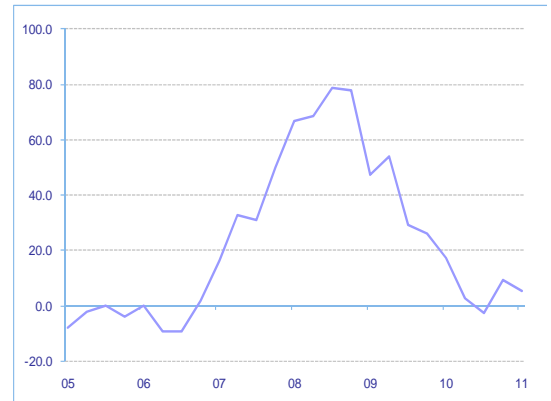
Both the increase in the number of households and better employment figures have pushed housing demand up slightly with a clear bias towards rental housing. Between the first quarters of 2010 and 2011, the total number of households rose from 758,000 to 112.16 million units. Of this total, 66.4% of households were homeowners while 36.4% were in rental accommodations. In this period, about 300,000 homeowners (0.7% of the total) have shifted into the rental market. From 2010 to 2011, the number of households living in rental housing jumped by slightly more than one million. This structural change began in the second half of 2006 and has pushed the weight of rental homes up by more than two and a half percentage points. The reasons for this change are: 1) the households' change in residential price expectations; 2) the unstable job market; and 3) the tightening standards for mortgage lending.

Chart 3  
**Home Ownership Rate. As % of total occupied homes**



Source: Census Bureau and BBA Research

Chart 4  
**Mortgage Standards. % of banks tightening standards**



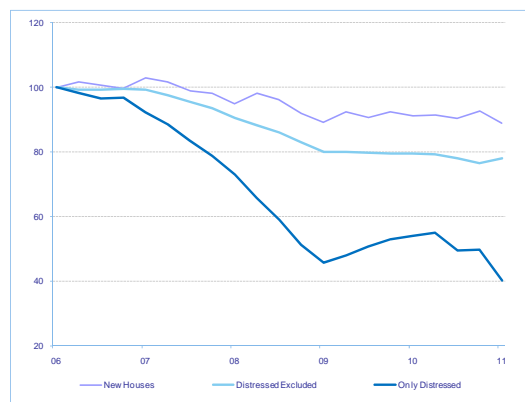
Source: Reserve Federal, Harver and BBVA Research

### Housing prices are showing a dual evolution: while distressed properties prices are adjusting intensively in almost all of the markets, non distressed properties prices are more stable

In the first half of 2011, the leading property price indices clearly contracted when compared to last year's price indices. Indeed, yearly depreciation at the end of the first quarter was between 4% and 8%, depending on the index consulted. These aggregate figures appear to indicate that property prices are declining across the board. However, a closer look at the composition of the housing price indices shows that there are in fact two submarkets: distressed properties (foreclosures and distressed properties in financial entities portfolios), where prices are adjusting sharply; and a submarket of non-distressed properties (new or existing) where prices have stabilized since the economic activity started to pick up.

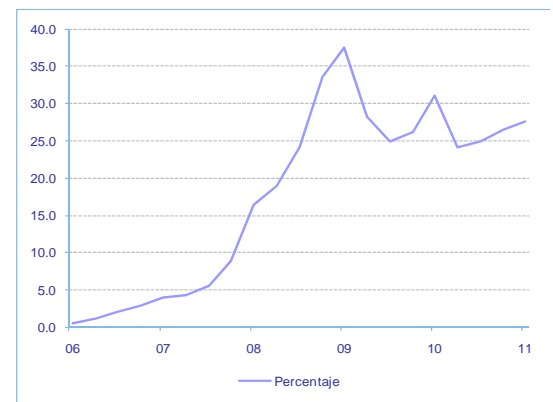
In fact, at the end of the first quarter, prices of distressed properties dropped more than 30% YoY. In the same period, the non-distressed homes price index declined 0.8% YoY. New home prices have been slightly more volatile in the period although they have not fallen sharply since the beginning of 2009.

Chart 5  
**Home Prices. Peak 1T2006 = 100**



Source: CoreLogic, Census Bureau and BBVA Research

Chart 6  
**Distressed Property Sales. As % of total sale**



Source: RealtandTrac

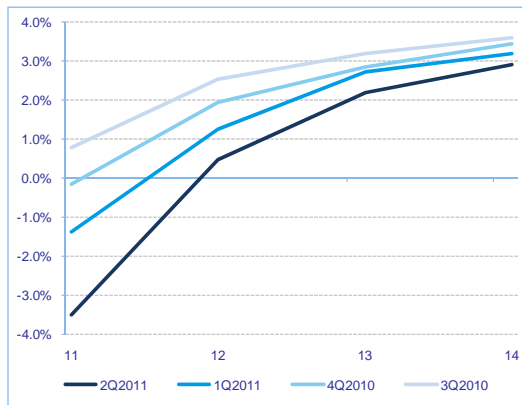
The improvement of the residential mortgage portfolio's quality and fewer mortgage defaults are helping financial institutions place more distressed properties on the market. In fact, between September 2010 and March 2011, the total portfolio of distressed residential properties owned by financial institutions declined 10%. According to recent figures from RealtyTrac, during the same period, the number of residential properties filing for foreclosure shrank by nearly 37%.

### Forecasts indicate that housing prices are unlikely to appreciate until the second half of 2012

Residential property price forecasts declined gradually in 2010 and the first few months of 2011. However, according to the last survey elaborated by Macromarkets (1), the outlook remains positive in the long term with prices continuing to depreciate through the end of 2011 and into the first half of 2012. Our year end forecasts point to a slight depreciation of more than 3% in 2011 with home prices beginning to rise in the last quarter of 2012.

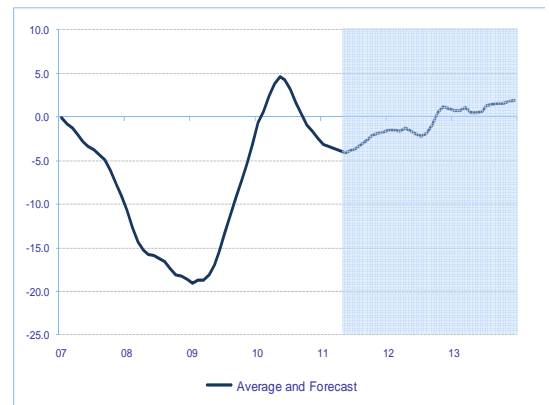


Chart 7  
House Price Expectations. 4Q YoY % change



Source: MacroMarkets

Chart 8  
House Price. YoY % change



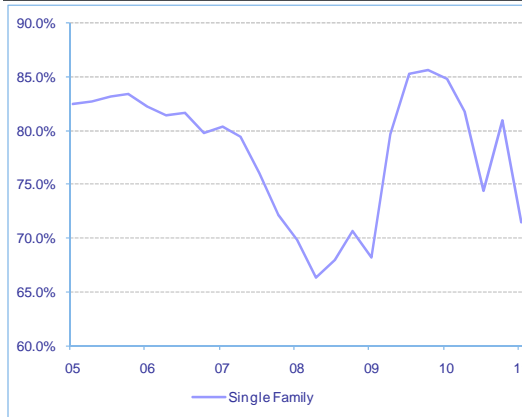
Source: CoreLogic and BBVA Research

### For new housing starts to increase, we need excess inventory to clear and builders' confidence to improve

Weak new home starts have put housing figures at a record low. The number of building projects and new home starts both held steady in first quarter of 2011 at an annualized rate of around 560,000 units a month, similar to the averages for 2009 and 2010. Among new home starts, multi-family homes for rental have gained ground while the weight of single-family new home starts has fallen to comprise 72% of the total during the first quarter of 2011, 8 percentage points below the 2009-2010 figures. As demand for rental properties remains, this trend in the composition of new home starts looks to continue in the second half of 2011 and into the first half of 2012.

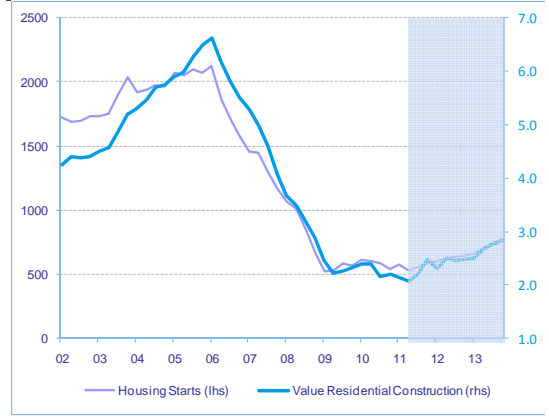
Our forecasts for new home starts show a positive trend in 2012 when we could see an average of 625,000 units, 11.5% more than the 2011 average, rising to just over 700,000 units in 2013. New home figures could be squeezed by the high volume of existing homes for sale and the addition of distressed homes held by financial entities. This unstable situation is clearly reflected in construction spending which shrank 5% in the first quarter of 2011 vs. 2010. According to our estimates, residential construction spending in 2011 will be nearly 3% less than in 2010 in real terms. However, this should pick up in 2012 and 2013, in line with better sales and development activity.

Chart 9  
Single Family Housing Starts. As % of total starts



Source: Census Bureau and BBVA Research

Chart 10  
Housing Starts and Residential Construction Expending. Thousands and YoY % change



Source: Census Bureau and BBVA Research

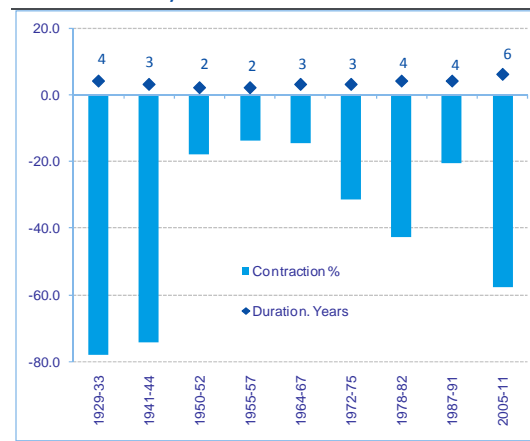
## Residential investment will continue to erode GDP growth in 2011, but will turn positive in 2012

Figures available for the first half of 2011 indicate that residential investment has continued to decline, albeit at a slower rate than in previous years. According to our estimates, residential investment will continue to erode GDP growth by 2% in 2011 before turning positive in 2012. Recovery will be slight in 2013 and 2014 and the contribution of this segment to economic growth will be significantly less than during previous recoveries.

The current housing recession is the longest (six years) and the third most intense, 60%, of the past 100 years, beaten only by the Great Depression (1929-1933) and the Second World War (1941-44).

Chart 11

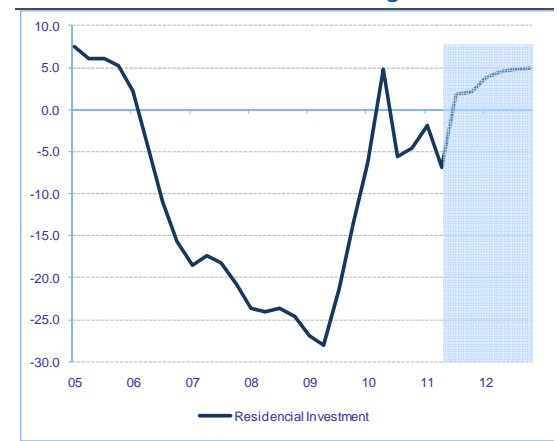
**Residential Recessions. Duration and investment contraction. In years and total decline (%)**



Source: BEA and BBVA Research

Chart 12

**Residential Investment. YoY % change**



Source: BEA and BBVA Research

### 3. Commercial Real Estate

#### CRE market recovery is not clear yet: higher long-term interest rates, expected for 2012, could harm cap rates forcing CRE prices to adjust further

Data for the early months of 2011 show the downturn in commercial real estate (CRE) for rental is slowing, with some signs of a slight rebound. We believe recovery is going to be slow and don't expect to see any meaningful improvement for a few quarters. In addition, there are still some underlying risks related to the level of long-term interest rates. Both the job market and business expectations must improve before CRE investment can pick back up.

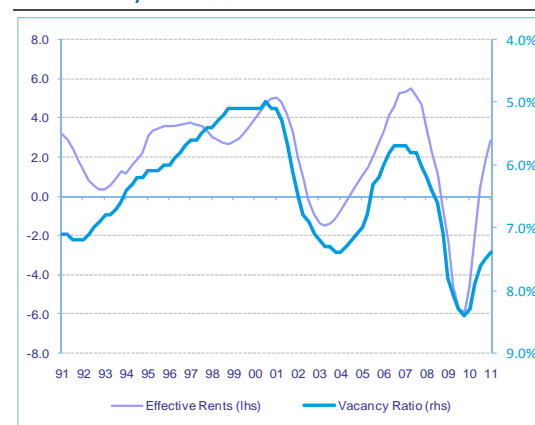
However, performance across segments has been uneven: the rental apartment segment rebounded in 2010, while office, retail and industrial segments remain low. In the hotel market, economic recovery will have to gather steam for any positive signs to appear. Currently driving the rental apartments segment is the shift in the bias of residential demand towards rentals over ownership. The rental apartment vacancy rate fell back to around its long-term average in the first half of 2011, with growth in rents outstripping inflation. Forecasts for this market indicate that the current positive trend and dynamism will continue in the second half of this year and throughout 2012, leaving scope for further declines in vacancy rates and growth in rents above 3%.

Employment growth in recent quarters, coupled with the dearth of new CRE space, have led to steadier vacancy rates and effective rents in the office, industrial and retail segments. Lower requested CRE cap rates have underpinned a rebound in yields of existing rental properties in practically all sub-segments. Even so, investment in CRE continues to decline, while prices have yet to stabilize. Forecasts for the second half of 2011 and 2012 call for a steadier CRE market: with a slight increase in the number of transactions, a slightly decline in available space and a stable level of rents in the absence of demand-side pressures. However, the risk of an uptick in interest rates adds upward pressure on cap rates, which could cause CRE prices to slump again.

#### Uncertainties in the residential market is boosting the rental apartments segment: the vacancy rate is declining, while rents are rising

Amid the real estate meltdown, residential demand has shifted towards rentals. According to REIS data, since the economy began recovering national rental vacancy rates have declined by nearly 2 percentage points (pp) to slightly more than 6% at the end of the first quarter of 2011, while effective rents have risen by 2.8%. Rising demand for rental apartments has fueled an increase in multi-family housing starts since the end of 2009. In fact, housing starts in the first half of 2011 were double the year-earlier figure, averaging around 150,000 units. However, this level is still far below the long-term average of around 350,000.

Chart 1  
**Rental apartments. Effective rents YoY % change and vacancy ratio (%)**



Source: Popertand and Portfolio Research and BBVA Research

Chart 2  
**Rental Apartments Started. Quarterly moving average (thousands).**



Source: Census Bureau

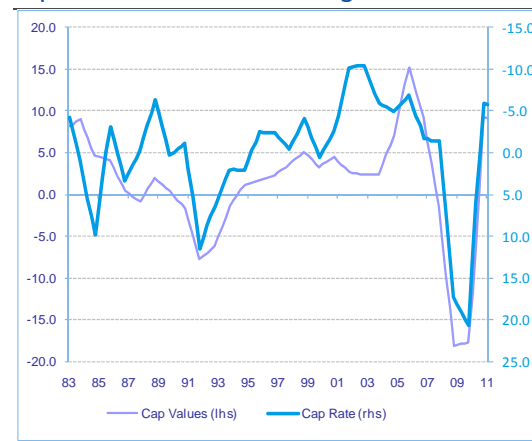
In the second half of last year and throughout the first half of this year, rental cap rates eased slightly as the risk related to this type of investment declined. Therefore, with rents growing, rental apartment prices have outstripped inflation since mid-2010.

Higher rents and prices have boosted returns, which turned positive at the start of 2010 and reached 6% by the end of the year according to National Council of Real Estate Investment Fiduciaries (NCREIF) data. Prices for this type of building eased in the first few months of 2011, squeezing returns; in fact, by the end of the first quarter, returns had ticked back to 3% on average. Trends show further declines throughout the course of 2011.

While uncertainty over the performance of owner-occupied home prices lingers and mortgage deleveraging continues, residential demand should remain skewed towards the rental segment. On our estimates, this process will continue until the second half of 2012.

Chart 3

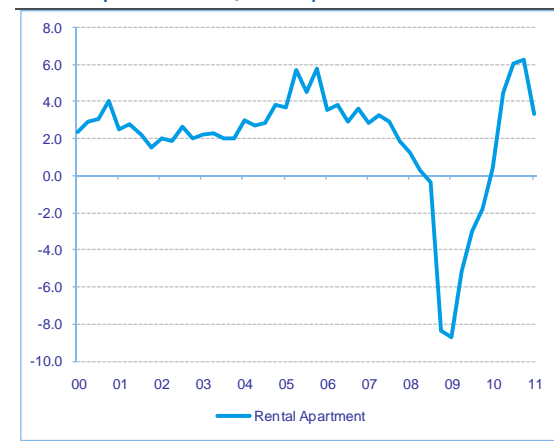
#### Rental Apartments. Capital Value and Capitalization Rate. YoY % change



Source: Popertand and Portfolio Research and BBVA Research

Chart 4

#### Rental Apartments. Quarterly returns %.

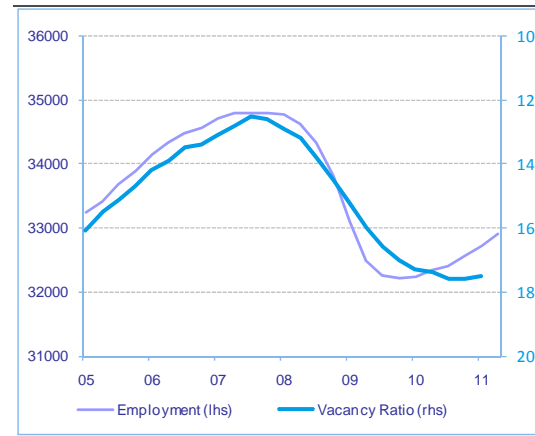


Source: NCREIF

### The downturn in commercial real estate has slowed thanks to the improvements in employment and household consumption. Further growth in employment is needed to positively reverse the trend of CRE investment

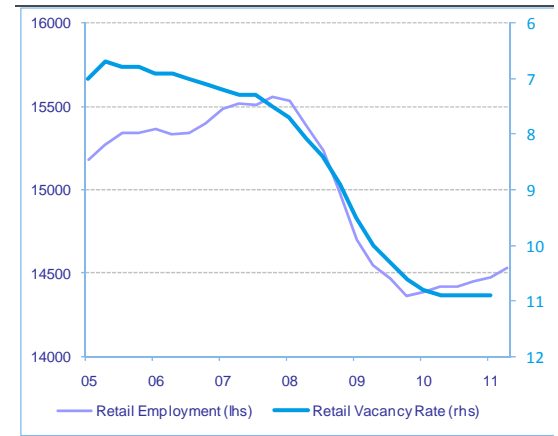
From the beginning of 2010 to mid 2011, total nonfarm payrolls increased by slightly more than two million, of which 300,000 were industrial and construction jobs and nearly 1.8 million were jobs in the services sector. The rise in employment has helped quell the increase in the stock of vacant properties and stabilize vacancy rates. To be sure, industries demanding office space contributed nearly half of the increase in service sector employment in the period. Higher household demand has also helped drive an increase in the retail sector, with nearly 200,000 more jobs, and demand for this type of commercial space. Taking current employment growth rates, it would take roughly three years to abolish the excess capacity in the office segment and slightly more than four years to eliminate the surplus in retail sales space. Employment growth needs to be stronger to reduce the level of excess supply and boost CRE investment.

Chart 5  
**Offices: Employment and Vacancy Ratio. Thousands and Ratio %**



Source: BLS, REIS and BBVA Research

Chart 6  
**Retail: Employment and Vacancy Ratio. Thousands and Ratio %**



Source: BLS, REIS and BBVA Research

**Returns have returned to positive territory and are back at similar levels to midway through the previous decade, but may not be sustainable in the second half of 2011 and in 2012 given the uncertainty surrounding long-term interest rates**

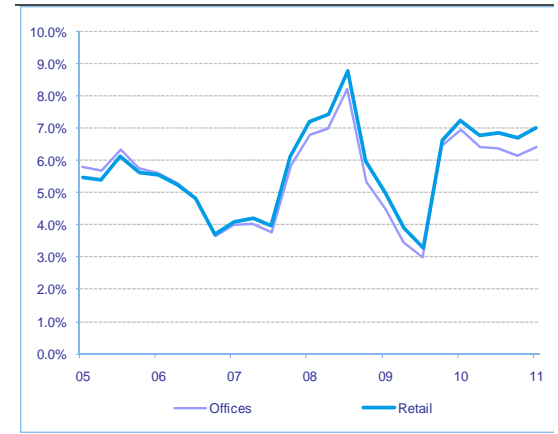
The return to positive CRE returns was mainly underpinned by price increases in this segment, not any improvement in effective rents, which continued to decline in the early months of 2011, albeit at a slower pace. Estimated returns in the office, commercial and industrial segments in the first quarter of 2011 were similar to pre-crisis levels.

Chart 7  
**CRE. Quarterly returns %**



Source: NCREIF

Chart 8  
**CRE. Cap rates minus real interest rates %**



Source: Popertand and Portfolio Research and BBVA Research

Across-the-board declines in cap rates drove up CRE prices. The risk premium has fallen enough to cushion the declines in effective rents and produce a slight increase in prices with interest rates hovering around 3.0% and 3.5%. In 2012, however, this trend could be undermined by rising long-term interest rates, which would push cap rates up and hurt CRE prices.

That said, upbeat prospects for employment growth, household income and consumption levels leave scope for declines in CRE vacancy rates in 2012 and 2013 and for an increase in the number of transactions. As business confidence is shored up, investment in real estate will rebound. Our forecasts point to growth in the first half of 2012.

## 4. Mortgage Market

### The quality of the mortgage portfolio is improving significantly, which is one of the first steps to the full recovery of mortgage financing

During the first six months of 2011, mortgage lending continued to decline and current data suggest that the deleveraging process will continue into 2012. Despite low interest rates, demand for mortgage loans remained weak. On the supply side, financial institutions continued with very tight credit standards for mortgage loans. In the residential segment, demand for mortgage loans will increase as home prices stabilize and households' expectations improve. In order for demand for loans to pick up and lending to expand in the commercial segment, it is necessary for the prevailing surplus of available commercial property and office space to decrease significantly and for the economic recovery to intensify.

In this context, financial institutions have also carried on cleaning up their balance sheets during the first six months of 2011, and a significant improvement in the quality of the mortgage portfolio is now evident. The number of loan defaults declined again, while net mortgage loan losses were notably lower than in the first half of 2010. For the first time since the real estate crisis began, the portfolio of foreclosed residential assets held by financial institutions also reduced. The portfolio of foreclosed commercial assets, however, remained at similar levels to those observed in the last quarter of 2010.

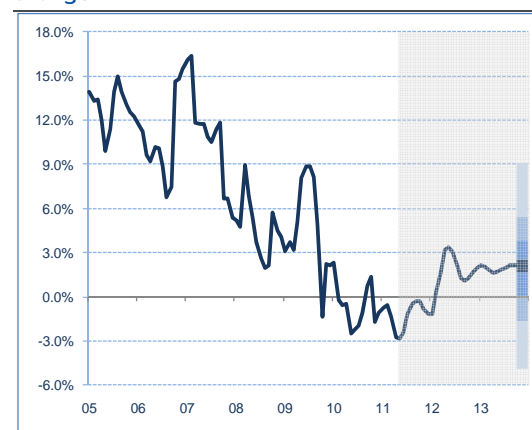
Against this backdrop, activity in the secondary market in 2011 has remained at similar levels to before the recession. In any event, mortgage bond issues are concentrated among government-sponsored agencies, while private issuers have disappeared from the market. The legislative changes being considered by Congress and the Administration will shape the securitization process in the near future.

### The fragility of the economic recovery, dropping property prices and the weak labor market are contributing to a limited demand for mortgage loans

During the first half of 2011, mortgage deleveraging by households and companies continued at a similar rate to previous quarters. At the end of the first quarter of 2011, the mortgage lending balance of the system was \$13.7 billion, down almost 3.0% YoY. The residential mortgage outstanding declined 2.5%, while the commercial real estate mortgage outstanding dropped 4.6% YoY. Between the peak recorded in the second quarter of 2008 and the first quarter of 2011, the volume of mortgage lending of the entire financial system shrank by close to \$1 billion, representing a 6.6% decrease from the aforementioned peak. Our estimates are that this outstanding could decrease by a further 5%, around \$0.7 billion, to approximately \$13 billion before beginning to recover in the second half of 2012.

Chart 1

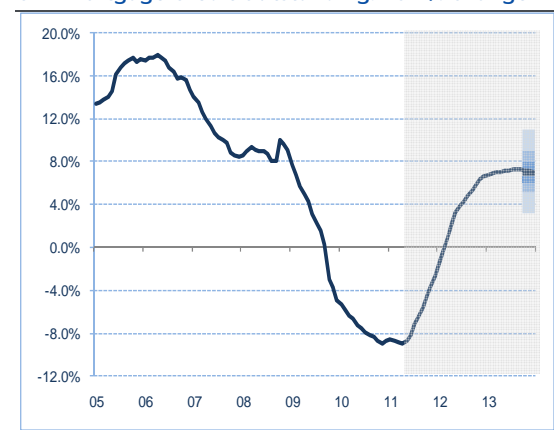
**Residential Mortgage Credit Outstanding. YoY % change**



Source: Reserve Federal and BBVA Research

Chart 2

**CRE Mortgage Credit Outstanding. YoY % change**



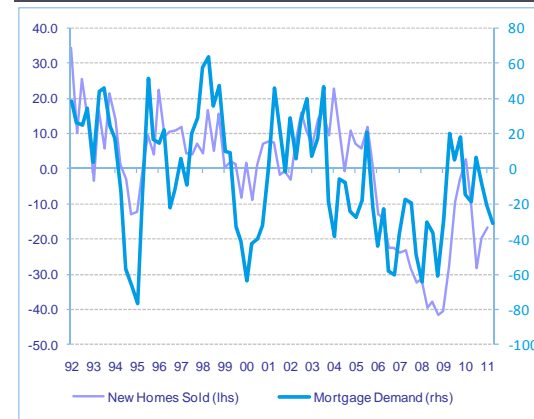
Source: Reserve Federal and BBVA Research

During the first half of 2011, demand for mortgage loans to acquire residential properties remained weak, as data from the Senior Officers Survey published by the Federal Reserve show. In this regard, in

the first quarter of 2011, total home mortgage originations reached \$300 billion, 23% down from the last quarter of 2010. Furthermore, the majority of the home mortgages originated in recent quarters have involved refinancing existing loans rather than the granting of new loans. In fact, according to data prepared by the Mortgage Bankers Association, refinancing transactions have increased to 70% of total lending originations in recent quarters. This refinancing process is driven strongly by the low mortgage loan interest rates prevailing. Home sales will have to pick up considerably if new mortgage loan applications are to recover.

Chart 3

**Residential Mortgage Demand and Housing Sales.**  
As % of responses and YoY % change



Source: Reserve Federal, Census Bureau and BBVA Research

Chart 4

**Mortgage Refinance. As % of mortgage originated.**  
4Q moving average

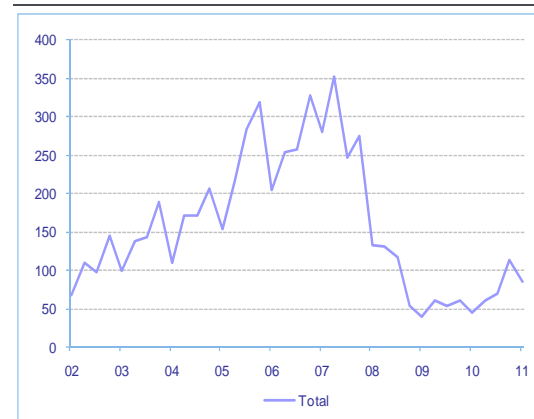


Source: MBA, Harver and BBVA Research

In the case of the commercial real estate segment, demand for loans rose slightly during 2010, although it remains at relatively low levels compared to the demand in previous years. During the first quarter of 2011, this demand shrank somewhat, although it rose YoY. Two factors have been the main drivers in this segment: the gradual improvement in employment rates, which is underpinning demand for commercial premises, and the opportunities created by foreclosed commercial real estate held by financial institutions being released onto the market at strong discount prices.

Chart 5

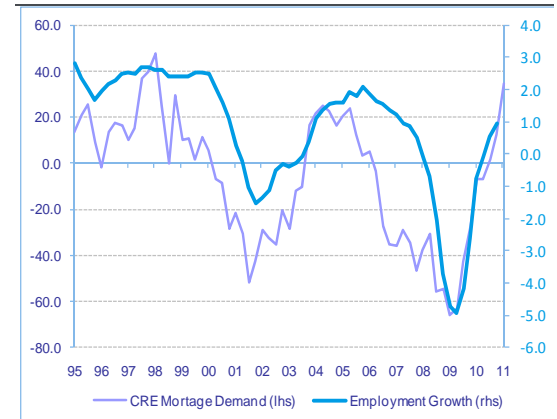
**CRE Mortgage Originated. Index 2001 average = 100**



Source: Mortgage Bankers Association

Chart 6

**CRE Mortgage Demand and Employment Growth.**  
As % of responses and YoY % change



Source: Reserve Federal, BLS and BBVA research

**As the quality of the mortgage portfolio improves, net loan losses decrease and loan defaults fall. Growth in new home foreclosures is winding down significantly, and our forecast indicates that it will stabilize during the second half of 2012**

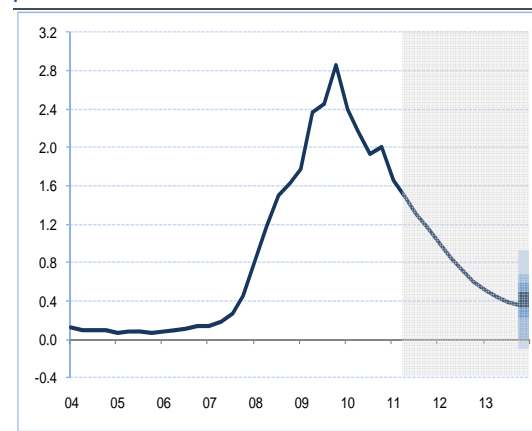
While households are gradually deleveraging, financial institutions are very slowly clearing bad debts; therefore the non-performing loan ratio remains stable. In fact, at the end of the first quarter of 2011, mortgage delinquency rates stood at very similar levels to the end of 2010 at around 7%.

Despite this, the quality of the mortgage loan portfolio has improved slightly since the beginning of 2010: the point at which net loan losses started to drop in both the residential and commercial segments. At the end of the first quarter of 2011, net chargeoffs in the residential segment represented 1.6% of the portfolio, 1.21 points below the maximum of the fourth quarter of 2009. Over the same period, net chargeoffs of the commercial real estate segment dropped by 0.92 points to 1.86% of the portfolio. Our forecasts indicate that this process will prevail throughout the second half of 2011 and will intensify during 2012, although levels similar to before the recession will not be achieved until the beginning of 2014.

While non-performing loan ratio remains high, the entry of new bad debts is gradually decreasing in all segments. In fact, in the first quarter of 2011, the percentage of mortgage loans 30 to 90 days past due dropped to 1.9%, 0.6 points below the maximum recorded in the last quarter of 2009.

Chart 7

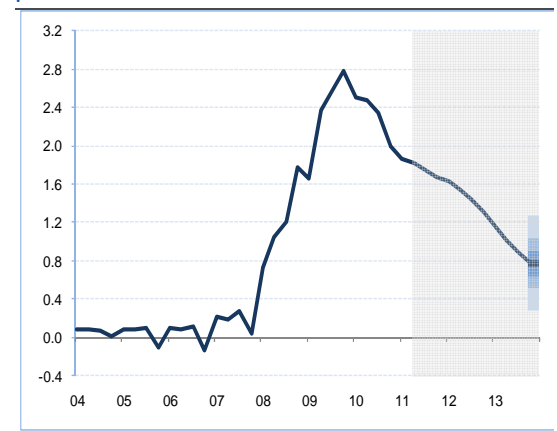
**Residential Mortgages: Net Chargeoffs. As % of the portfolio**



Source: FDIC and BBVA Research

Chart 8

**CRE Mortgages: Net Chargeoffs. As % of the portfolio**



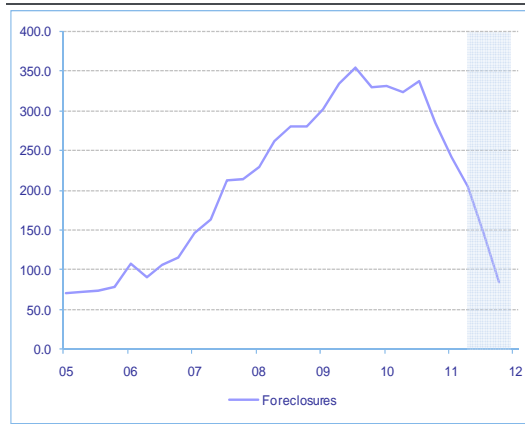
Source: FDIC and BBVA Research

The volume of foreclosed homes also fell in line with this, as shown by the data published by RealtyTrac. In May 2011, slightly more than 200,000 foreclosure processes due to mortgage default were initiated 40% less than the peak observed in March 2010. The downward trend in this indicator suggests that the volume of foreclosures will normalize in the first quarter of 2012.

The improvement in the quality of mortgage loans originated in the last two years also indicates that the future non-performing loans ratio will remain at manageable levels. Indeed, the non-performing loan ratios for 2009 and 2010 are considerably below the average for the period 2005-2008, as shown in the data collated by Lending Processing Services.

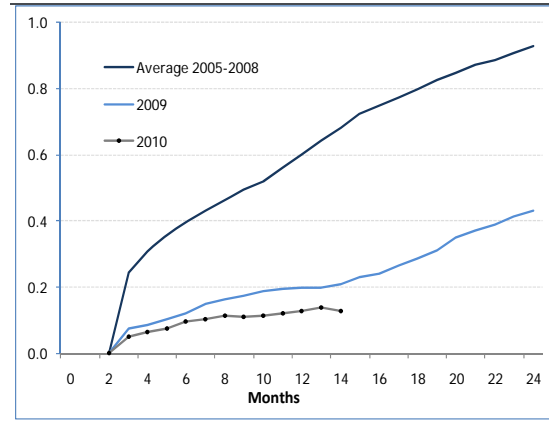


Chart 9  
**Foreclosure Fillings. Quarterly moving average (thousands)**



Source: RealtorTrac and BBVA Research

Chart 10  
**Residential Mortgage Delinquency by Vintage. As % of the portfolio**

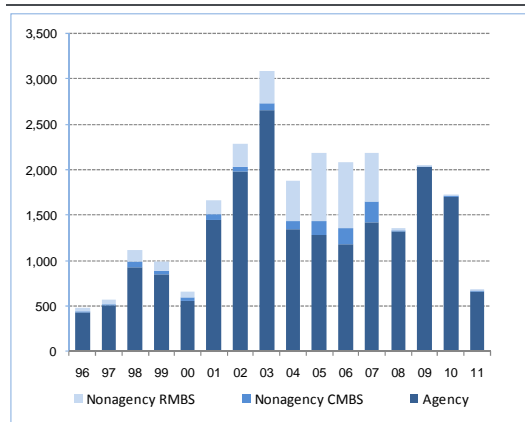


Source: Lending Processing Services and BBVA Research

**The number of mortgage backed securities issued on the secondary market will also remain high in 2011, although these issuances basically comprise in the governmental sponsored agencies**

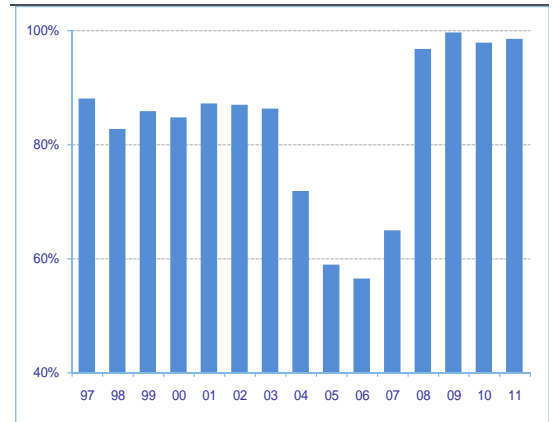
During the first five months of 2011, close to \$700 million of mortgage backed securities were issued, 8.3% higher than those issued in the same period of 2010. The securitization of mortgage assets was not interrupted by the real estate crisis, although this activity has been restricted to issues by government- sponsored agents (Fannie Mae, Freddie Mac and Ginnie Mae). The high number of mortgage securities issued suggests that this re-financing system retains its former advantages and that is still efficient to obtain funds from the equity markets.

Chart 11  
**Mortgage Backed Securities Issuance. \$ Billion**



Source: SIFMA and BBVA Research

Chart 12  
**GSE's Issuances. As % of total**



Source: SIFMA and BBVA Research

Currently under discussion at various government regulators is the definition of a qualified residential mortgage (QRM), which is the residential mortgage standard that is exempt from credit risk retention requirements. If the rules for achieving QRM are set conservatively, for example, at a 20% down payment, no 60-day delinquencies on any debt obligation in the past two years, mortgage payments not greater than 28% of income, and so forth, the result will be extremely safe securitized products. On the other hand, these products will not apply to the largest pool of possible homeowners. The regulators' task is to balance access to mortgages and the desired aggregate risk in the secondary market, the outcome of which will define the pace of securitization in the future.

Another potential regulatory wrinkle for mortgages is the threshold for a jumbo mortgage status at the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. Interim ideas from both Congress and the Obama administration suggest a desire to lower the credit risk to the government from the GSEs. One way to accomplish this, in theory, is to gradually lower the jumbo threshold and increase the cost of GSE guarantees in order to catalyze the private market for Residential mortgage backed securities (RMBS) insurance.

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