Commercial Real Estate – The Next Shoe to Drop?

"Over the next few years, a wave of commercial real estate loan failures could threaten America's already-weakened financial system. The Congressional Oversight Panel[6] is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy."

Congressional Oversight Panel's February Oversight Report
"Commercial Real Estate Losses and Risks to the Financial System"
February 10, 2010

Having been burned by the meltdown in residential real estate, investors have cast a wary eye toward the commercial side of the market. A recently released report by the Congressional Oversight Panel (COP) has added to that anxiety by pointing out that trouble in the Commercial Real Estate (CRE) market could hobble the nascent economic recovery by severely curtailing lending at small and mid-sized U.S. banks. While no one disputes that the coming CRE loan losses are problematic, what is less certain is the extent to which these loans can derail the economy. In this section, we examine the scope and severity of the underlying problem to determine the proper course of action for our client portfolios.

The COP report includes some sobering statistics. Nationwide, at least $1.4 trillion in CRE debt is expected to roll over during the next three years as commercial properties mortgaged in 2005, 2006 and 2007 reach their refinance date[7]. According to the COP, half of the CRE mortgages will be underwater[8] by the beginning of 2011 (compared to a fifth of residential mortgages underwater currently). The report also noted that of the roughly 8,100 U.S. banks, 2,988 small institutions[9] have "problematic exposure to CRE loans," meaning that their level of CRE loans is 1) at least 300% of total capital or 2) their construction or land loans exceed 100% of capital. The COP estimates that these banks could face $200 billion to $300 billion in potential losses, which may force these institutions to dramatically curtail their lending (at best) or file for bankruptcy (at worst). Since the start of 2008, 181 banks and savings institutions have been seized by regulators, including 16 this year. While troubling, this is still much lower than the previous downturn in commercial real estate between 1986 and 1994, when 1,043 thrift institutions and 1,248 banks with total assets of roughly $726 billion ($1.19 trillion in 2009 dollars)[10] were taken over by regulators.

ORIGIN OF CRE LOAN PROBLEM

To understand why these problems are especially acute at small and mid-sized banks, it is helpful to explain how we got to this point.

1) Small Banks Crowded Out of High Quality Loans by Large Banks. The highest quality borrowers in the space (i.e., commercial real estate secured by large properties with steady income) gravitated toward origination by larger institutions since these properties typically required larger loans than smaller and community banks could provide.[11] In addition, larger institutions that pooled and securitized their loans also provided lower cost, non-recourse loans that borrowers found very attractive.

2) Small and Mid-Sized Banks Took On Riskier Loans To Compensate. In order to compete in the commercial real estate space, small and mid-sized banks originated higher risk loans that were not typically securitized, including non-stabilized properties, land and development deals. This meant that banks not only issued a higher proportion of lesser quality commercial loans, they also held on to *(continued next page)*

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[6] *The Congressional Oversight Panel is the watchdog group tasked with overseeing the government's $700 billion Troubled Asset Relief Program (TARP).*

[7] *Unlike residential mortgages, which can often be paid over 30 years, CRE mortgages held by banks must typically be paid or refinanced within five years. CMBS are typically 10-year terms with a balloon.*

[8] *Meaning the borrower's debt is more than the property is worth.*

[9] *Defined as banks with $100 million -$1 billion in assets*

[10] *Federal Deposit Insurance Corporation,* Number and Deposits of BIF-Insured Banks Closed Because of Financial Difficulties, 1934 through 1998.

[11] *Dugan Testimony, Dugan Testimony, March 4, 2008, Senate Banking Hearing; Richard Parkus,* The Outlook for Commercial Real Estate and Its Impact on Banks, *at 17 (Jul. 30, 2009).*

Investment Theme (continued from 6)

Lack of credit for potential CRE tenants who can't get small loans to build out space for start-up businesses is compounding the problems brought on by the economic downturn.

them rather than sell them off to other investors.

3) Economic Downturn and Lack of Credit Exacerbated Losses. Job losses, curtailed spending and corporate restructurings all put additional pressure on banks, some of whom had not fully recovered from the losses suffered on their residential mortgage loans. Currently compounding the problem is lack of credit for potential CRE tenants who can't get small loans to build out space for start-up businesses. Not only has credit dried up, but lenders face several additional risks. These include the borrower's inability to cover the interest and principal payment that comes due, as well as the borrower's inability to refinance the loan given tougher bank underwriting standards and significant decreases in the value of the underlying property.

Extend and Pretend

Some banks have responded proactively to the coming wave of loan losses by restructuring the terms of the troubled loans. As long as the interest payments are made and the loans are technically "performing," some banks have chosen to extend the maturity of these loans for two to three years with the aim of buying time for the economy and borrowers to get back on track and, hopefully, help banks avoid large loan losses. While these restructuring efforts could make for a "soft" landing over the short term, it may only be matter of time before some of these problem loans re-emerge. Of the roughly $140 billion in troubled commercial mortgage assets in the U.S., $17.1 billion has already been modified in some way, according to data research firm Real Capital Analytics. To the extent these loans are not included as nonperforming assets, they could potentially give a misleading view of true credit quality in the industry.

COUNTERPOINT – WHAT COULD GO RIGHT

While the scope of the coming loan losses has been largely discussed and priced into stock prices of small and regional banks, there are several countervailing factors that could lessen their impact.

1) FDIC Wind-Down Process Highly Efficient. In the event of bankruptcy, the FDIC has a well-defined process to wind down the operations at these institutions, which should help avoid a disorderly collapse and "run" on the financial system.

2) Banking System Better Able to Absorb Losses. The banking system is much better capitalized than before the residential mortgage meltdown, which should help regulators isolate losses at specific banks and avoid "contagion" or spread of credit-related issues to non-affected banks.

3) Stronger Underwriting Standards for CRE Loans. Underwriting standards are higher for CRE loans than they are for residential mortgages. The average CRE mortgage loan to value (LTV) ratio is between 55 and 70%, while LTVs for residential mortgages typically start at 80%.

4) Small Banks Not Systematically Important. CRE loans are disproportionately held by small banks, which, by definition, are not "too big to fail."

5) Economic Recovery May Be Better Than Expected. These dire loan loss predictions could end up being overstated, particularly if the economy rebounds, unemployment decreases or the securitization market revives and credit for developers begins to flow once more.

So while the coming commercial real estate loan losses will likely restrain lending at small banks and prolong weakness in the economy, they are unlikely to create another Lehman-like shock to the financial system or serve to freeze credit markets overnight – at least in isolation. Combined with credit issues in other areas of the debt market (namely residential loans, corporate defaults and state and local government debt levels), CRE losses have the potential to materially exacerbate any credit related systemic issues.

PORTFOLIO IMPLICATIONS

Our portfolios are currently underweight financials (relative to our benchmarks), with only five banks in the global portfolio: two U.S. domiciled regional banks and three large, multinational (foreign domiciled) banks. While all five banks have varying degrees of exposure to commercial real estate loans in the U.S. (either directly or through their U.S. operations), the most exposure to these loans would reside with the regional Cullen Frost Bank (CFR). That said Frost Bank has a well-established reputation for conservative management, evidenced by the fact that it was one of very few banks in the country to reject TARP funds, as well as the only large Texas bank to not go under during the previous commercial real estate bust in the late 1980s.

From a tactical standpoint, we will continue to closely monitor the loan loss ratios and provisions for the banks in our client portfolios, and will take the necessary steps to minimize the effect of CRE loan losses on the overall portfolio. ■