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Next economic crisis looms: Commercial real estate defaults

Kevin G. Hall | McClatchy Newspapers

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WASHINGTON — Two years after fissures in the residential housing market gave way to a national collapse of home prices and sales, experts warn the next shoe to drop is the commercial real-estate market, bringing more woes to the battered economy.

Thousands of commercial mortgages valued at hundreds of billions of dollars are approaching a renewal date. By some estimates, two out of every three will no longer meet the original loan conditions and won't be able to refinance. And with prices for commercial properties expected to plunge, a vicious cycle may unfold much as it has in the nation's housing market.

"It's the next wave to hit. It's the next round of bad news," said Scott Talbott, the senior vice president of government affairs for the Financial Services Roundtable, a trade group for big banks and other financial institutions who are collectively concerned about the coming problems.

A commercial mortgage meltdown is likely to prolong the nation's economic recovery. The falling prices in commercial real estate will lead to additional bank losses at a time when banks are sapped by home mortgage defaults and soaring credit card defaults. This could lead to future additional taxpayer assistance for the banks.

The reality is already on display. On April 16, the nation's second largest mall developer, General Growth Properties, filed for bankruptcy protection. The Chicago-based company owns more than 200 malls across the U.S., and was unable to renegotiate its debts as they came due.

Six days later, a 40-story office tower on New York's Avenue of the Americas was seized by its creditor, a Canadian-owned pension fund. The tower's owner, Macklowe Properties, couldn't meet loan terms.

"On the street, the rumor is it is coming and it's going to come fast and furious. Some people are predicting September," said Paul Waters, a New York-based executive vice president of brokerage operations in North America for NAI Global, a top-five commercial real estate brokerage with operations across the globe.

Just like the housing meltdown, the commercial real estate crunch is likely to begin as a slow bleed that gains momentum. The coming commercial real-estate crunch is likely to be spread evenly across the nation, in large part because of an outgoing economic tide that's spared few companies anywhere.

"There's going to be a lot of trouble on Main Street with some of these commercial and industrial buildings. The biggest impact will be on some of the smaller owners," Waters said. "The smaller local regional players that are stretched thin may have some great difficulties with their mortgages."

How bad it gets will depend on speed of economic recovery. Office space and multifamily apartments, two huge components of commercial real estate, are highly dependent on employment. Even if the economy begins growing again late this year as forecast, the number of unemployed is expected to keep rising well into next year.

"The translation is that office vacancy rates would continue to rise until mid-to late-2010," said Christopher Cornell, an economist specializing in commercial real estate for Moody's Economy.com, adding that "it's a drag on the recovery" well into next year.

The last crisis in commercial real estate — which includes office space, malls, industrial parks and multifamily apartments — came in the early 1990s. The problem then was an oversupply of new properties. Today, the driver is a deep economic downturn, with the economy contracting by more than 6 percent in each of the last two quarters.

As in the housing meltdown, weakened lending standards are a big part of the story for commercial real estate. Unlike housing, however, the ill effects from weakened commercial lending standards have been camouflaged to date because they've had a longer horizon than housing did over which to implode.

"If you take a look between 2005 and 2007, the underwriting standards on both the consumer side and the commercial side were spinning out of control," said Kevin Blakely, the president of the Risk Management Association, a Philadelphia-based trade group for financial risk managers. "I think it is a bigger issue than we like to admit."

In housing, many of the loans with poor underwriting went bad within two years, when adjustable-rate mortgages were due to reset to higher interest rates and raise monthly payment costs for homeowners.

However, commercial properties carry mortgages with lives of five years or 10 years. And these loans issued from 1999 to 2007 are coming up for a rollover — refinancing under similar terms. Today's economic downturn and credit crunch makes that unlikely, however, as credit standards have tightened.

As in housing, many commercial properties have mortgages that were bundled together in pools, sliced and diced and instead of being held by banks were sold to investors as bonds and securities. Thousands of these commercial mortgage-backed securities, or CMBS, are reaching their maturity dates over the next three years. Ten-year mortgages

issued in 1999 and 2000 start coming due late this year, and five-year loans issued from 2005 to 2007 come due early next year.

"If you stop and think about what is coming up for maturity over the next couple of years, either on the banks' books or CMBS, there is going to be a day of reckoning as those loans mature and they have to be rebalanced and reset to today's underwriting standards," said Blakely, who worked 17 years as a bank regulator followed by 17 years as a bank executive and risk officer.

A March study by the Wall Street arm of Deutsche Bank, Germany's largest financial institution, points to this day of reckoning. It found that the number of U.S. commercial loans that hadn't refinanced within a month of their end date had tripled.

Refinancing usually happens months ahead of the end date. Since October, commercial refinancing has dropped from a pace of more than 400 mortgages a month to fewer than 100 a month, the bank said.

The report, entitled "Commercial Real Estate at the Precipice," said that under lenient underwriting standards, 56.8 percent of existing commercial mortgages wouldn't qualify for refinancing. Using conservative standards, two thirds won't make the grade.

That suggests that lenders will have to extend loans, much like they've tried to freeze adjustable-rate residential mortgages at their original lower rate to avoid a foreclosure. Even if the commercial loans are simply extended for a year or two, however, commercial real-estate prices are forecast to keep dropping so the time bomb will be delayed not defused, the report concluded.

"In our view, much of these losses are unavoidable, even in a mass (loan) extension environment," wrote Richard Parkus, the report's author.

Forecaster Moody's Economy.com expects \$375 billion in losses on the \$3.5 trillion in commercial mortgage loans and securities outstanding. That a loss rate of about 11 percent, nearly twice the rate of home mortgage foreclosures, and the forecaster thinks that about \$200 billion of those commercial losses are still ahead.

"This is significant, but small compared to the over \$1.1 trillion losses ultimately expected on residential mortgage loans and securities. Commercial mortgage losses will be a significant problem for many mid-sized and small banks," said Mark Zandi, the chief economist for Moody's Economy.com. "In fact, most of the banking failures that occur in the next several years will be due to losses on commercial mortgage loans."

Earlier this year, the Treasury Department and Federal Reserve announced a program in which they'll lend to investors willing to purchase the safest, top-rated commercial mortgage-backed securities. The Fed is trying to use its power as a lender of last resort to help keep some credit flowing into commercial real estate markets. This effort, however, is of limited importance because it targets the safest of commercial mortgages and won't address all that ails this important sector.

Additionally, pools of commercial mortgages are expected to be included in the auction of so-called toxic assets being readied by the Treasury Department through a public-private partnership.

Still, commercial real-estate brokers are bracing for protracted hard times.

"There will be a re-engineering of the culture of the real estate business," said Waters, the NAI Global executive, who expects few new development projects until the mortgage problem runs its course. "All the avenues to dispose (of bad commercial loans) are going to be utilized."

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