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DEBT PERCEPTION

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and Gerald Klassen

The lights went off in the U.S. commercial real estate markets in the summer of 2007, when the credit markets froze. Even though the Federal Reserve said the credit crunch was "contained" in the subprime residential market and that there was "no contagion" in the other credit markets, commercial mortgage professionals knew differently.

Before this, commercial real estate markets were clearing, with a high volume of transactions and increasing prices. In July 2007, transaction volume fell off a cliff.

The National Association of Realtors reported volume in second quarter 2008 was 70 percent lower than second quarter 2007. Bid prices dropped hard and fast. Sellers kept their asking prices too high, hoping that the change in market sentiment was only temporary.

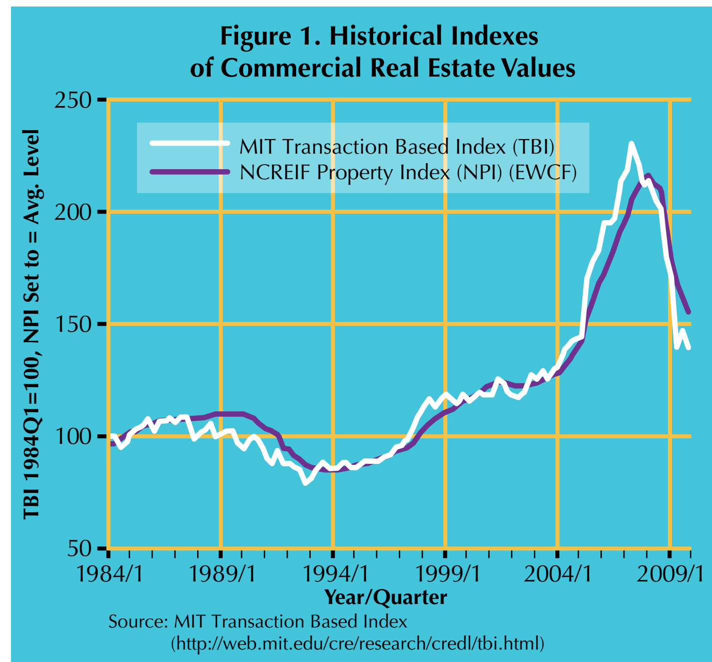
How far did bid prices fall? No one will ever know because there were no transactions to document the trend.

Foreclosure Flood Ahead

For almost three years now, there has been little transaction volume outside of the distressed debt market. "Normal" sales comps are few and far between, making it difficult to determine current market values. The MIT Transaction Based index (TBI) indicates that values are down about 40 percent from the peak values of 2007 (Figure 1).

TIAA-CREF has written down their portfolio of "trophy" real estate properties by about the same amount. The Congressional Oversight Panel estimates that nearly half of the $1.4 trillion in commercial real estate loans scheduled to mature between 2010 and 2014 are presently underwater (Congressional Oversight Panel, February Oversight Report, Feb. 10, 2010).

Trends in the banking industry and FDIC policies are likely to keep transaction volume muted in 2010 and probably 2011 as well. The long-anticipated flood of foreclosures and distressed property sales is yet to come.



A Rolling Loan Gathers No Loss

In 2009, several phrases were coined to describe banks' attitudes toward commercial real estate loans (CRE). Early in the year it was "kick the can down the road," meaning that the banks wanted to avoid taking large losses on CRE and were willing to extend loans rather than require repayment. If necessary, loan reserves were tapped to keep mortgages "current" and "performing."

The phrase "extend and pretend" came into the vernacular next, meaning the bank would prefer to extend a loan and pretend there was no loss. This ultimately led to "a rolling loan gathers no loss."

The actions taken by federal regulators have had two important results. First, " extend and pretend" has stifled transaction volume growth in the U.S. market. Second, credit available for commercial real estate has declined as bank regulators have instructed banks all over the country to reduce their CRE exposure. In the second half of 2010, expect the commercial real estate market to remain in this uncomfortable limbo. Only trophy properties with trophy tenants will likely find lenders.

To get a clearer picture of the repercussions of this policy going forward, a few more details are useful. CRE in the banking system includes more than loans for office, industrial, multifamily and retail real estate. It also includes loans for acquisition of land, development of subdivisions and construction of new homes (Table 1).

Intense Pressure to Limit Real Estate Lending

The principal bank overseers, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) have stringent limits on the amount of CRE loans each bank can make. Banks with a ratio of Total CRE to Tier 1 Capital of 300 percent are deemed to be "CRE concentrated" (Table 2).

Many U.S. banks (including Texas banks) are over the suggested limits and under heavy pressure to reduce their CRE loans outstanding. Consequently, it is difficult to get a loan to buy commercial real estate, develop a subdivision or build a house. The good news is that Texas banks are healthier than their peers in other states (Figure 2). But they are still under intense pressure to limit real estate lending.

The question on investors' minds all over the world is this: When will banks begin to foreclose on their "broken" real estate loans and sell the collateral properties back into the market? The answer appears to be that they won't sell until they have accumulated enough reserves to withstand the losses they will incur when they stop "extending and pretending." Until the FDIC and the OCC are comfortable that the banking system can withstand the losses, they will continue to kick the can down the road.

Table 1. CRE Exposure by Bank Size ($Millions)

Institution Size by Total Assets	Bank Count	Total CRE Loans	Commercial Mortgages	Multifamily Mortgages	Construction and Land	Unsecured CRE
>$100 Billion	20	600.5	318.3	79.7	160.5	42.0
$10 Billion to $100 Billion	92	373.4	209.6	57.0	93.8	13.0
$1 Billion to $10 Billion	584	447.8	272.9	45.9	123.3	5.7
$100 Million to $1 Billion	4,499	412.5	269.0	32.0	108.0	3.5
$0 to $100 Million	2,913	29.7	20.7	1.9	6.7	0.4
Total	**8,108**	**1,864.0**	**1,090.6**	**216.5**	**492.3**	**64.6**

Source: Congressional Oversight Panel, February Oversight Report, Foresight Analytics LLC. "Commercial Real Estate Exposure by Size of Bank as of 3Q 2009"

So how can real estate professionals and investors participate in commercial real estate transactions in this market environment? It depends on the condition of the individual bank and the investment strategy of an investor.

A bank that has established sufficient loan loss reserves might be willing to sell off its troubled real estate because it has already recognized the loss. It may want to sell to avoid further losses or because it does not have the resources to work out the property.

A bank that has not established sufficient loan loss reserves is more likely to want to "extend and pretend" its loans to postpone loss recognition until it has enough capital. The larger the loss, the longer the bank will try to extend. At some point in the future the bank will have built enough capital to absorb the losses and sell the real estate. A bank in this condition will not be a source of transaction activity.

The Federal Reserve is helping banks rebuild their capital by holding down the fed funds rate. This allows banks to pay low interest rates on bank deposits and keep more profit to build up their capital.

Finding Homes for Failed Bank Assets

A bank that purchases the assets of a failed bank may be a source of transactions. When a bank fails, it is usually merged into a "good bank." The good bank acquires the deposits and some of the loans of the failed bank.

Typically the acquiring bank gets a loan-loss guarantee from the FDIC to limit the losses they incur from the loans acquired from the failed bank. It would seem that these banks would be more willing to sell the distressed real estate at reasonable prices because of the loss guarantees. However, sales may not be immediate.

The loss-sharing agreement on commercial real estate and residential mortgages runs for eight years and ten years, respectively. The FDIC announced in March that it is reducing its loss-sharing percentage in future loss-sharing agreements. So troubled real estate acquired from a failed bank could be buried in the acquiring bank for a long time.

If a weak bank is unwilling or unable to sell its distressed assets and it is sold to a good bank, sometimes the acquiring bank will not accept all the bad assets from the failed bank. In fact, there may not be any bank willing to buy assets from the failed bank.

In these circumstances, the FDIC acquires the bad loans from the failed bank. Some of these assets will be sold by auction directly from the FDIC. With the wave of maturities between 2010 and 2014, the FDIC may become the "fountain" from which distressed assets flow into the hands of investors.

The most common strategy in this market is purchasing distressed mortgages at a discount and then either working out the loans with the borrowers or foreclosing on the properties.

Table 2. Banks With 'CRE Concentrations'

Size Group	Total	CRE Concentrations	Banks with CRE Concentrations/Total Banks within Asset Class
>$100 Billion	20	1	5%
$10 Billion to $100 Billion	92	27	29%
$1 Billion to $10 Billion	584	358	61%
$100 Million to $1 Billion	4,499	2,115	47%
$0 to $100 Million	2,913	487	17%
Total	**8,108**	**2,988**	

Source: Congressional Oversight Panel, February Oversight Report, Foresight Analytics LLC. "Commercial Real Estate Exposure by Size of Bank as of 3Q 2009"

However, the FDIC is developing an alternative model that may limit the number of properties coming into the market through auction. In recent months, it has replicated Wall Street's securitization model and bundled up a quantity of low-quality loans to create a form of government-guaranteed commercial mortgage-backed security. The security rather than the distressed assets is sold to investors.

FDIC's Alternative Model

The FDIC guarantee on the security means that investors will get a low interest rate for their investment. This allows the FDIC to effectively borrow against the troubled assets they have acquired at a low interest rate and capture the gain on the distressed assets if the assets can be sold at a higher price in the future. Securitization also enables them to raise the funds needed to take down more troubled banks in the future without going to the U.S. Treasury for a financial bailout.

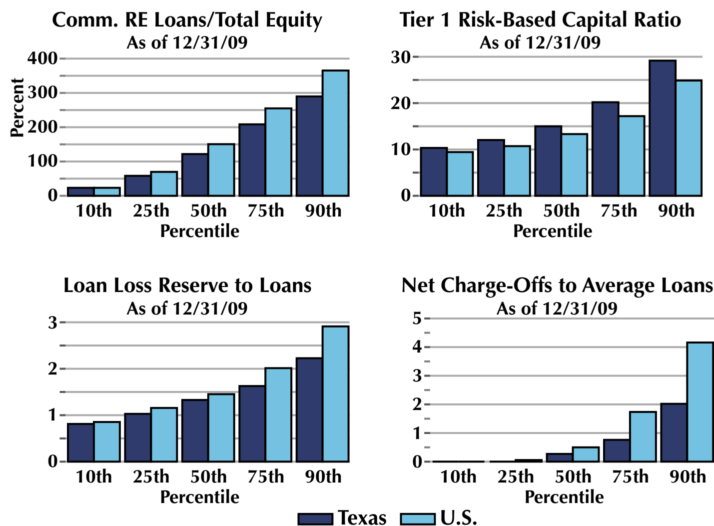
So, what does all this mean? First, it means that transaction volume for CRE is likely to remain at low levels for the rest of 2010 and probably 2011 as well. Banks are going to be reluctant to foreclose and sell troubled properties. Private investors are not going to want to sell their properties in a market expecting massive price discounts. They will choose to hold on to their properties until a more opportune time.

Second, the lack of transaction volume and the huge overhang of troubled real estate held on bank balance sheets will have a dampening effect on price appreciation as well. Until the banking system clears its CRE inventory, investor appetite will be restrained. If the bank regulators change course and demand that CRE losses be recognized, a lot of properties could come into the market in a short time and put significant downward pressure on prices.

The bank regulators will do everything they can to avoid this situation. So, the most likely outcome will be a prolonged period of "nuclear winter" in the CRE markets until the banking system heals sufficiently to clear the decks and start over.

On the demand side for CRE, an interesting situation is developing. Real estate investment trusts and private equity firms have raised billions of dollars in capital to acquire distressed real

Figure 2. CRE Exposure: Texas vs. U.S. Banks



Source: The Carson Medlin Company

estate. To date, they have been unable to acquire properties that meet their investment criteria, so they are sitting on a war chest of cash. They will not be able to sit on that money for long before their investors ask for the money to be returned.

Big Investors Scramble for Limited Good Deals

These entities could actually become "distressed buyers" in 2010 and 2011 as the pressure mounts for them to deploy capital. There could be a situation in which banks are unwilling or unable to sell their real estate, private owners are unwilling to sell into this market and these big investors scramble to outbid each other for the limited number of quality deals. An investor with a high-quality building might find that it will fetch a handsome price soon.

Transaction volume also depends on investor strategy. Investors in distressed debt are reporting activity is greater now than it has ever been. The most common strategy in this market is purchasing distressed mortgages at a discount and then either working out the loans with the borrowers or foreclosing on the properties. This is being called "loan to own."

The traditional model of purchasing the equity position of a property owner does not apply in this market. Market values have fallen so far that owners have negative equity. Owners will do the best they can to hold on to the property as long as it makes economic sense to them. They are hoping that economic conditions change and property values increase so they will be able to refinance when the mortgage matures. Therefore, while they may be distressed, they are not motivated to sell.

When a loan is underwater, the owner has no equity to sell. The only thing an investor can purchase is the remaining value of the lender's position in the mortgage. Investors should be talking with banks, because they have become the real owners.

The current crisis is slightly different from the 1980s savings and loan (S&L) crisis. The Resolution Trust Corporation was not a distressed owner. They were not in a negative equity position, so they could afford to dispose of property at low prices because the bank shareholders and creditors had already taken the loss.

Follow Loan Maturity Trail to Distressed Properties

In this crisis, the distressed owners and banks are still in the picture and regulators are doing everything possible to prevent their failure. The spread between bids and asking prices remains wide because investors have a post-S&L crisis orientation while banks and distressed owners have a pre-S&L crisis orientation.

One way to locate distressed real estate is to watch for loan maturities. In March, the *Dallas Morning News* reported a much higher level of foreclosure postings in the Dallas-Fort Worth area than in prior months. They also cited a report by First American CoreLogic, which stated that "DFW led the nation in commercial mortgage maturities in February. More than $4 billion of about $20 billion in U.S. commercial property loans that came due in February were on properties in North Texas." The trail of loan maturities will likely point the way to distressed transactions.

Another way to identify maturing loans is to research commercial mortgage backed securities (CMBS) deals. According to the Mortgage Bankers Association, 20.4 percent of commercial real estate debt is held in CMBS trusts. Detailed property and loan level information for CMBS deals can be found using tools like Bloomberg Professional (http://about.bloomberg.com/product_fixed_income.html). Bloomberg gathers the information and presents it in a searchable database.

The extreme intervention of the Federal Reserve and FDIC in the banking system during the recession has had unintended consequences. In 2009 the banking sector held 44.5 percent of all commercial real estate loans. The result has been a scarcity of real estate transactions so far.

According to Guy Langford of Deloitte & Touche LLP, real estate funds have raised $115 billion of capital for investing in U.S. real estate. Globally, $189 billion of capital has been raised but not yet spent through third quarter 2009. Contrast this with $1.4 trillion of commercial mortgages maturing in the U.S. between 2010 and 2014. There will likely be plenty of distressed debt transactions to go around.

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THE TAKEAWAY

Banks are not likely to begin foreclosing on "broken" commercial loans until they have sufficient reserves to withstand the losses they will incur by doing so. If bank regulators demand that these CRE losses be recognized now, properties could flood the market and push prices down. But regulators do not want this to happen, so they will probably be accommodating and try to help the banks earn their way out of this crisis.

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