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Extend and Pretend

Implications for Real Estate

By Mark G. Dotzour

In “normal” times, when a commercial real estate (CRE) loan matures and the property value has fallen below the loan amount, the owner must either come up with more equity, or the property is foreclosed on and is sold to a new owner. The lender takes a loss and moves on. The new owner can then lease it to businesses at a lower rent because its investment is smaller.

What is Meant by ‘Extend and Pretend’?

Clearly, these are not normal times. Many maturing loans are being extended rather than foreclosed on. This postpones the day of reckoning when the owner loses the property and the lender incurs the loan loss. This phenomenon is called “extend and pretend.” The lender extends the loan and pretends it is still performing.

Banks are weighed down with loans like this. Wall Street has sold billions of dollars of these loans to investors all over the world. Why don’t the banks and other lenders foreclose on these properties and let the market clear? Why don’t they sell them to new owners that can fix up the properties and find tenants for them?

The answer is that after the massive losses incurred by banks from failed residential mortgages, they are not sufficiently capitalized to immediately recognize the additional losses they have in their commercial real estate loans. After closing more than 315 banks in the past three years, the FDIC Deposit Insurance Fund (DIF) is $8 billion in the red. The FDIC indicates it could take 17 years to rebuild the DIF to desired levels.

Federal policies initiated in the past two years suggest extend and pretend could be in place for many years to come. Rather than take the losses immediately, policy makers have decided to amortize these losses over a number of years.

In early November 2010 there was an example of the end of extend and pretend for one bank, Wilmington Trust, which was the 53rd largest bank in the country. Roughly 75 percent of their $8 billion loan portfolio was in commercial real estate. The bank had nearly $1 billion in troubled real estate loans. Regulators ordered new appraisals on the properties, and the losses were so big that the bank was forced to be sold for $4 per share. Investors who purchased the stock for $7 the previous trading day were sorely disappointed.

A Little Backstory

A review of price indices, such as the Moodys/REAL Commercial Property Price Index, reveals commercial real estate prices increased nearly 90 percent from January 2001 until the peak in early 2008. This explosion in prices was fueled by cheap mortgage money and poor underwriting. Loans were made in excess of 90 percent of the value of the properties.

Investors believed rents would increase by 10 percent or more for many years. Euphoria was rampant. The price implosion began in July 2007 as the credit markets completely shut down for CRE. Several major commercial price indices now indicate “institutional quality” real estate has declined 40 percent since the peak in 2008.

So now properties that had an 80 to 95 percent loan are underwater. The holders of the junior mortgages are also underwater. The first mortgage holder may have a loss as well.

However, if the original owner is still making the payments and keeping the loan current, one can pretend the mortgage is still operative and there is no loss on this loan.

Since July 2007, the volume of commercial real estate transactions is off by about 80 percent. Real Capital Analytics estimates transaction volume peaked at more than $120 billion in first quarter 2007. A year later, volume declined to about $40 billion. By first quarter 2010, volume had fallen to about $10 billion, down 92 percent from first quarter 2007. Sales volume remains sluggish. So it is truly difficult to know what the actual value of CRE is.

With CRE volume at such subdued levels, banks can claim there is "no active market" and pretend the prices of commercial real estate cannot be determined. This allows them to postpone recognition of the loss.

How Long Can We Pretend?

This situation will continue until regional and community banks build up sufficient loan loss reserves to sell the properties and take the losses. This could take many years.

In late summer 2008, some real estate loans started to trade at around 25 cents on the dollar, when Lone Star Funds started buying toxic loans from Merrill Lynch and CIT. It appeared the market was starting to clear at new price levels. But the Federal Reserve "called time out" and said those prices were "fire sale prices" and the market has been dormant ever since. This was the beginning of extend and pretend.

The pretending can continue as long as current owners of CRE continue to make payments on their loans. Even though the collateral value is now less than the loan, this can be ignored as long as the payments are being made. These loans often mature at the end of five years. This means a huge number of the most damaged CRE loans will mature in 2011 and 2012.

Media attention has focused on this wave of maturities and how they will be refinanced. Foresight Analytics has estimated nearly $200 billion in real estate loans matured in 2010, and more than $200 billion will mature each year through 2013. How will these loans be refinanced when their value may be lower than the loan amount? Unless Wall Street can reconstruct the commercial mortgage-backed securities market, it is likely these loans will not be refinanced. They too will have to be extended.

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Trapped Real Estate Assets

The extend and pretend policy has created a lot of "trapped" real estate properties in the banking system. They are trapped because they are owned by banks that do not want to own them. Billions of dollars of investment capital has been raised by real estate professionals to purchase these properties, but so far the transfer has not happened.

One group of commercial real estate is trapped in "bad" banks that have not failed yet. The FDIC listed 860 banks on their "troubled bank list" at the end of third quarter 2010. Some of these banks are in trouble because of the high level of commercial real estate loans on their books. These banks are forced to extend and pretend their commercial real estate loans, because the losses they have incurred are larger than the total capital of the bank. In effect, without extend and pretend, they are insolvent.

This is why so many banks are reluctant to sell the commercial real estate loans on their books. When they build up sufficient loan loss reserves, they will be ready to sell these "toxic" real estate loans. Until then, they have no choice but to extend and pretend.

Some commercial real estate properties are trapped in the good banks that have taken over failed banks. Under normal conditions, real estate investors would approach the good bank and make an offer to purchase the "broken" real estate from the good bank. But now, the FDIC offers the good bank a loan loss guarantee on the commercial real estate loans as part of the incentive to acquire the failed bank. These guarantees can last as long as eight years from the date the loans from the failed bank are acquired. The FDIC is not in any hurry for the acquiring banks to sell the toxic real estate.

Yet another group of real estate properties is trapped at the FDIC. When a bank fails and the FDIC cannot find a bank to take over that bank, the FDIC takes control of the assets of the failed bank. Under normal circumstances, investors could approach the FDIC and purchase the troubled commercial real estate directly from the FDIC.

While the FDIC is selling some of these properties at weekly auctions, other properties are not being marketed. The FDIC is "securitizing" them into commercial mortgage-backed securities (CMBS) and then borrowing money from investors by selling these bonds instead of the real estate.

This means the FDIC does not have to sell these properties for years. Any cash flow from the real estate is used to pay the principal and interest on these bonds. Because the FDIC can borrow money by selling CMBS at low interest rates, and investors that buy CMBS from the FDIC are willing to accept a low interest rate, it does not cost the FDIC much to warehouse this troubled real estate and keep it off the market for a long time.

One group of trapped properties is held by owners who are not under duress. Maybe they are tired of property management, want to reallocate their retirement portfolio, or would like to sell a shopping center and buy a second home. These people would *like* to sell, but they do not *have* to sell. As long as extend and pretend is in place, they are not likely to try to sell their properties.

With the huge overhang of troubled real estate in the banks and the CMBS market, everyone is waiting for prices to fall as this massive amount of real estate comes back into the market. Normal owners have left the market and are unlikely to return until the banks disgorge the CRE inventory. This happened in the 1990s when the Resolution Trust Corporation was selling foreclosed properties. Normal owners hid on the sidelines until the government selling wave was over.

Last but not least, some real estate properties are trapped in the CMBS market. These properties were not financed with bank loans but by Wall Street through sales of huge pools of securitized loans to investors. This market exploded in the past decade, peaking in 2007 when $210 billion of loans were issued in the United States. This form of financing vaporized, dropping to less than $9 billion in 2008 and plummeting to $2.2 billion in 2009. Many of these loans were interest only with a five-year term, while others had a ten-year term. Waves of these loans will mature between now and 2017.

As long as extend and pretend continues, sales volume will be severely retarded.

So how will these maturing loans be refinanced? In 2009, about $150 billion of CRE matured and only $2.2 billion in new bonds were sold. Obviously, many of the loans that matured have been extended. Investors waiting for the flood of maturing CMBS loans to default have been disappointed, because the flood has not materialized.

It appears extend and pretend has become the policy in the CMBS market as well. When a loan comes due, the servicer extends it for up to five years. The extension often comes with a fee and revised loan terms that make it easier for the lender to foreclose in the future.

The latest twist in CMBS extensions includes the reduction of interest paid on the loans. In a recent modification of one of the largest CMBS loans outstanding, the actual interest rate was unchanged, but the interest paid was reduced, creating "negative amortization." This reduces the cash required to keep the loan performing, while the principal on the loan increases each month.

When a property is sold out of the loan pool, funds from the sale can be used to pay back the unpaid interest and also pay for tenant improvements and leasing commissions on the remaining properties in the pool. Bond investors can hope the last remaining properties in the pool will be worth enough to finally retire the debt.

Citigroup predicts between $25 billion and $41 billion of new CMBS will be issued in 2011. Foresight Analytics estimates about $200 billion of commercial real estate mortgages will mature and need to be refinanced every year between 2010 and 2015. Where will the financing come from to refinance these maturing loans?

Distressed Buyers Waiting

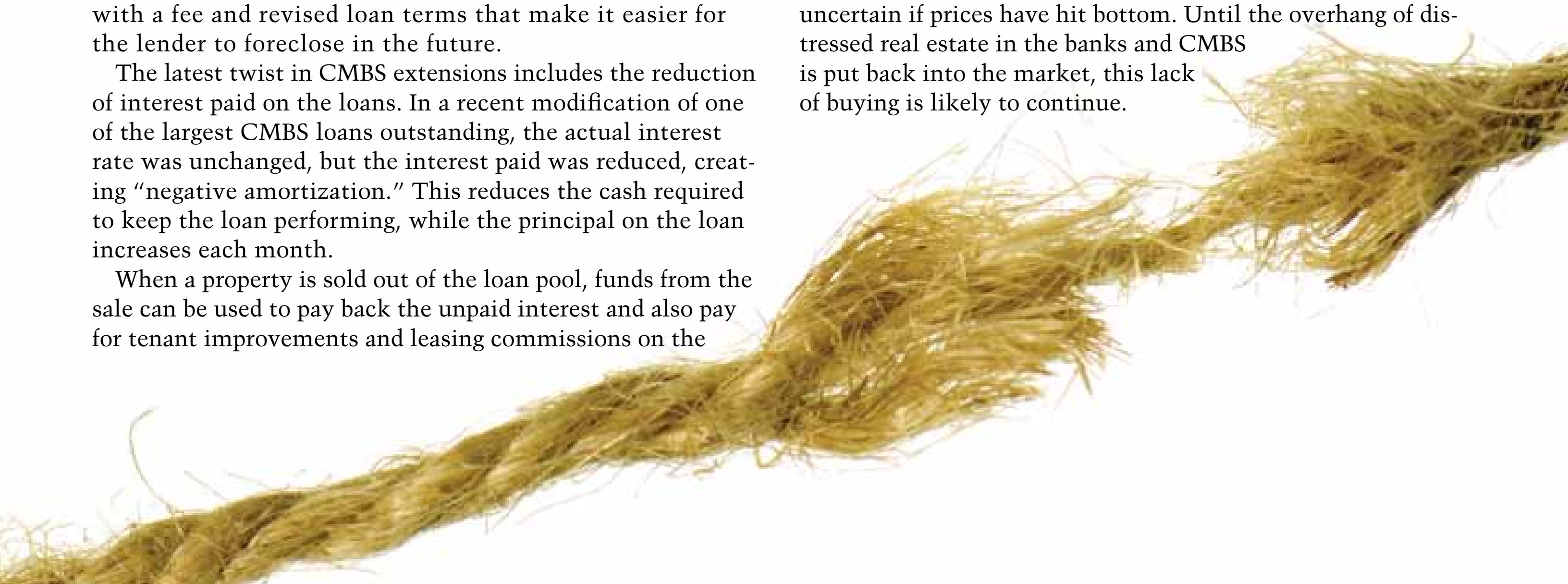
After the collapse of the real estate finance market in July 2007, many investors started to raise funds to invest in distressed commercial real estate they knew would ultimately come back into the market at lower prices. Private equity firms, private and public real estate investment trusts, high net worth investors and even publicly traded homebuilders all have billions of dollars ready to purchase commercial real estate.

Many of these entities hoped to achieve "opportunistic returns," which means an internal rate of return of more than 20 percent. Some senior Federal Reserve staff referred to these people as "bottom-fishing sharks trying to steal these properties."

Some of these funds have a limited time frame to invest their money and must return the money to investors if they are unable to do so. These funds are essentially "distressed buyers" needing to deploy capital.

This distress is showing up in what some are referring to as a "double bubble" in commercial real estate. It is not uncommon for a "trophy property" full of high-credit tenants to have 30 bidders and several of them at full price. Intense competition by bidders in Boston, New York City, Washington, D.C. and San Francisco is driving prices back toward the peak prices of 2006-07.

Unfortunately, these trophy properties are a small percentage of all U.S. commercial real estate. Properties in smaller cities and properties with significant vacancy are not selling at all. Bidders cannot get financing and, even if they could, they are uncertain if prices have hit bottom. Until the overhang of distressed real estate in the banks and CMBS is put back into the market, this lack of buying is likely to continue.



Implications of Lengthy Extend and Pretend

It is becoming clear that the government policy is to continue the extend and pretend policy indefinitely. With tools such as FDIC loan loss guarantees and FDIC-backed securitizations and the lack of liquidity to refinance maturing CMBS loans, the uncertainty regarding the value of commercial real estate could continue for another five to eight years.

This means that normal sellers will continue to sit on the sidelines and not dispose of their property for many years to come. Banks will have limited capacity to make new real estate loans. Until banks clear their books of troubled real estate loans made in the past, they will be unable to make needed real estate loans.

In the near future, Texas will start to create jobs again and the relentless population growth will continue. New homes will be built in new subdivisions. The people who move into these homes will want shopping centers nearby. Businessmen and women will want offices near where they live. Who will provide the financing for this new development when the growth resumes? Until the FDIC and the Federal Reserve resolve this problem, banks will have limited capacity to fund future growth.

Implement Policies to Increase Real Estate Value?

The ultimate hope of the extend and pretend scenario is that if the process is postponed long enough, market prices will rebound and greatly reduce losses on the outstanding loans. But hope is a nebulous concept, not a valid investment strategy.

The government should want to increase the bid prices of commercial real estate to reduce the total losses in the banking system. Several things would increase bid prices for troubled real estate immediately, including:

- increasing the rate of depreciation for commercial real estate by allowing investors to depreciate the property for 15 years with an accelerated cost recovery system;
- allowing investors to use losses incurred with commercial real estate investments to offset earned income from their jobs;
- allowing for a zero capital gain if the investor holds the property for four or five years; and
- offering low interest financing for investors that buy troubled property from a bank.

All of these things have been done in the past and have been successful. These are the kinds of incentives that would increase bid prices for all commercial real estate and reduce the anticipated losses to the banking system and taxpayers.

Positive, Negative Impacts

Investors that buy today must take into account the possibility of continued declines in rent and must be prepared to withstand the selling wave when the extend and pretend policy ends. Ultimately, when the distressed real estate is sold, the new owners will have a lower cost basis and will be able to make a good return on investment at a lower level of rent.

This has a positive and negative impact on the market. First, it will put downward pressure on rents of all buildings as the newly released hostages compete for tenants. Second, it will help the overall economy rebound because the availability of office, industrial and retail space at lower rent levels will lower the cost of business and encourage business formation.

As long as we continue to extend and pretend, sales volume will continue to be severely retarded. This lack of volume creates severe financial duress on a wide range of businesses, including real estate brokerages, real estate leasing firms, title insurance companies, appraisal firms, law firms specializing in real estate, moving companies and construction firms that specialize in tenant finish.

Most Americans do not want to see a prolonged period of economic stagnation in their country. Real estate is always one of the sectors of the economy to lead economic recovery. Construction jobs and real estate services jobs are an important part of our labor force. Perhaps it is time to start making plans to restore the industry.

Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.

THE TAKEAWAY

The commercial real estate sector is in the grips of the "extend and pretend" policy under which lenders are extending the loans on troubled commercial real estate instead of foreclosing and taking the loss now. As a result, a massive amount of distressed real estate will eventually flood the market. In the meantime, investors are waiting on the sidelines, not buying until this flood of properties occurs.

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Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

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