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Commercial Property Faces Crisis

Delinquency Rate at 1.8%, Near Peak of Last Recession; Parallels to S&L Debacle

By Lingling Lei

Commercial real-estate loans are going sour at an accelerating pace, threatening to cause tens of billions of dollars in losses to banks already hurt by the housing downturn.

The delinquency rate on about \$700 billion in securitized loans backed by office buildings, hotels, stores and other investment property has more than doubled since September to 1.8% this month, according to data provided to The Wall Street Journal by Deutsche Bank AG. While that's low compared with the home-mortgage delinquency rate, it's just short of the highest rate during the last downturn early this decade.



Some experts say it now looks as if the current commercial real-estate slump will rival or even exceed the one in the early 1990s, when bad commercial-property debt played a big role in dragging the economy into a recession. Then, close to 1,000 U.S. banks and savings institutions failed. Lenders took about \$48.5 billion in charges on commercial real-estate debt between 1990 and 1995, representing 7.9% of such debt outstanding.

Since late 2007, a total of 47 banks and savings institutions have failed, of which a dozen or so had unusually high commercial-mortgage exposure. Foresight Analytics in Oakland, Calif., estimates the U.S. banking sector could suffer as much as \$250 billion in commercial real-estate losses in this downturn. The research firm projects that more than 700 banks could fail as a result of their exposure to commercial real estate.

Commercial property may not be hit as hard as many fear if the economy pulls out of recession more quickly, driving up rents and occupancy rates. And greater availability of financing -- a key goal of the Obama administration -- could lift property values.

[General Growth Properties](#) Inc., one of the biggest mall owners, has been teetering on the brink of a bankruptcy filing and recently failed to repay maturing loans on two shopping centers in Hayward, Calif., and Humble, Texas, according to Trepp, a firm that tracks the commercial-property debt market. John Hancock Tower in Boston is being sold in a foreclosure auction. Recent additions to the list of properties with delinquent mortgages include an office building in Stamford, Conn., a hotel in Las Vegas and a shopping center in Ohio.

Souring Loans

The problem was underscored when Moody's Investors Service downgraded [Bank of America Corp.](#) Wednesday, citing likely increases in souring "credit cards, residential and commercial real estate loans." The bank declined to comment on the downgrade.



Boston's John Hancock Tower is to be auctioned after lenders moved to foreclose on owner Broadway Partners.

Commercial real-estate debt is potentially more dangerous to the financial system than debt classes such as credit cards and student loans because of its size. The Real Estate Roundtable, a trade group, estimates that commercial real estate in the U.S. is worth \$6.5 trillion and financed by about \$3.1 trillion in debt. Partly because the commercial real-estate debt market is nearly three times as big now as in the early 1990s, potential losses in dollar terms loom larger.

According to an analysis of bank financial reports by The Wall Street Journal, the broad shift to real-estate lending can be seen by comparing commercial real-estate loans -- including both mortgages and construction loans -- with banks' so-called Tier 1 capital, a key indicator of a bank's ability

to absorb losses. In 1993, less than 2% of the nation's banks and savings institutions had commercial real-estate exposure exceeding five times their Tier 1 capital. By the end of 2008, that had risen to about 12%, or about 800 financial institutions. A higher ratio means a thinner cushion for loans that go sour.

The Federal Reserve and the Treasury are moving to adapt a funding program to make it attractive for investors to buy debt backed by office buildings, hotels, stores and other income-producing property. The program, called the Term Asset-Backed Securities Loan Facility, or TALF, was begun to finance purchases of debt backed by consumer credit, and officials will expand its use to include commercial-property debt.

Read the report provided to The Wall Street Journal by Deutsche Bank Research:

"Commercial Real Estate Outlook Q1 2009"

The Fed is an institution that traditionally makes short-term debt available. In TALF, federal loans run three years, already a duration Fed officials are uncomfortable making. But even that might not be long enough to spur investor demand for commercial mortgage securities, which typically mature over 10 years.

Real-estate industry executives have been trying to resolve these issues with Fed and Treasury officials in meetings led by the Federal Reserve Bank of New York, say people familiar with the matter. The government officials are considering extending the TALF to accommodate the needs of the commercial real-estate industry but no decisions have been made. In a statement Monday, the Treasury suggested the Fed might alter the terms of its loans to investors to make them more attractive for long-term securities.

Jeffrey DeBoer, CEO of the Real Estate Roundtable, said, "The danger is a repeat of what happened on the residential side: A complete choking up, foreclosure disasters and increased stress on the banking system."

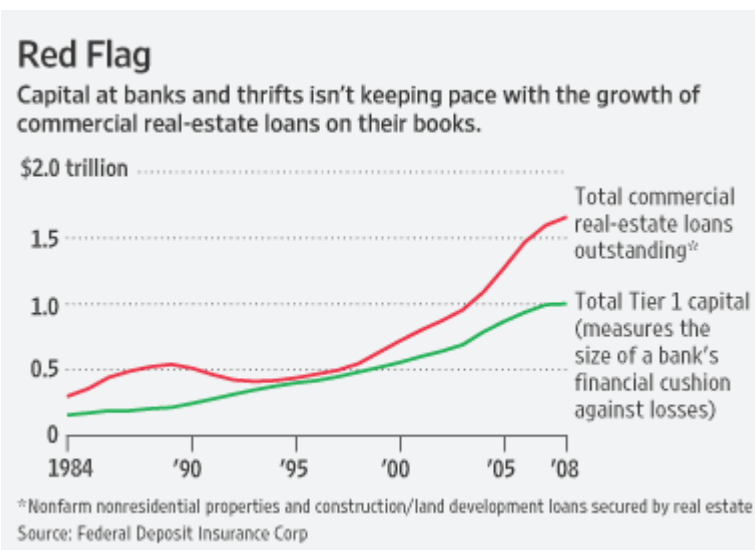
As recently as last summer, delinquency rates on commercial mortgages were at historically low levels, and many experts thought problems wouldn't be as bad in this downturn.

Worst of Times

But owners could borrow so much on the expectation of rising property values and cash flows that some are at risk now that rents and occupancy are falling. "In just seven months, we've gone from the best of times to the worst of times," said Richard Parkus, head of commercial mortgage securities research at [Deutsche Bank](#).

Even some performing loans could face trouble because of a fall in values of the properties, making it hard for owners to refinance when loans come due. Currently, many banks are agreeing to grant short-term extensions on loans. But "that's just kicking the can down the street for awhile," said William Rudin, an owner of New York City office buildings. "That doesn't solve the problem."

Of \$154.5 billion of securitized commercial mortgages coming due between now and 2012, about two-thirds likely won't qualify for refinancing, Deutsche Bank predicts. Its estimate assumes declines in commercial-property values of 35% to 45% from the peak in 2007. That would exceed the price drops in the downturn of the early 1990s.



The bank estimates the default rates on the \$700 billion of commercial-mortgage-backed securities could hit at least 30%, and loss rates, which figure in the amounts recovered by lenders, could reach more than 10%, the peak seen in the early 1990s.

Besides securities backed by commercial real-estate loans, about \$524.5 billion of whole commercial mortgages held by U.S. banks and thrifts are expected to come due between this year and 2012. Nearly 50% wouldn't qualify for refinancing in a tight credit environment, as they exceed 90% of the property's value, estimates Matthew Anderson, partner at Foresight Analytics. Today, lenders generally won't loan over 65% of a commercial property's value.

In contrast to home mortgages -- the majority of which were made by only 10 or so giant institutions -- hundreds of small and regional banks loaded up on commercial real estate. As of Dec. 31, more than 2,900 banks and savings institutions had more than 300% of their risk-based capital in commercial real-estate loans, including both commercial mortgages and construction loans.

At First Bank of Beverly Hills in Calabasas, Calif., the amount of commercial-property debt outstanding was 14 times the bank's total risk-based capital as of the end of last year. Delinquencies reached 12.9%, compared with the average of 5% among the nation's banks and thrifts.

"In perfect hindsight, we would have done less commercial real-estate lending," said Larry B. Faigin, president and CEO. The bank this month announced a deal with a leveraged-buyout and restructuring firm in Chicago, Orchard First Source Asset Management, under which Orchard will provide new capital. Within two years after the deal closes, First Bank will significantly reduce its concentration in commercial real-estate lending and have less than half of its assets in the sector, Mr. Faigin said.

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